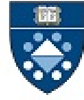

Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Frederic Mishkin[1] Member, Board of Governors of the Federal Reserve System
Interviewer Name	Matthew A. Lieber (Contractor) Yale Program on Financial Stability
Date of Interview	October 20, 2020
Lessons Learned No.	2020-04

Introduction:

The Yale Program on Financial Stability (YPFS) contacted Rick Mishkin by email to request an interview regarding Mishkin's experiences as a Member of the Board of Governors of the Federal Reserve System from 2006-08, and as Director of Research at the Federal Reserve Bank of New York from 1994-97.[2] A leading expert on monetary economics and financial markets and a full professor at Columbia University's School of Business since 1983, Mishkin has authored twenty books including his textbook, *The Economics of Money, Banking and Financial Markets,* recently updated in its 12th edition published in 2018.

In this interview, Mishkin discusses how his experience as research director at the New York Fed expanded and honed his academic work on financial markets and financial crises, his subsequent experience as a Member of the Board of Governors including efforts to educate inflation hawks about financial crisis response, why no one predicted the financial crisis (with one dramatic exception), the logic of quantitative easing, post-crisis reforms and re-regulation, current Fed programs to respond to the COVID-19 crisis, and the challenges ahead including emergency interventions, central bank independence, moral hazard, and fiscal responsibility.

[*This transcript of a telephone interview has been edited for accuracy and clarity.*]

Transcript

YPFS: **Welcome, Professor Mishkin. How did your experience in the New York Federal Reserve Bank as Director of Research – your first Fed stint - shape your outlook on monetary policy making in practice?**

[1] The opinions expressed during this interview are those of Mr. Mishkin, and not those any of the institutions for which the interview subject is affiliated.

[2] A stylized summary of the key observations and insights gleamed from this interview with Mr. Mishkin is available in the Yale Program on Financial Stability's *Journal of Financial Crises*.

Mishkin: It allowed me to focus more on monetary policy issues. And one of the things that came out of that was the book that I did with Ben Bernanke.[3] I started the project at the New York Fed, I got one person to sign on with me at the New York Fed, Adam Posen. When I started the project, I called Ben and said, "Ben, do you want to get involved in doing this?" Ben said, "Yes," and then he brought on Tom Laubach. I was always very interested in monetary policy, but now it pushed me even further in that direction.

It was a continuation of earlier research. Ben and I had done a paper on monetary targeting, and it seemed natural when I got to the New York Fed. The big issue was the inflation targeting, and that's something I wanted to work on. And the book had a significant impact. It was considered a very important book in that area by central bankers and not accidentally. It also was a blueprint for what eventually happened when the Federal Reserve adopted inflation targeting in 2012.

I would say my academic research really led to very important impacts as it did for Ben in terms of what happened during the financial crisis. Ben's 1983 paper on the Great Depression established him as a top monetary economist. It basically said that Friedman and Schwartz were very narrow and only focused on the money supply. And that to understand what happened during the Great Depression, you have to understand that it was a financial crisis So that was his famous paper.

And I had done research in a 1990 paper, which was a history of financial crises in the US from 1857 on.[4] So Ben and I were very interested in monetary history and in particular, in terms of financial crises. We were really lucky in particularly with Ben, but I think I was also helpful during that period, that we had somebody who was there at the right person at the right time because Ben really understood financial crises.

When the financial crisis first hit in August of 2007, 80% of the FOMC participants, the Governors plus the regional bank presidents, lacked understanding about what was going on. They were unable to analyze the situation clearly because they just had never thought about this. As was most of the economics profession. The economics profession didn't really understand financial crises. And we were really lucky to have a Chairman who did think about this and really understood them. This meant that as soon as the crisis actually started in August 2007, Ben was pretty much on top of it, and I was as well.

[3]Mishkin, Ben Bernanke, Thomas Laubach, and Adam Posen, *Inflation Targeting: Lessons from the International Experience* (Princeton University Press, Princeton, NJ), 1999.
[4]Mishkin, "Asymmetric Information and Financial Crises: A Historical Perspective," in R. Glenn Hubbard, ed., *Financial Markets and Financial Crises* (University of Chicago Press: Chicago, 1991): 69-108.

I was the biggest advocate inside the FOMC for taking more actions. It came directly from this academic research that I had done prior to even going to the Federal Reserve System to understand how the world had changed. The financial crisis is very non-linear. I have a paper called "Over the Cliff".[5] In August, something really unusual had happened. In December 2007, I wanted to be even more aggressive than the rest of the Committee. I wanted to dissent from the decision at the December meeting, because we were only going to do 25 basis points. I thought we were behind the curve, and I discussed it with Ben. It wasn't that Ben didn't agree with me, but he had a different problem, which was he had to educate the rest of the FOMC.

I said to Ben, "I just don't agree with our policy, I think we're way behind the curve, we've got to get out in front of this." Ben basically said, "Look, the committee, I don't think it's ready yet". And so, I said to Ben, "I'd like to dissent." And then Ben and I had a discussion about this. Ben said, "If you dissent, it's two problems. One is, it's very rare a Governor dissents. And also, everybody knows you're my buddy. So, it's going to look like you don't have confidence in me" And I said, "You know, you're absolutely right". And so, at the December 2007 meeting, this was all in the transcripts. I actually said, "I would really think that we're not doing the right thing. I would normally dissent, but it would create too much political problems for the Federal Reserve." To Ben's credit, within a week of that meeting, he came to me and said, "You were absolutely right". But Ben had different considerations, and he may have been right.

Sometimes you have to lose the battle in order to win the war, as Ben realized. I was preparing to give a speech on January 11th, 2008, an outline of how I thought we should think about dealing with the crisis. This is a little bit of the arcane processes of how the Fed works. When you give a speech, if a speech is given in public, it has to be announced ahead of time, along with the topic. In this case, I had arranged to give a speech at a conference at the Federal Reserve Bank in New York.

We could make a decision to either keep the speech private or tell the public that I was giving a speech on the following topic. I had a choice. I wrote up the speech, saying that we'd made a mistake in not getting in front of it. It was a speech to outline how to think about financial crisis and how monetary logic is different: it has to be much more preemptive. You have to get out in front because you're trying to affect risk premiums. So, the keyway your policy works is not by lowering interest rates, but actually by lowering the credit spreads and that indicates you're going to backstop the system. So, I wrote the speech, I sent it to Ben. You don't make a speech without having the Chair read it and give your comments on it. Ben said, "This speech is perfect." And I said to Ben, "Look, do you want this to be public? Or do you want it to be private?

[5]"Over the Cliff: From the Subprime to the Global Financial Crisis," *Journal of Economic Perspectives,* Vol. 25, No. 1 (Winter 2011), pp. 49-70.

And Ben said, "No, I definitely want it to be public," because Ben wanted to move. And then, it was very shortly thereafter when the Fed started cutting rates very rapidly.

YPFS: And what was the audience that you were aiming at with that speech?

Mishkin: Yes, there was aiming in that speech. And in fact, particularly because of my position- that everybody knew Ben and I had written this book on inflation targeting and had done a lot of research together- anything that I spoke about was going to be viewed as being even more in line with what the Chair wanted. So, it became even more incumbent upon me to be careful.

One way to get influence inside the FOMC -- a subtle way of doing it, if you ever work in a committee, the way to be effective in a committee -- is to get other people to bring up your idea and then think it's their idea. One way of doing that is to get something out there, the research, particularly in speeches, then other people read it. And then they bring it up in the FOMC committee meeting before you do. And that's a way to get people to buy in. If you instead go and beat people over the head and said, "Here's my idea". They'll frequently react to it much less positively. So, I gave the speech, and then that became part of the discussion in the FOMC when we then started to actually lower rates.

So, Ben and I had, to some extent, coordinated an education process of the FOMC. Being a Governor, not the Chair, my job was to be Ben's conscience, but not to basically to put it out there, because if you had resistance, you might have problems. In fact, there was a bad shock with the stock markets, very sharp stock market decline early in, very shortly after that January 11th speech. In a sense, it prepped the way for them. The idea was out there and then now the committee started to get scared.

That's when you saw a big shift in the way policy was being done at the Fed. It became preemptive: in 2008 rates started to be cut extremely quickly. It was extremely important in terms of both the reaction of the Fed, and particularly because the Chair had done this research. Ben understood my work. In fact, Ben's 1983 paper was influenced by a paper that I had written on the Great Depression and I published in '78.[6] And then my work in financial crisis on this historical research was very, very influenced by Ben's work. And then we had the opportunity that our research actually really mattered an awful lot.

YPFS: An awful lot indeed because you had been for decades working on this already. And then you broached the idea (of) expanding the lender of last resort policy in 2008, emergency liquidity outside the banking sector.

[6]Mishkin, "The Household Balance-Sheet and the Great Depression," *Journal of Economic History* 38 (December 1978): 918-937.

When you went into the Board of Governors in 2006, were you anticipating that there's going to be a financial crisis?

Mishkin: Not at all. The way I think we missed this, I had written a lot on financial crisis and actually published a book in 2006 on financial crisis in emerging market economies.[7] *The Next Great Globalization* is basically a book about financial crises and how you have to open up. But if you open up the wrong way, you have very, very bad things happen to you. So indeed, I was an expert on it, but we always thought that this would only happen to economies with bad institutions. We got lulled into thinking that it couldn't happen here. It's a little bit the issue that is raised by Reinhart and Rogoff -- "this time is different" but in different places.[8]

In fact, and my research had focused on exactly this issue of lender of last resort. I disagreed very strongly with people who I respect tremendously, Marvin Goodfriend and Ben McCallum; they did not like using directed lending. They thought the Federal Reserve should never do this, and I disagreed strongly. And the paper that you actually referred to is exactly written for that point.[9] So it was not that I didn't think there was an issue that something could happen, but I thought that we could manage it.

I never could have imagined what happened after Lehman Brothers, because it was so shocking. The only person I think who really got this right and understood it was Raghu Rajan. Anybody else who said they predicted the crisis is just absolute baloney.

YPFS: A name or two come to mind ...

Mishkin: It's always amazed me how marketing can work, the one economist who got it absolutely wrong, claiming it was all about a foreign exchange crisis, the collapse of the dollar. The dollar actually rose during the crisis; it did not fall.

But Raghu got it exactly right, though even Raghu could probably tell you that he didn't imagine it was as bad as it actually was. This is the problem: what happened before the crisis was one big carry trade. In a carry trade, basically you borrow in a currency that has very low interest rate. Then you buy assets in the currency with a very high interest rate. The good news is you make a lot of money while everything's fine. But of course, part of the reason why a

[7]Mishkin, 2006, *The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich* (Princeton University Press: Princeton, NJ).
[8]Carmen Reinhart & Kenneth S. Rogoff, 2009, *This Time Is Different: Eight Centuries of Financial Folly,* Economics Books, Princeton University Press, edition 1, number 8973, October.
[9]Mishkin, "Anatomy of a financial crisis," *Journal of Evolutionary Economics* 2 (1992): 115-130.

country has a high interest rate relative to others is because there's exchange rate risk.

Raghu described it brilliantly in this paper that he gave at Jackson Hole in 2005.[10] The conference was basically a big fond farewell to Alan Greenspan. Raghu was like the sober guest who spoiled the party. Basically, Rajan wrote that we have incredible encouragement of risk-taking right now in Wall Street, because of the nature of compensation and so forth. The classic example of this is AIG, where they basically were doing a carry trade. They were selling this insurance and making huge amounts of money and getting huge bonuses. But, of course, if the tail risk happens, then you blow up.

When you do research on financial crises, what you understand is they all have a very similar pattern, but the problem is the initiating shock is always a surprise. It's always something you didn't think about. And so, it's very hard to predict them. If a financial crisis was easy to predict, people would sell beforehand, and you'd never have the bubble.

There was only a small group of people who had really done research, understanding (the real patterns of financial crisis). The economics profession, in macroeconomics was all doing work on representative agent models and rational expectations, none on financial frictions at all.

There was this group who were like me, Ben Bernanke, Mark Gertler, and so forth, who were actually very worried about financial frictions. That was a key part of their research. But it wasn't general equilibrium. So, it wasn't built into any of the standard macro models or the DSGE (Dynamic Stochastic General equilibrium) models that people talk about. But we were lucky that we had people and particularly that we had Ben at the Fed, somebody there who was doing research that was very respected but not in the mainstream of where the field was.

Most of the macroeconomists were completely surprised by what happened. Here (at the Fed) what you had happen is people understood what was going on when they saw it. But predicting it was very, very difficult. Because you never could have imagined that it was as bad as it was. It was like this hidden thing that was going on. And the only person who really saw the hidden thing was Raghu Rajan. And he was pilloried for it when he gave the paper.

YPFS: **And the interventions-- quantitative easing, emergency liquidity outside the banking sector, more liquidity provision, asset purchases, and balance sheet expansion, forward-looking guidance -- all that got**

[10]Raghuram Rajan, 2005, "Has financial development made the world riskier?" *Proceedings - Economic Policy Symposium - Jackson Hole*: 313-369.

elaborated. What was the thinking in '07, '08? Was this focus on spreads you mentioned part of the quantitative easing approach?

Mishkin: Yes, absolutely. What went on during the crisis shows the quality of the (Federal Reserve) organization, in the way things were done. Things were done in a systematic way, on the one hand, but in a completely a non-systemic way on the other. That there was an understanding that the key here was the credit markets and the credit spreads. Quantitative easing is actually a misnomer. A lot of people misunderstand quantitative easing. Because quantitative easing sounds like a big expansion of the balance sheet, which indeed it is. But there are very strong reasons why that might have zero effect. So, Japan did this huge quantitative easing. It had no effect. And my writings on this, if you read my textbook, there's a whole discussion of this.

Ben hated the word quantitative easing. So, what Ben routinely said was, "Don't call it quantitative easing. Call it credit easing." And this is important because the quantitative part, the expansion of the balance sheet, is actually a symptom. It's something that comes out of what you're trying to do. You can't lower short-term rates enough. So, you have to actually affect both the credit spreads and long-term interest rates. So, it's not that you're expanding the balance sheet, it's the way you're expanding the balance sheet.

YPFS: Right. You're buying these asset classes. This has not been done before, right?

Mishkin: Also, there was a basic understanding, typically by Ben, that we had to go in and basically try to keep credit markets functioning and keep credit spreads from getting out of control. But the methods of doing it were not clear.

We tried actually, at the August special meeting in August 10th of 2007, we lowered the discount rate. I was a very strong advocate of lowering the discount rate, which we did. It didn't work because nobody wanted to draw from the discount window because of so-called stigma. The Fed kept on bringing one program up after another. Some worked, and some didn't work. And the ones that worked, the ones you threw against the wall that stuck, you kept them there. And then the ones that didn't, you let go by the board. But it was educated; it wasn't that they were just throwing stupid stuff against the wall. They were throwing good work against the wall.

YPFS: And how do we measure that effectiveness of the intervention, when working could mean not being taken up, just the demonstration effect?

Mishkin: Right. And so, some of the things that were put in place, they just let it die by the bye. The nice thing about a lot of these programs is that when things get better, they just disappear. If you look at the crisis sequence over a year and a half, the Fed tried one thing, then they said, "That's not working. We need

something else. Discount window. Then we'll do TALF." All of these different things. It was sort of an evolutionary process.

We could have had another major financial crisis with the COVID pandemic. My new edition to the textbook has a whole section on this now. We're incredibly lucky that the COVID pandemic did not occur before the financial crisis. Why were we incredibly lucky? Because the Fed had basically done a wargame against how to deal with COVID.

With the financial crisis, it was spread out. It wasn't done immediately. There was a lot of learning by doing. Within two weeks of the pandemic, early March, nobody was worrying about it. And March 11th, we were in a panic. And two weeks of that, March 14th and 15th, the Fed took all these programs that they had developed during the financial crisis and restarted them again, with some additions that were clear because of the COVID issue. It wasn't just Wall Street that was a problem. There were a lot of small businesses that were running into problems. Remarkably, the federal government response was incredibly rapid. It was done within two weeks, rather than over a year.

The second thing, this also actually impacted what happened in the federal government. Because remember it took a long time? Remember that the TARP program was voted down the first time. My paper in *Journal of Economic Perspectives* discusses this ("Over the Cliff," 2011). What got us in trouble was that you no longer could count on the federal government, because they blew it. We're now in a situation which is infinitely more partisan than it was in 2006. And yet the Congress passed the $2.2 trillion bill. It was remarkable. So, what's happening now, between about things, is what would have happened if we had not had the financial crisis. And then we would have also been in big trouble.

So, it turns out that the timing, the fact that the global financial crisis occurred first, actually helped provide war games. So that both the Fed and the federal government operated in an incredibly rapid way to respond to the crisis. And, again, this comes from my academic research-- a lot of the work I'd done on financial crises in the US, this lender of last resort issue- was that the faster you do this, the less you have to do. It is one of the key lessons of financial crises. And this was why my speech on January 11th was important, because I said, "You got to get ahead of the curve." And the remarkable instance of this was in the Black Monday crash in 1987. Greenspan got up and announced that they were going to have a program of opening up the discount window to whoever needed it. And, as a result, nobody needed to borrow.

So, in fact, a lender of last resort, if it's done right, the quicker you do it, the less you have to do. But the Fed was pretty good during the financial crisis, but not nearly as fast. And I thought they were a little bit behind the curve; but still

relatively very good. But they really were ahead of the curve with the COVID crisis. And that's one of the reasons why we're doing as well as we are.

YPFS: **On the global financial crisis of 2007, please, Professor Mishkin, give us the best scientific, short explanation about the causes. You have disagreements about financial regulations, how much they were responsible, the credit bubble, etc.**

Mishkin: It's a little bit financial, the weakened financial regulation. But I think there's much too much emphasis put on weakened regulations.

When you actually do research historically on financial crises, what you see is that financial crises frequently are like a rogue wave. I actually have a sailboat in the Hudson River. And it can be flat, and all of a sudden, you've got a big wave come up. The frequencies align, where a bunch of things all happen at once, where, out of nowhere, sort of a big wave comes. That's the right way to think about what happened during the financial crisis, which was that there were a whole set of things that happened, a lot of them accidents, that all, when they came together, created this rogue wave, this huge tsunami.

Let me give you some examples. So weakened regulation is one thing, but very, very important part is the change in the corporate governance of investment banks. Because investment banks changed from a partnership structure to a corporate structure. And what that did is that it actually incentivized all these people, like think of the AIG guys in that unit issuing credit default swaps. But all these guys who did not have ownership of the company were making decisions, and then there's a managing group that may or may not know what they're doing.

But the guys who were getting paid $15 million bonuses actually came out extremely well from this. Because they made the $15 million bonuses. Think of the AIG guys who did their thing, they got the bonuses. They blew up and almost bankrupted the country. And it's the company that takes the hit, not the individual. Because they don't have to give the money back. They don't do the claw backs. So that was extremely important.

Third was major financial innovation. You study financial crises, they frequently curve because of the financial innovation or financial liberalization that goes wrong. And so, this is discussed extensively in my book on globalization, and also in my textbook. So, it turned out that there were all these things that sort of were accidents of history that came at once. And that's the idea of the rogue waves, that everything piled up all at once. That's why it's so hard to predict financial crises. The financial innovation meant that they actually didn't understand what they were doing. This is very common in financial history, that you do something like the corporate structure, and you get the South Sea bubble. This is very, very common.

The way financial development occurs, it's two steps forward, one step back. You have an innovation. You didn't realize that the business model wasn't quite right. There's a blow up. And then they eventually fix the business model, so in the long run, it's a very good thing.

So, securitization is a very good thing in the long run, but nobody really understood the flaws in the originate-to-distribute model, so they didn't get the right business model. The way I think of it, the idea that it's a monocausal is not quite right. One example of a monocausal view is by the right-wing guys that think it was all that pushing banks to make loans, because of the red lining there is. You know those?

YPFS: The GSEs. It was the GSEs, and it was the CRA, right?

Mishkin: Again, the right way to think of what happened is as multi-causal. And if you study financial crises, from a historical perspective, that's exactly what you find.

YPFS: So, of all these factors, mainly, if we had to put name on them here - "industrial/regulatory" factors. You haven't so much mentioned the macroeconomic? Is that a big part of this, or not so much?

Mishkin: Little bit. Because there's good news and bad news from doing good monetary policy which stabilizes the economy. We had what we call the great moderation. And the problem with the great moderation is people may underestimate the amount of risk that there is in the economy. And that actually gets them to take more risk than they should. So, the road to hell is paved by good intentions. The fact that the Federal Reserve, basically starting with Volker, finally got its act together, created an environment which was more stable, which is exactly what you're supposed to do. But that actually then increased risk taking. So, again, I don't consider it one of the big factors. But, again, it's part of the thing that leads to the rogue wave.

YPFS: Yeah. That's really a key point, that multi-causal aspect. Now to reforms. In leaving the Fed, you joined up with the Squam Lake Group as a major participant. I'm not sure if you were the chief of that group.

Mishkin: The two leaders were Ken French and Matt Slaughter at Dartmouth. And the reason why it's called Squam Lake is because Dartmouth had a conference facility at Squam Lake. So that's why it's called the Squam Lake Group. It was just a name that we gave it because that's where we first met.

YPFS: The Squam Lake website lists all sorts of proper reforms. Could you speak generally to post-crisis reforms and how well you think that they reflected the lessons learned?

Mishkin: There's some very good things and there are a few bad things that happened. The most important thing that has happened is that banks are much better capitalized than they were before. And also, one of the huge regulatory failures - the SEC did an absolutely horrendous job before the crisis, and what was always very upsetting to me is that the Fed got blamed when it was really more the SEC. But why did the SEC get off the hook? Because it was a political appointment. The head of the SEC was a pure political appointment.

When the new administration came in, the Obama administration, they put in somebody else who was both competent and also one of the smartest, savviest persons, because she basically said, "They did it all wrong and we need more funding." So, the SEC actually came out ahead of the game as a result of this. If you look at where the big problems occurred, it was not the banking system, it was in the investment banks. It was the shadow banking that blew us up. But the SEC made the case for more funding and did make some strides in the right direction. There's much more awareness. In fact, because there are no freestanding investment banks anymore, they're now all financial holding companies, and they're now regulated. One of the big things that's happened is that the banks are better capitalized, and the investment banks, which were super under-capitalized, are now capitalized the same way banks are.

YPFS: Is that the systemic regulatory body that we have moved closer toward?

Mishkin: Yes, and I think that it was a very good thing that we understand that now we have SIFIs, systemically important financial institutions, which could even include insurance companies, because we learned that it wasn't just banks. AIG was a huge contributor to the crisis. And they're regulated very differently. So, they're scrutinized much more, have higher capital requirements, and so forth. That's actually very positive.

The one big negative thing, Dodd-Frank actually had a misconception of the crisis in a very, very important way. Dodd-Frank takes the view that it was a regulatory failure. And again, this is why understanding the crisis is so important in policymaking. The view that it was just bad regulation that led to all this risk taking is absolutely not correct. Because of what I've said before, it was this combination of things, although bad regulation was a contributing factor, but not a major one. In the same way, by the way, do I think that monetary policy was too easy was a contributing factor? Yes, I do. I think the interest rates were too low before the crisis. But it wasn't the major cause.

As a result, Dodd-Frank takes the view that as long as we don't have too big to fail, that we never could have a crisis again. And, and in fact, there was a lot of concern about the moral hazard created by the Fed's lending facilities. A lot of the lending that was done during the crisis was under 13(3) C, which is unusual and exigent circumstances. And I actually would say that that Paul Volcker was not criticizing the Fed when he said that the Federal Reserve went

to the legal limits that it could go to. That was certainly true during the Bear Stearns episode. The way they bailed out Bear Stearns was at the legal limits. We ended up buying assets, which on a pure legal basis we're not allowed to do, but we did it legally by doing something called a non-recourse loan.

The way I think of this is that the Fed was able to operate much faster and do things that helped save the world, which Dodd-Frank now no longer allows the Fed to do, because there's this view that it creates moral hazard. Does it create moral hazard? Absolutely, yes. The right way to deal with that is to actually improve regulation, but not take away the ability to react in an emergency. So, Dodd-Frank puts tremendous limitations on the Fed. The way that you can still do unusual lending is the way it was done during COVID. It has to be with an agreement with the Treasury. So, the good news is that we had a sensible Treasury during the COVID crisis. All of these things that the Fed is doing could not have been done without the support of the Treasury. But what if you have somebody political, or the person who was the head of the Treasury didn't know what the hell he or she was doing? Then you could be in real trouble. So, it turned out that's actually a very bad feature of Dodd-Frank.

YPFS: This is important. This restriction, what's the name of that? Is there a name for that?

Mishkin: Yes, they no longer allowed the Fed to operate under 13 (3) C of the Federal reserve act. So, the Fed, by itself, could decide under unusual and exigent circumstances to do non-standard lending. And Dodd-Frank actually says, "No, it can't do that unless it actually has approval of the Treasury."

YPFS: I'm aware of the practice. I didn't realize that it was curtailed by Dodd-Frank.

Mishkin: Interestingly Dodd-Frank was going to be an even worse bill, but Dodd who was leaving the Senate knew it was his legacy, that it couldn't be a terrible bill. So, a lot of his anti-Fed stuff did not get into the legislation. The initial stuff he wanted to do was more heavy-handed.

The one thing that I think was a mistake in Dodd-Frank is this limiting of the Fed. Again, it's the whole concept, which is, we'll never need lender of last resort. We don't need these credit programs, and they create moral hazard. Why? Because well, we're going to get the regulation right. The reality, again, when you study financial crisis, is there's always something that's surprising that happens and your regulation can anticipate it.

YPFS: Was that where that orderly liquidation authority clause was designed to ... is that a step forward?

Mishkin: The question is whether actually they're able to do it. It's not clear. The idea there is, as long as you've already had liquidation, you never need a lender of last resort. I think that's a huge thing. In fact, what we saw during the COVID pandemic is we needed exactly the lender of last resort again. The Fed did this. Whatever criticism I have of the Fed, they performed brilliantly in March of 2020.

YPFS: With regard to quantitative easing, during the slow recovery, after the crisis had been stabilized, you had the long recession. There was criticism on financial repression. Some argue that QE has made worse wealth and income inequality. What is your take on the criticisms of QE as a policy in the 2010s?

Mishkin: It's the second best. Quantitative easing is not something that you want to do as a normal policy tool. It creates all sorts of problems that regular monetary policy does not create. Expanding the balance sheet of the Fed actually politicizes the Fed. The Fed becomes much more of a fiscal agent, which is actually very bad for the independence of the Fed. I'm not happy about Jay Powell saying that we should start worrying about income distribution and the fact that there's discrepancies between races in terms of the COVID and all this stuff. It's terrible because it makes the Fed more of a political organization rather than an independent central bank focused on a limited set of objectives.

Is quantitative easing policy a good policy? In a first-best world, absolutely not. You'd much prefer to use monetary policy. The problem, however, is the effective lower bound. Basically, a normal monetary policy becomes ineffective. You now have to go to nonconventional policies, and with the non-conventional policies, you're now in a situation where you're the second best.

You still need to do monetary policy, but they do have some negative aspects. Do quantitative easing and having the interest rates at zero increase risk-taking? Yes. Could it create some problems in terms of excessive risk taking? Absolutely. But also, you have to think about the fact that the Fed wants to keep rates low and commit to it in order to encourage people to take risks, because they want them to spend more.

YPFS: You have the debt overhanging, the deleveraging. The financial repression critique seems to not take into account that everyone was underwater.

Mishkin: Oh, absolutely. So let me give you an example. In the FOMC, there were people that kept on saying, when we had interest rates at zero and quantitative easing, that were going to lead to excessive risk taking. It's one of the reasons I don't get invited anymore to the Jackson Hole conference, because the head of the

Federal Reserve Bank of Kansas City was very pissed off at me. I would say to him, "Show me the money."

Is it true that having zero interest rates and quantitative easing can cause excessive risk taking? Sure, it can. But in fact, you want to get risk-taking to be done in this context. So, you have to show me that there's a problem. I agree that you have to monitor more carefully when you have this environment. But on the other hand, it's not an argument to raise interest rates, and these guys continually wanted to raise interest rates. They were absolutely wrong. To Ben's credit, what he eventually did, there was always this standard thing that if you had more than one dissent, that it would look bad for the chair. If you had more than two dissents, it was basically a vote of no confidence in the chair. The guys who were dissenting were wrong continually for seven years. They were wrong during the crisis. They were wrong afterwards. There's a set of people that, if you look at the people on the Committee, they absolutely had everything wrong.

So, Ben eventually said, "You know what? If you want to dissent, it's your problem. Look stupid." He didn't say this to them, by the way. But in effect, this is what he did. If you want more dissents, you can dissent. But it was coming from the people who had continually been wrong. So, he broke this tradition, which was actually good that he broke it, which is that you couldn't hold the committee hostage by saying, "We're going to have a lot of dissents." Basically saying, "They're dissents, and people think that your dissents are ridiculous. Go right ahead."

YPFS: **QE means you have to monitor the risk-taking more, you said. Are there areas of activity out there today that you see as potential systemic risks? For example: Moral hazard, shadow banking that has morphed but is still out there, leveraged loans, mortgage originators etc.**

Mishkin: Look what happened. We had a shock, that if you look at the shock of COVID, this is an unbelievable, scary shock. If you think of things non-linear during the financial crisis, it's nothing compared to what happened with COVID. Okay? Basically, we had these lock downs, which was very interesting because it was an aggregate supply shock because we basically couldn't produce goods. But it also shut down demand even more because nobody could shop. Savings rates are at incredibly high levels. I'm not spending any money. I can't go anywhere. We haven't gone on a vacation or done anything since March of 2000. We had to cancel things a couple of times. So, the shock was huge for COVID. And yet actually, the financial system, basically, nothing happened.

It's not that there wasn't some risk taking that you might worry about. But this idea that there was huge excessive risk taking because of quantitative easing

and low interest rates is just not correct. The financial system handled this extremely well. Again, it helped that the Federal Reserve was there to do what it did, because it made sure that the markets still functioned. But there's no evidence. So the way I think of this is that the system that was put in place after the financial crisis is what helped us deal with COVID: Given the nature of the shock, the effect on the economy is actually much less than a lot of people anticipated

I teach this, and say that we're incredibly lucky that COVID happened after the financial crisis because some of these regulatory reforms, the fact that the Fed understood the Lender of Last Resort role better, and so forth, and that the federal government didn't make the stupid mistakes it made like with TARP and the initial setup to TARP, all meant that we avoided a financial crisis, we avoided financial instability.

YPFS: **Regarding COVID and the extraordinary speed and effectiveness of the Fed intervention, all that recognized, you don't have a worry that the system is leaving too much heavy lifting to the Fed. But is this not a concern that the Fed steps up and tries to solve the whole thing?**

Mishkin: Absolutely. There's no question that having the federal government dysfunctional is a big problem. It now has put the Fed in a position where it's actually doing things it's really not supposed to do in a long run basis. The Fed is not supposed to be helping direct credit to small businesses or to corporate sector and buying corporate bonds or whatever.

All these things the Fed has done really politicizes the institution, because the whole idea of the Fed is that basically it should be independent. It should not be something that politicians fiddle with every day, and yet the Fed has done that. And look at the recent example. Trump had the most severe criticism, and I think that's not ever happened in this country. But look at what happened. He was criticizing the Fed saying how terrible they were. And he stopped it. Why? Because the Fed has now done what he wanted. so, you see the extension? That's very dangerous.

The Fed has moved from being a pure monetary policy institution, now to actually having quasi-fiscal policy elements. And that's not a good thing for the institution. In fact, I am actually quite critical of Jay Powell not going out and saying that the only reason that it makes sense right now to do what the Fed is doing is because this is not something where there's a moral hazard issue. This is an act of God, the COVID crisis, and you can act very differently when there is in act of God. The moral hazard issues of what they've done in COVID are much, much less than the moral hazard issues of what they had to do during the financial crisis. The COVID-19 policy is basically quantitative credit easing on steroids. In areas that weren't done before and so forth. The reason why I think it's okay is because COVID is an act of God, and you should never

do this if it's just a normal financial crisis. Much more limited actions are taken in that case, and yet the Fed has never articulated this, and I think the Fed is in a very dangerous political position, by the way.

YPFS: **Do you think that's going to be enough that the Fed, with all this innovation, do you think we can avoid a collapse, a real deep nasty recession, without fiscal action whoever is running the Congress?**

Mishkin: Well, I think we can, in the following sense, which is you're talking about the unemployment rate is already below 10%. The issue now is that how fast the recovery occurs will be affected by fiscal policy. The Fed basically can't touch more than it's doing now. And as we say, this is the second-best world, the Fed is doing this because if the fiscal authorities don't get their act together. It's being debated right now whether they can come up with a new package. I'm actually sympathetic to the issue that, unfortunately, nobody's talking about how we're going to pay all this debt back.

I'm actually a big advocate for extremely big spending right now. It's like you're in a wartime situation, World War II, you don't worry about having big deficits when you got to beat Hitler, same thing as beating COVID.

However, at some point you need to basically say, "We're going to get fiscally responsible." And there's no evidence that anybody's thinking about that. The only thing in which the Congress is bipartisan how irresponsible both the Republicans and the Democrats are in terms of long run fiscal sustainability, But that's a separate issue.

There's no question that the recovery will be slower if there's no fiscal action taken right now. I'm supportive of them doing the $2 trillion bill right now. On the other hand, I'm very worried that nobody's talking about the long run sustainability, and that's what the Republicans who were criticizing this should be focused on. The political process is now paralyzed and not focusing on the right thing.

The way of also thinking of this is about regulation too because the Fed actions create moral hazard. And I sometimes like to refer to this like the Seinfeld, the Soup Nazi, the moral hazard Nazis. Look at the way fire departments work. Fire departments have two goals, two roles. One is fighting the fires, and then there is regulation to prevent fires, fire codes. But when you have the fire that's getting out of control, you don't worry about regulation. Put out the bleeping fire first.

YPFS: **That's a good analogy. Yeah. You can take it too far, moral hazard.**

Mishkin: That's the right analogy to work with. So, I'm somebody who's written a lot on the moral hazard issues and worry about them, but during the crisis where all these people say we shouldn't do stuff, some inside the FOMC. My view was that you have to realize that you're in a firefighting mode.

So for example, before the crisis, I had tremendous disagreements with Tim Geithner on a lot of issues because Tim is still from the Larry Summers school, which is you worry about only the short run, don't worry about the long run. So, we had all sorts of issues about monetary policy in that regard. However, during the crisis, Tim and I were very big allies because Tim had the view: "We got to put out the goddamn fire and not worry about moral hazard issues." And I really agree with him on that. I think the same issue comes up with fiscal policy right now, which is we have to worry about the long run about fiscal balance. That's the regulatory part of it. That's the fire sprinklers and everything else, but during a crisis, you got to get the job done. You got to put out the damn fire.

YPFS: That's really interesting. So here we have the Fed stepping it up once, tightening up the regulations, the whole scheme, intervening so effectively, and then facing these political issues? What do you make of that?

Mishkin: Well so, the way I think about this is that, again, you have to operate in a world the second best. Where I think the Fed is not doing its job right now is they need to communicate. And this is actually some of the things I've been very critical of Jay on. Jay's been very good in many, many ways, very good during the crisis. But Jay also doesn't focus on communication in terms of providing transparency the way he needs to, and this relates to the way they report guidance, but in particular, I think it's extremely important for the Fed to get out there and to say, "Guys, this is an emergency which is like Pearl Harbor, and we have to operate in a very different mode."

On the other hand, there's a long run issue for what the Fed does, and I think one of the big moral hazard problems right now is that if the government expects the Fed always to solve the problems of fiscal policy, of expansionary policy for the government, it's a very bad situation. So, I think that what has not been emphasized nearly enough by the Fed is that there are cases where you have an act of God. There's not moral hazard. In fact, I'd even say this about the financial crisis, this idea of the rogue wave theory of financial crisis which I gave, is one where, in fact, moral hazard issues are less than you might think because it's not just an accident.

And that's why during a financial crisis, don't worry so much about moral hazard, worry about stuff, putting out the fire, and then actually worry about moral hazard once you've got it under control. The same thing is true of what's happened recently, that both the Fed and even the federal government have to

understand that an act of God like this is not creating moral hazard. Nobody could predict it. Anybody could say, "Well, eventually.", and there are movies like Contagion, but the idea that anybody really could predict this, this is really an act of God. This is like a hurricane, it's like a tsunami. And in that context, you have to say that we operate differently then, but this is not normal times.

When things get normal, hopefully not too far in the future, the Fed should not be involved in doing what it's doing now. It should not be basically the arm of the Treasury. And so, the Fed needs to really emphasize this and much more, in order to basically deal with this political issue, because the problem is that they've now gone way beyond what they've ever done before. The politicians love to lay off things on to other people. This is part of the problem of why Supreme Court things have become so important because the Congress won't legislate. There's really a similar issue here, and it really is very, very worrisome going forward.

YPFS: **Professor Mishkin, I think that is a perfect summary. Thank you again on behalf of the Yale Program.**

Suggested Citation Form: Mishkin, Frederic. 2022. "Lessons Learned Interview by Matthew A. Lieber, October 20, 2020." Yale Program on Financial Stability Lessons Learned Oral History Project. Transcript. https://ypfs.som.yale.edu/library/ypfs-lesson-learned-oral-history-project-interview-frederic-mishkin

Copyright 2022 © Yale University. All rights reserved. To order copies of this material or to receive permission to reprint any or all of this document, please contact the Yale Program for Financial Stability at ypfs@yale.edu.