

Goodhart, Charles A.E.

**Article**

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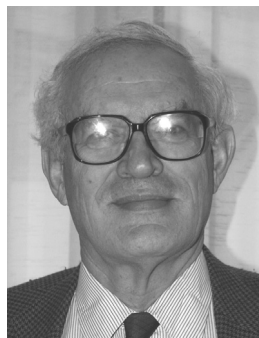


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## Forum

**»Minsky I find enormously attractive but his issues are very difficult to model in any rigorous way.«**

*Interview with Charles A.E. Goodhart\*\*\**



*Charles Goodhart, you studied economics at Cambridge and Harvard. What was your motivation to become an economist and was there anyone whose ideas and attitude impressed you most?*

I started in economics because my father had a plan for his three children. My oldest brother was to become prime-minister of England. My older brother was to become a law professor because my father had been an academic lawyer. I was to go into business to try to restore the family fortunes because neither politics nor academics make very much money. But as always, children disappoint their father.

I found economics fascinating, when I started it. I had been brought up at school, being taught that there would always be a right answer. There was a king-reigning between 1473–1498 – you had to get the years correct; when you had a maths problem, there was always a correct answer. It was a great relief for me to come up to university to find that in economics no one knew the answer. It seemed to me to be a discipline where I could actually make a difference. Because there was so much still to be done and so much still to be understood and so much still to be learned.

I went to Cambridge in 1958–60 when the old guard, the people who had worked with Keynes himself like Joan Robinson and Richard Kahn, were by that time quite senior. Of that generation, the one that I found most interesting and attractive was Nicholas Kaldor. But the people who were really more inspiring were the younger faculty about the age of 30 to 40. People like Frank Hahn, Robin Matthews, Robin Marris. It was the younger people that one relates to more, I think, as an undergraduate. They taught me a lot. They were not continuously fighting the ideological battles of the past.

\* Charles Goodhart was the Norman Sosnow Professor of Banking and Finance at the London School of Economics (LSE) before he retired. He obtained the Bachelor of Arts Degree from Cambridge and Ph.D from Harvard University. Before joining the LSE, he worked at the Bank of England for seventeen years as a monetary adviser, becoming a Chief Adviser in 1980. Together with Mervyn King, he founded the Financial Markets Group at LSE. He was appointed one of the first outside independent members of the Bank of England's Monetary Policy Committee. He taught at Cambridge and LSE.

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I remember coming back to Cambridge, England, after I had been at Harvard, Cambridge Massachusetts, to find that the faculty were talking about nothing other than capital theory, growth theory, and in particular the reswitching hypothesis. They could not talk about anything else. That was the year when Robert Solow was visiting Cambridge. The battles on whether there is such a thing as capital and how could you possibly measure it went on and on, to a point where I simply decided growth theory was better avoided.

*Instead of growth theory you engaged in money and monetary policy.*

That was almost entirely by mistake. When I went over to Harvard in the early 1960s I already had an idea about the thesis that I wanted to write, which was about the downturn in 1907 following a financial crisis in the USA. This was one of the most severe financial crises that had ever occurred. Everything went down very sharply, but then bounced back very quickly. I wanted to compare and contrast that with the crisis starting in 1929, when the downturn was actually less steep than the downturn in 1907. In 1929, it was far less of a really devastating financial crisis but it went on down and it did not reach its bottom until about 1933. I wanted to try to discover what caused the difference between the bounce-back in 1907/08 and the continuing decline into depression in 1929–33. I found, however, that I could not do it due to the fact that the bounce-back in 1907/08 was so very quick and there were no quarterly data on GDP, output and so on to analyse it thoroughly. But there were masses and masses of very good monetary data. I came to the view that the economists of the time like O.M.W. Sprague and E.W. Kemmerer had actually missed certain aspects of the 1907 crisis in the USA, so I wrote my thesis on the subject of the finance of trade and the New York money market 1900–1913, which went pretty well. That put me into monetary history. Having done that in Harvard I thought I could do a companion study in Cambridge, England, when I came back and I did a book on British monetary developments in the same period. After that I moved to the London School of Economics (LSE) and from LSE I was invited to go into the Bank of England in 1968.

Ever since about 1960 the Bank of England had a policy of inviting relatively young and promising monetary economists into the Bank of England to show them how the Bank of England worked and to get the academic views of the people who were going in. At this time the Bank of England really had no economists who knew about the new monetary theories in the USA, the ideas by Friedman and the Chicago school. They simply had no idea about what Milton Friedman was saying. I had been exposed a bit to the monetarist theories of Milton Friedman at Harvard. I reviewed Milton Friedman and Anna Schwartz's book and what is more, since I had by then become a specialist on the American monetary system in 1900–1913, I actually got sent that particular chapter in the Friedman/Schwartz-book. I corrected it in one or two places and there are a couple of footnotes in Friedman and Schwartz deriving from these corrections.

So my role in the Bank of England was to explain the developing monetary theory to the Bank of England and explain what the Bank of England policies were to the academic world. This was fascinating – I was sort of the interface between the Bank and academia which gave me an influential position within the bank. I stayed on until 1985.

*You acted there as an adviser to the Bank of England later on and to their Monetary Policy Committee.*

Yes, I actually became their chief monetary economist. In fact, I was really their chief monetary economist from the time I went into the Bank of England. They just did not have anybody else who knew about the developments of academic monetary theories coming out of the USA at this time.

*You mentioned that your function in this bank was to bring academia into the bank. What was the effect? Was it a success or not and what do you think is the influence of academia on economic policy, and monetary policy in particular?*

The influence of academia on monetary policy has become steadily greater over the whole time period that I have been around – until perhaps the last two years. And if you now look around, you see Ben Bernanke, you see Mervyn King, you see in the European Central Bank Lucas Papademos and Tommaso Padoa-Schioppa. Now we have Lars Svensson in the Riksbank. Effectively, the Central Banks (CBs) have been overtaken in fact by academic economists and so the influence of academia on monetary policies has become greater and greater.

That is largely because of two academic developments which have been absorbed and became generally accepted by the political establishment eventually in every country. The first one was the medium- and long-run vertical Phillips-curve. The theory was that monetary policy could affect only inflation in the longer term and that the rate of growth and the equilibrium-level of unemployment were determined by real factors which could not be influenced by monetary policy. Therefore monetary policy should be related to an inflation target. The second element is the argument about time inconsistency which requires the CB to be independent for obvious reasons.

That led to the current development where CBs focus on their macro-economic function trying to maintain the inflation target. This had an incredible period of success known as the 'Great Moderation'. The Achilles heel of that has turned out to be that the CBs also traditionally had the responsibility of maintaining financial stability. CBs came to believe that virtually all their responsibility was maintaining the inflation target. They really took their eye off the ball of financial stability and asset prices. However, one of the key findings has been that the great financial bubbles and busts have generally followed periods in which there has been no problem with inflation, upwards or downwards. The 1920s was actually a period pretty close to price stability. In Japan in the 1980s, there was some slight upwards pressure on inflation but nothing of significance. The lesson of history, which was not learned by CBs, was that you can get these Minsky type asset-price surges and then complete busts under conditions in which virtually nothing appears to be wrong with the progress of inflation. Again the same was true throughout the 19<sup>th</sup> century. As everyone knows there was generally price stability in the 19<sup>th</sup> century. But yet, this was punctuated by major occasions of financial crises: 1873, 1891–93, 1907, and others one could name, too.

*Before we come to the present financial crisis, I would like to ask a question which has to do with your theoretical background and your relationship to the Post-Keynesian tradition building on uncertainty and money. How would you describe your relationship regarding the views of Paul Davidson on the one hand and Hyman Minsky on the other? Moreover, there has been a debate between Basil Moore and you on endogenous money and exogenous interest rates. How would you distinguish your view from theirs? Or are there more or less broad similarities?*

I very much sympathise with the underlying argument that Paul Davidson and Basil Moore make that macroeconomics and general economics is far too fixated on the hypothesis that there is an equilibrium to which the economy, other things being equal, will revert. The difficulty is that trying to provide and obtain an alternative model which does not lead to an equilibrium is so difficult that it is almost impossible to grasp and make sense of it. So I sympathise with the non-ergodic approach which Paul takes but I cannot actually get my mind quite round how it would work.

Minsky I find enormously attractive. I think that Minsky's views on the dynamics of an asset-cycle are absolutely right. Minsky's difficulty again was that he was unable to formalise the models that he had into a sufficiently rigorous mathematical format to persuade the rest of the profession. Minsky's issues, default and so on, are very difficult to model in any rigorous way. For quite a number of the last few years, I have been trying to provide fairly formal models which I hope will enable the Minsky-type-approach to be done in a more mathematical, rigorous way.

The people who are influential in this area are Martin Shubik at Yale, and one or two others at Yale. I am working with a young colleague of Martin Shubik's called Dimitri Tsomocos with a view to try and make Minsky type models more formal. And these are models in which default and heterogeneous agents are absolutely essential to the whole exercise. But of course it is a great deal more difficult: The difficulty is that reality is complex and trying to model something so that it is both realistic and yet capable of being modelled formally is very difficult. And I do not do the modelling, I am glad to say. My colleague Dimitri Tsomocos does it. What I am trying to do is get him to do the modelling in such a way that central bankers and other academics will understand what we are doing and how we are doing it and why we are doing it.

*Are these models capable of explaining the current crisis?*

Yes, certainly in principle. Dimitri and I have just done a model on the housing crash, on the interaction between a banking system, a housing market and a shock which will cause an interactive reaction between housing prices and defaults in the banking-system. Yes, it can be done. But it is a much more complex model than the standard three equations DSGE mainstream model.

*What in your view are the main causes of the present financial crisis? Which is the role of monetary policy, on the one hand, and which role would you allocate to 'misguided regulation' in financial markets, on the other?*

The crisis was partly due to the imbalances, the global imbalances, that glut of saving in Asia and whatever, which held interest rates too low for too long and which enabled a massive expansion of leverage, a search for yield and a reduction in risk aversion. So you got a huge increase in leverage.

Unfortunately, regulation has been focusing far too much on the micro structure rather than the macro structure and has therefore looked at the risk weighted assets of individual banks rather than the expansion of leverage in the system as a whole. Therefore in fact regulation did nothing, or virtually nothing, to restrain the upwards bubble pressure. Then, if anything, regulation has reinforced the downward pressure, combined with mark-to-market accounting. But mark-to-market has a lot of virtues, and therefore I think we need to be quite careful about trying to throw it out completely.

The other feature was the fact that everyone in the USA was betting on a continuing upward increase in housing prices. That bet went very wrong. This included the credit rating agencies. The credit rating agencies' ratings were effectively largely based on assumptions that housing prices would not fall. It was much more the wrong bet than that they misbehaved because of conflicts of interests. Probably, there was a conflict of interests, too. But I put the blame on a generalised wrong bet.

That then got reinforced because securitization meant that the holders of these collateralised mortgage debt obligations (CDOs) did not actually know what was in their CDOs. And even if they could have come to a reasonable judgement to what was likely to happen to housing prices, foreclosures and defaults, they did not know what proportions of sub-primes and where they were and all that. So they were not really able to assess what the value of their securitised CDOs and such were. When they were not able to really assess what the value was, you got a huge division between the price at which sellers were prepared to sell and buyers were prepared to buy. The spreads widened out. They widened out so far that the only people who were prepared to sell were those who were forced to sell. So you got distressed sales. The combination of distressed sales and mark-to-market meant that you got a massive erosion of capital. Then, you combine the erosion of capital with uncertainty and you have this complete collapse of the wholesale markets.

The intellectual basis on which regulation has been done, a belief that these wholesale markets were so efficient, that they would always be accessible to banks who had sufficient capital, was wrong. They also believed that Basel I and Basel II would provide sufficient capital and that markets would always work. Of course, both of these intellectual bases simultaneously collapsed.

The CBs did not really know what had hit them, they were still intellectually working on the assumption that, when the banks got into difficulty, they would come to them with good assets and that they could then discount or repay or whatever. But the banks did not have any good assets. It was more of a stigma if you were seen to come to the CBs to help. So the CB really had quite a lot of problems to deal with this crisis. There was a very long learning process which went on for a period of months by which time the whole state of the financial system had got worse. The housing market did not turn round, and then you got the troubles of Fannie Mae and Freddy Mac. Afterwards you had the one really big major

mistake in this whole exercise which was letting Lehman Brothers go bust, September 15<sup>th</sup>. That transformed a difficult, severe problem into absolute, total, outright panic.

*Meanwhile we have these massive bail-out packages by the state in the UK, in the USA, in Germany, in Austria. Are these measures sufficient to prevent a much deeper crisis or what in your view should be done in order to contain this crisis and in order to prevent mutual re-inforcements of the financial crisis and the real economic downturn which started well before September 2008?*

One of the interesting issues is why the original Paulson plan in the US was actually so badly devised. The plan that was devised in the Bank of England and the Treasury in the UK, a success Gordon Brown took all the credit for, is clearly necessary. It remains dubious whether it will be sufficient, because, as you indicated, we have now got a severe recession interacting with the banking system. The defaults on housing will continue. The recession will be deep enough and long enough, so there will be defaults in many other areas as well. That means that the erosion of banking capital has not come to an end, and it is perfectly possible that the tax payers in all the major countries will have to put up yet more money because the capital position will be under further downward pressure over the next year. One of the things I would like to emphasize in this context is that even if interest rates do have to go to zero as they may well do in the USA, possibly in the UK, less likely in the Euro zone, that does not mean that monetary policy then becomes useless. A CB can continue to undertake expansionary policies even after the zero lower band is hit, and should do so.

*What are the instruments?*

Effectively monetary expansion – the CB is the sole bank which does not have to worry about capital constraints. The CB can buy anything.

*Is it not already happening in the USA?*

Yes it has. The FED has begun to buy commercial papers and may well continue to do this. The Bank of Japan in the period of the zero interest rate policy became the biggest single institution in the whole of Japan and frequently it made more profits than anybody else. When I meet my CB ex-colleagues I pat them on the back and say, »Do you realize that you are about to become the biggest institution in the whole country? You will be a dominating factor in this scene over the next few years, and you will have to be.«

*Let us assume that we can prevent a really deep and long-run depression by means of active monetary policies, but maybe even active fiscal policies. What would you recommend to implement in order to prevent such a crisis from occurring within the near or not so near future?*

I am not heterodox; I am orthodox in the sense that I do think that providing a CB with an inflation target and using interest rates primarily for the achievement of that target, is actually the correct policy. I also believe that the CB should have responsibility for financial

stability. What it needs is instruments to achieve that. These instruments have to be macro-prudential regulatory instruments. At the moment, CBs actually do not have such instruments. It is my current research, my current work to try and propose sets of such instruments that a CB could use. I am hoping to bring out a couple of publications soon. I got a book coming out on the regulatory response to the financial crisis fairly early on in 2009. And I am currently writing with colleagues a paper for Charles Wyplosz's Geneva report on the fundamental principles of banking regulation, in which I hope to set out mechanisms which provide CBs with instruments which will enable them to carry out their responsibility for financial stability.

The two main areas of financial regulation are capital and liquidity. On capital, the need is to have some kind of counter-cyclical instrument which ought to be based much more on leverage because it was over-all leverage, the increase and then the reduction of leverage, that is a problem, rather than on levels of risk-weighted assets. I am trying to put flesh on the bones of the proposal that the capital regulations, capital adequacy requirements, should be counter-cyclical and based much more on leverage ratios. As for liquidity, the need actually is to try and get some sensible liquidity regulation in place because effectively there were not any such. I think there is a need to introduce those and also, if possible, to make these counter-cyclical as well. But we need to take it step by step. We should introduce liquidity regulations of some kind, where there have been none.

*The interview was conducted by Eckhard Hein and Torsten Niechoj in October 2008.*

#### *Selected Publications of Charles A.E. Goodhart*

The business of banking, 1891 – 1914, London: Weidenfeld and Nicolson 1972 • Monetary Theory and Practice, London: Macmillan 1984 • Money, Information and Uncertainty, Cambridge, Mass.: MIT Press 1989 • The Central Bank and The Financial System, Cambridge, Mass.: MIT Press 1995 • House Prices and the Macroeconomy (with B. Hofmann), Oxford: Oxford University Press 2008 • The Future of Banking Regulation: The Basel II Accord (eds., with H. Benink, J. Danielsson), Oxford: Wiley-Blackwell 2009 • The Regulatory Response to the Financial Crisis, Cheltenham: Edward Elgar, forthcoming • The Fundamental Principles of Financial Regulation. ICMB Geneva Report (with M. Brunnermeier, A. Crockett, A. Persaud, H. Shin), forthcoming