



**Episode 366 – If there were an Aristocracy of Wrong,
Its Lords would be Fed Chairmen**

Guest: Mark Thornton

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WOODS: Since I couldn't be at the Austrian Economic Research Conference, the next best thing is to poach as many of the papers as I can and turn them to episodes of my show. So I was looking through the schedule, and your paper, of course, just leaps off the page. It leaps off the schedule—"Transparency or Deception: What the Fed was Saying in 2007." Well, you know a red meat headline. You can write a red meat headline for our audience. Now, that's not a red meat headline for a lot of audiences, but for this one, it certainly is.

I know you are something of an expert on this. I know you had a paper some time ago about what economists were saying around the time of what eventually became the dot-com bust, and now you're talking about what the economists at the Fed, which is what the Fed chairmen are—they are supposed to be economists—what they were saying in 2007. You were also one of the earliest people to warn about the housing bubble. So you are uniquely placed to report on this with some real credibility. So give us the background here. The background of the paper seems to be that there's been a lot of boasting about the transparency of central banks over the past couple of decades. They have become more transparent, and that this is to the good, but you seem to be saying transparency is only good when they are telling you the truth.

THORNTON: I think it's very worthwhile just going back and looking at the history, looking at what people were saying about economic crises before they happened, and so what I did was I went back to 2007 and looked up the speeches given by the chairman of the Federal Reserve, the vice chairman of the Federal Reserve and some of the leading members of the Board of Governors to see what they were saying about the economy, whether they were telling us that there's trouble ahead or whether they are telling us that things are all fine and good. And I framed the paper around this concept of transparency, which is basically the Fed telling us what they are doing and telling us what they plan on doing, and so there's been this trend towards transparency. Under the gold standard, they didn't have to be transparent because gold did the job for us. When we went off the gold standard, the Fed went into a secrecy mode where they didn't tell us anything about what they were doing or anything about what they planned to do, but gradually over the last 10 to 15 years the Federal Reserve and other central banks have become more transparent. The thinking is that if the Fed tells us what they are doing and what

they plan on doing and how they are voting, then markets will be more stable and be more efficient, and basically economists have found that that's true. As the Fed has become more transparent and has told us what they're doing and what they plan on doing, stock markets and interest rates and bond sales have become more efficient and more stable, and so all the papers have been reporting that this transparency in terms of the numerical data has ended up with better results.

What I looked at was the non-numerical data, not the numbers that the Fed was telling us, but what it was saying to us, and there were several important speeches in 2007 where the chairman, the vice chairman, and the Board of Governors went out to, for example, the American Economic Association that Ben Bernanke talked about in important conferences in New York and elsewhere, where literally thousands of economists gathered together to hear the words of the chief operating officers of the Federal Reserve itself. So it's that kind of data.

WOODS: The Fed seems to be interested in promoting confidence in its speeches. It wants to promote consumer confidence, and it wants to promote—and this is what you're pointing out in your paper—our general confidence in the Fed's ability to prevent crises and to fix crises once they occur. So we don't expect to hear a lot of bearish warnings in Fed speeches, and generally, that's not what we get. And even when things are bearish, they still try to look for the bright side. They still try to refer to a disaster as a challenge—we still face challenges, which always means we don't know what to do about this situation. So this seems to be linked to the idea that the success of the economy, the health of the economy is due at least partly to our confidence, our confidence in how things are going, to psychology. It looks like they are playing to that in their statements.

THORNTON: Oh, that's absolutely correct, and I think everybody should understand that. The Fed is talking about consumer confidence, investor confidence, financial market confidence, but the reality is that this whole thing is a con game, where they are taking advantage of us, and they are doing so with fancy words and misleading languages, and so you have to understand that's what the Fed is about. They are operating an economy, a monetary system, and a banking system where money is just pieces of paper, and the banking system has, generally speaking, no reserves in the bank. So you've got a real flimflam type of operation involving paper money, which isn't worth anything really and banks that don't have any deposits in them if all depositors were to try to get their money simultaneously. So they are always trying to build confidence, and they use the language of the Federal Reserve to try to mislead people about what's really going on so that they can continue on operating the system for the benefit of the big banks.

WOODS: You're saying that the fact that the numbers are more readily available, and there's transparency in terms of what the Fed is doing and that this has had good results. It's an interesting observation because it's true that what the Fed is currently doing is something that people can easily find out, but the real question for anybody who is a market actor is: what is the Fed going to do in the future? And that's where you have to get out your crystal ball. That's

where you have to take these Fed speeches, whether it's a spokesman for the regional banks or the Fed chairman himself or herself, and you've got to decode them. You've got to figure out what FedSpeak is. You've got to figure out how to read between the lines of these speeches to figure out what's going on in the future. So they may be transparent about what's happening at this moment, but what really matters is, what are they going to do next week? What are they going to do in six months? And you have to be some kind of soothsayer to figure out what it is they are going to do. So it's not a matter of we have all this clarity about what's going on. What in fact we have, as compared with what we would have under sound money, is still a whole lot of white noise that entrepreneurs have to somehow work their way through.

THORNTON: Yeah, take, for example, the last press conference by Janet Yellin, who is now the chairman of the Fed, and all of the ink that was spilled over what she said in the statement that they released in which the word patience had been deleted from the previous stock press release, basically, and that was supposed to be an uber-indication of what was going to happen involving Federal Reserve policy and interest rate settings and so forth, and how the removal of that one word—the removal of the word patience and the other words in the press release, and that shook markets to the core. That's the kind of situation we're in right now, where one word can move a trillion dollars' worth of value in the stock market. So this transparency thing, which was considered to be so good for so long—now we're at the end of our rope, and they've been able to get away with this confidence game, Tom, because people don't seem to be paying attention to what they do, what they say, what they are all about. I have been asking people, friends, and people I come across, when was the last time that we had seven years of near-zero interest rates in the economy? And people are dumbfounded. They haven't even thought of this issue. When in fact, it's never been done in human history before, where we've had essentially zero interest rates for a period of seven years, and so hopefully, this paper will get into people's minds and they will start thinking critically about what the Federal Reserve is all about and what they are doing to us and how that is going to impact our future going forward.

WOODS: All right, let's turn to the primary focus of the paper, which is specifically what was going on 2007 and a couple of years leading up to it—leading up to 2007—what people like Ben Bernanke were saying. I think some of us have even memorized some of the most outrageously wrong statements that were coming from Ben Bernanke, who was, as you point out, an economist of impeccable credentials. Maybe he really believed these things. I can't get inside his head. But tell us what an observer of the Fed was hearing from the Fed chairman in, let's say, 2006.

THORNTON: Well, in 2006, which predates the paper, the most famous quote was when he was testifying in the press conference afterwards where he said that he had made an investigation into mortgage lending practices by banks and other financial institutions, and his conclusion was that things were never better in the economy with regard to mortgage lending practices by U.S. financial institutions. Of course, this was precisely the time when people were getting no down payment loans, no documentation loans, loans with teaser rates for which they really

couldn't afford the primary payment, and so that, I think, was probably maybe one of the most outrageous quotes that I have trying to bring to people's attention for quite some time. And I think, you know, if this great economist with a team of hundreds of economists and accountants can make an investigation into mortgage lending practices at that time, when all of that silly, dangerous mortgage lending was going on, and for him to say that things were now — they were never better than mortgage lending standards are at that time in 2006.

WOODS: Let's turn to an economist people are less likely to have heard of: Fred Mishkin, who I remember our friend Xavier Mera, who was a Mises fellow for quite some time, working on his dissertation. He had to read Mishkin's textbook in money and banking, and he was just pulling his hair out, and he wrote at least one Mises Daily about something in that textbook and how terrible it was. Well, Mishkin was also a governor of the Federal Reserve Board, and he made his own remarks about the prospect of a housing bubble and what the Fed should do and so on and so forth, and you quote him extensively. Give us the background there.

THORNTON: Fred Mishkin is the acknowledged expert in money and banking. He's written the number one text. It's been around forever. He's been working for the Fed as a consultant and member of the board for a long time. He was there on the board during the housing bubble, and he made a lot of just zany statements regarding bubbles during 2007 right before the housing bubble crashed. He said, for example, over the past 10 years, we have seen extraordinary run-ups in house prices, but it's extremely hard to say whether they are above their fundamental value. Nevertheless, when asset prices increase explosively, concern always arises that a bubble may be developing and that its bursting might lead to a sharp fall in prices that could severely damage the economy. But when you answer the question of should a monetary authority try to prick or at least slow the growth of developing bubbles, Mishkin's answer was, "I view the answer as no." In other words, if the Federal Reserve is not worried enough to change policies and address bubbles, you should not be worried, either. So basically, Mishkin is denying a bubble or denying that the Fed could change it or denying the fact that the Fed should change it, and this is occurring right as the bubble reaches its absolute peak.

WOODS: He does elaborate on this point, and one of his arguments is if the Fed were in a position to determine that a bubble existed, then market participants would also presumably have figured out that a bubble existed. In effect, he's saying that there's no particular reason to think that we would be the only insightful people in the economy. The market would pick up on it, and it would burst the bubble on its own, or the bubble wouldn't develop because the market would correct for it because market participants figure out when prices are out of whack. In a way, it kind of reminds me of the arguments of Eugene Fama.

THORNTON: Oh, yeah, I mean Mishkin is just laying it all out to have mud thrown in his face for what he's saying at this time. He even said that the bursting of asset bubbles does not lead to financial instability, but the punch line here is, let me give it to you, "There are even stronger reasons to believe that a bursting of a bubble in house prices is unlikely to produce financial instability. House prices are far less volatile than stock prices. Outright declines after a run-up

are not the norm and declines that do occur are typically relatively small. Hence, declines in home prices are far less likely to cause losses to financial institutions. Default rates on residential mortgages typically are low and recovery rates on foreclosures are high. Not surprisingly, declines in home prices generally have not led to financial instability. The financial instability that many countries experienced in the 1990s, including Japan, was caused by bad loans that resulted from declines in commercial property prices and not declines in home prices.”

So Mishkin is just giving you one reason after another why you shouldn't be worried about a housing bubble because of all these reasons that it's not going to adversely affect the stock market, the financial firms, which of course, it did dramatically affect the stock market, losing more than half of its value. Financial firms went out of business in record numbers. Lehman Brothers, for example—the mortgage companies went out of business, and the economy went into a recession. Basically, what Mishkin's argument leads to is that if you're just a consumer, don't worry about buying a house because everything is going to be all right, and if he's speaking to people in the finance industry, he's telling them: don't worry about the housing bubble. Feel free to lend and give out mortgages to people who have bad credit. So he's sending the absolute wrong message to a large number of critical people in the economy at precisely the wrong time. He's giving them bad information that's 180 degrees wrong at this time.

WOODS: Later in your paper you talk about two economists who are still lesser known than these others. Do they have their own unique errors for you to report? Or are they just repeating the errors of Mishkin and Bernanke?

THORNTON: Well, no, they are all taking different angles. They have all got different areas of specialization. Donald Cohn, I took a look at his speech, which was called “Financial Stability: Preventing and Managing Crises,” which was a speech that he gave at the Exchequer Club Luncheon in Washington, D.C. in February of 2007, and he was basically talking about the issue of financial crises, and he's saying obviously you can't rule out the possibility of sharp movements in asset prices, but there's really a lot of factors that if you take into consideration would lead you to downgrade those types of concerns, because the Federal Reserve—he was playing up the Federal Reserve, as they all did, about its role in marketplaces, and its supervising these financial firms, and that they are in the position to deter financial crises, and as the central bank, they would strive to foster economic stability, and as a supervisor of banks and financial institutions, the Fed is working with them to improve risk management and market discipline.

So basically he's the guy that sort of specializes in the supervisory role of the Fed and its role in supervising banks and financial institutions, and he's basically telling his audience that the Fed has lined up a multi-layered approach to prevent financial crises, to identify risk in financial firms and to encourage management responses to risk to try to spread risk and eliminate risk and manage risk and to look out for black swan-type results. But the best quote, I think, from

Donald Cohn is, “A second core reform that emerged from past crises was the need to limit the moral hazard of the safety net extended to insure depository institutions, a safety net that is required to help maintain financial stability. Moral hazard refers to the heightened incentive to take risk that can be created by an insurance system. Private insurance companies attempt to control moral hazard by, for example, charging risk-based premiums and imposing deductibles. In the public sector, things are often more complicated.”

So basically, what he is saying is that because of the unstable nature of our money and banking system, the fact that we don't have gold that's stored as deposits in banks, but we have paper that's not stored anywhere, but is simply lent out multiple times, and then we have the FDIC insuring those deposits so that nobody is concerned about the fact that we have a money and banking system that is so inherently unstable. So he's saying the Fed is really working that angle, making sure we're definitely preventing future financial crises and instability, and then he goes on and says, “The systemic risk exception has never been invoked, and efforts are currently underway to lower the chances that it ever will be.” And basically, what he's saying there—what he's referring to there—the systemic risk exception is the Fed bailing out the big banks. This was in 2007. In 2008, the Fed began the process of bailing out the large banks on a massive scale, which of course, induces a moral hazard because now that the banks have been bailed out, now they have the estimation that they will be bailed out in the future as well. So the thing that they never resorted to, which is a massive, system-wide bailout of the big banks in the fact that they never wanted to do that—well, they blew that promise within less than a year from then.

WOODS: There is one other point in your paper I want to make sure that we hit on. You make a brief reference to a study, and then I think there's been something also done in the Huffington Post, maybe less formal, involving the relationship between economists and the Fed and the way in which the Fed's ubiquity throughout the economics profession makes it unlikely that someone would want to position himself as an opponent of the Fed. Can you explain that?

THORNTON: Well, yeah, this is the whole battle line, basically, between the Austrians and mainstream economists. The Fed is a big player in the economics profession. It hires hundreds, if not thousands, of economists, and it gives away grants and research money to many, many other economists, and so they have a very powerful role in the economics profession, and well, for example, Larry White has showed that 80% of the members of the editorial boards of the leading journals, academic journals, in money banking and macroeconomics either work for the Fed, have worked for the Fed, or have been a consultant, a paid consultant to the Fed. So there is a lot of dirty money that's dominating modern, mainstream macroeconomics that comes from the Fed. So if you're an Austrian who is trying to reform the system and who is trying to make a statement, you're going to be completely iced out of those kind of positions and that kind of money, and generally speaking, although not exclusively so, from those journals. And so there's a lot of dirty laundry with respect to the Fed and the economics profession, and it—you know, we're getting more and more revelations with regard to this. For example, Mishkin,

whom I mentioned earlier, actually got a \$100,000 grant for co-writing a paper about the Icelandic economy.

WOODS: Yeah, I remember this.

THORNTON: Yeah, so he wrote a paper, well, basically, he signed his name to somebody else's paper that said that the Iceland economy was really great, really stable, really progressive, lots of jobs, free hot air, you know, just one thing after another, and he was basically paid \$100,000 to put his name on somebody else's paper about Iceland. Of course, shortly thereafter, it was found out that the Icelandic economy was just a total bubble, and a nation of fishermen was turned into a nation of mortgage sellers, mortgage dealers, and the whole economy melted down. The whole banking sector melted down, and it was a total disaster, I think less than two years after Mishkin got that \$100,000 check. So, again, you're hoping for science, but you're getting a very distorted picture of the world because mainstream academics, including economists, are bought and paid for in many cases.

WOODS: Well, not a very cheerful conclusion to our discussion, but on the other hand, this had been going on for a long, long time until people—it still goes on, but it went on without really any public knowledge because the public was completely in the dark about the Fed and its activities. If they knew anything about it, it was just a benign overseer of financial activity, and now, you know, there is a growing skeptical community, and no one has done more to promote that than Ron Paul and the Mises Institute, and I would say Mark Thornton has been a major part of this very, very welcome intellectual development. So as always, Mark, thanks for your time, and we'll talk to you again soon.

THORNTON: Thank you very much, Tom, it was great to be on your program.