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Lessons Learned: Frederic Mishkin

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Lessons Learned

Frederic Mishkin

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Rick Mishkin served as a member of the Board of Governors of the Federal Reserve System from 2006 to 2008 and as director of research at the Federal Reserve Bank of New York from 1994 to 1997. A leading expert on monetary economics and financial markets and a professor at Columbia University's School of Business since 1983, Mishkin has written 20 books, including the textbook The Economics of Money, Banking, and Financial Markets. *This Lessons Learned is based on an interview with Mishkin conducted on October 20, 2020; the full transcript may be accessed here.*

In responding to a crisis, the most effective solutions may not be obvious, so organizations need to be flexible and innovative.

The Federal Reserve's actions during the crisis, Mishkin said, show the quality of the organization. Mishkin assessed the Fed's 2007–08 crisis response as relatively effective: "Things were done in a systematic way, on the one hand, but in a completely non-systematic way on the other," he said. He commended the Fed on its flexibility and innovation.

According to Mishkin, the Fed tried one thing, and if that did not work, it said, "we need something else."

> 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.

Crucially, shared Mishkin, the Fed was able to learn, develop new methods, and continue innovating until something worked. For example, he continued, in August 2007, interbank lending markets came under serious strain after the first disclosure of massive losses in subprime securities at BNP Paribas. At Mishkin's urging, the Fed lowered the discount rate. But it didn't work. Banks feared that borrowing at the discount window might trigger a run on deposits. Bank funding markets remained seized up. In December 2007, the Fed launched the Term Auction Facility (TAF), which inspired more confidence among banks and enabled the Fed to support a broader range of counterparties without the stigma of the discount window.

Another example of the Fed's flexibility and innovation Mishkin cited is with respect to quantitative easing. According to Mishkin, Fed Chair Ben Bernanke established that we had to "try to keep credit markets functioning and keep credit spreads from getting out of control. But the methods of doing it were not clear."

With short-term interest rates near zero, the Fed's main monetary policy tool was spent. However, the central bank can push long-term rates down by buying financial assets, which it did in a massive way with effective results. There was much debate about the explosion in the size of the Fed's balance sheet. But, Mishkin explained, the Fed's emphasis was always on the credit markets and the spreads between short- and long-term rates. The expansion of the balance sheet followed as a consequence; it was not the objective. "Quantitative easing" suggests a balance-sheet expansion without a focus on credit conditions, Mishkin said. For that reason, he recalled, Bernanke would have preferred people to call it "credit easing."

Past crisis experience can be used to prepare for future crises: The Global Financial Crisis provided a war games experience for the Fed's COVID-19 response.

Mishkin noted that the contrasts between the Fed's 2007 and 2020 interventions are consistent with findings from his academic research on central bank effectiveness as lender of last resort: "The faster you [ease credit], the less you have to do. It is one of the key lessons of financial crises." Mishkin pointed to the Black Monday market crash in 1987: "[Former Fed chair Alan] 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." In 2007–2008, Mishkin said, 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.

We're fortunate to have had the Global Financial Crisis before the COVID-19 pandemic, Mishkin said; it acted as sort of a war game for a future crisis. In 2020, the Fed understood its lender of last resort role much better than it did in 2007, Mishkin continued. The agency had on the shelf a game plan for fighting a crisis, including emergency programs. The Fed announced the Primary Dealer Credit Facility (PDCF) and the Commercial Paper Funding Facility (CPFF) four days after the March 13 national emergency order. By contrast, it took the Fed seven months to deploy the same facilities following similar credit market tremors in August 2007.

He described how the Fed applied its learning to the COVID response in March 2020:

> 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 results were effective, said Mishkin. First, the Fed delivered a remarkably rapid response. And second, it was a highly effective intervention amounting to a case of crisis prevention. Overall, said Mishkin, the Fed "performed brilliantly in March of 2020."

Intervention assessment and crisis preparation should continue after the crisis has calmed, because the landscape will have changed and the next crisis may require different modalities.

Assessing post-crisis reforms, Mishkin said the most important change is that banks are much better capitalized than they were before. Also improved is the capitalization and monitoring of large nonbanks, with investment banks transformed or subsumed into bank holding companies. Shadow banking, which "blew us up" in 2007, is less of a vulnerability today.

Mishkin worried, however, about the Federal Reserve's capacity in a future crisis to serve as lender of last resort. Under the Dodd-Frank Act, use of the Federal Reserve Act's Section 13(3) emergency lending authority is conditioned upon the Treasury secretary's approval. He noted:

> 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.

More generally, Mishkin is concerned about political pressures on the Fed. Mishkin fears that the current Fed under Chair Jerome Powell is acting like more of a fiscal agent of the Treasury than an independent central bank. Congressional failure to legislate on issues like income distribution and racial discrepancies, Mishkin said, has politicized the Fed at the expense of its focus on a limited set of monetary and financial objectives: "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."

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