THE FED

Sept. 30, 2009, 3:39 p.m. EDT

Kohn plays down tightening challenge

Fed has faced the question of when to tighten before, he says

By Greg Robb, MarketWatch

WASHINGTON (MarketWatch) - A leading voice at the Federal Reserve played down the complexity of the challenge facing the central bank on the question of when to pull the trigger to hike interest rates, saying that the situation was not so different from past episodes.

"The headache isn't that much different than usual," Kohn told an audience of monetary policy experts gathered at the Cato Institute, a conservative think tank. The timing will be tricky, but do-able, he said.

"Given the highly unusual economic and financial circumstances, judging when the time is appropriate to remove policy accommodation, and then calibrating that removal, will be challenging," Kohn said. Read his prepared remarks.

To stabilize financial markets and the economy, the Fed has used extraordinary measures, including buying a wide range of securities. As a result, the Fed has created a large amount of reserves on its balance sheet and has lowered short-term interest rates to near-zero.

At some point, after the economy starts to grow on its own, the Fed will reverse course, raising interest rates, withdrawing support for credit markets, and even sell assets it has accumulated. Financial markets are starting to obsess about the timing of this "exit strategy."

In his remarks, Kohn said the Fed would, as always, have to move based on its forecast and could not wait for clear conditions on the ground.

Kohn said he couldn't give financial markets a "short list of things" to watch.

"I can't predict how rapidly we will have to raise short-term interest rates from around zero or remove other forms of accommodation; that too depends on how the economy seems to be recovering and the outlook for inflation," he said.

The Fed is worried about moving too slowly and jumping too quickly, he said.

Kohn also said the Fed had the tools to exit without causing volatility in financial markets.

He said the Fed is developing new techniques to drain reserves from bank balance sheets, including using reverse repurchase agreements against mortgage-backed securities and creating time deposits.

Kohn said he didn't think there was much use in increasing the reserve requirements.

The Fed may sell the assets that it holds if necessary.

The Federal Open Market Committee met last week and said that exceptionally low interest rates are likely to be warranted for an extended period. See full story.

Kohn said that, although economic conditions "have apparently begun to improve," there is a lot of slack in the economy. "Resource utilization is quite low, inflation is subdued and continuing restraints on credit are likely to constrain the speed of the recovery."

Earlier Wednesday, Dennis Lockhart, the president of the Atlanta Federal Reserve Bank, said the central bank was in no rush to tighten monetary policy. Lockhart said he couldn't be sure that the economy had reached a sustainable path. See full story.

Kohn suggested that the hardest part of the current policy environment may be how the central bank communicates its decisions to the public.

Many economists question whether the Fed would have the will to tighten policy if there were still clear signs of economic distress, such as high unemployment.

A key tool in tightening will be that banks now can earn interest on deposits at the Fed. This means that the Fed can hike the interest rate it pays for deposits to increase other interest rates, Kohn said.