Conversation With Charles Goodhart

This conversation was held through an exchange of e-mails between J. J. Senna and Professor Goodhart in the final days of March 2014. Charles Goodhart is Emeritus Professor of Banking and Finance with the Financial Markets Group at the London School of Economics, having previously (1987-2005) been its Deputy Director. Until his retirement in 2002, he had been the Norman Sosnow Professor of Banking and Finance at LSE, since 1985. Before then he had worked at the Bank of England for seventeen years as a monetary adviser, becoming a Chief Adviser in 1980. In 1997 he was appointed one of the external members of the Bank of England's new Monetary Policy Committee, a position he held until May 2000.

Free Banking

In your 1988 book, *The Evolution of Central Banks*, you showed that the role and functions of central banks evolved naturally and were a necessary part of any modern banking system. However, two of the main writers who had dealt with the subject several decades earlier, namely Bagehot and Vera Smith, although realizing it would be "childish" (Bagehot's word) to think of closing the Bank of England, revealed a theoretical preference for an economy without a central bank. That was the "natural" solution, they thought. In the 1970s and early 1980s, the theme was revived by studies which examined some historical experiences with free banking. The conclusion was that free banking was not as chaotic a system as was generally believed. In 1998, Greenspan somehow endorsed such interpretation. In reference to the US case he said that the system was not "as free as commonly perceived" but also not "nearly as unstable". This view may have contributed to a sort of a laissez-faire approach of some central bankers. The recent crisis probably changed that in a definitive way. Do you agree with this comment? Among the measures taken after the crisis, both locally and by the international community, which ones would you select as the most promising ones, given the objective of gaining firmer control over the banking industry? What are we still missing in that regard?

Greenspan's adherence to the Efficient Market Hypothesis (EMH) was not widely supported by central bankers outside the US. However, they had a different set of false beliefs. These were:

1) That so long as the monetary authorities maintained stable inflation, there would be no major macro-economic disturbance;

2) That so long as there was no major macro-economic disturbance, the Basel II CARs would guarantee that banks would always maintain sufficient capital to meet difficulties;

3) That so long as banks were Basel II compliant, they would always be seen as strong enough to be able to maintain sufficient wholesale funding to meet any temporary liquidity shortages.

As you know, all these three comfortable myths were proven to be mistaken in 2007/8.

There was another generally accepted error, which was that lending on property, both commercial and residential, was relatively safe, particularly in the USA, where a diversified portfolio of houses, diversified over the whole of the USA, had only shown a small decline in prices once since 1945. People, including the regulators, simply did not see the dangers from credit extension for housing. Possibly the best book on this is by Michael Lewis, 'The Big Short', where what is notable is that the people who foresaw and bet on the basis of the sub-prime crisis were all typically 'loners' who took no notice of the conventional wisdom.

One of the great pities of the regulatory ferment following the Great Financial Crisis (GFC) is that attention has been focused on the banking system rather than on the methods, forms and processes of housing finance. I have myself lived through three financial crises in the UK (1973-75, 1990-92, 2007-09), and all of these have been caused by a bank credit-fuelled housing and property boom. This boom was typically financed by standard retail banks, and the suggestion and claim that somehow the problem was due to nefarious risk-taking in investment or universal banks is, in my

view, invalid. It is true that both Bear Stearns and Lehman's were investment banks, but both got into difficulties because of their holdings of mortgage-backed securities, while their derivative books were good, and also because they were not able to access the protection of the Fed.

So I think that much of the direction of regulation since the GFC has been largely misguided, e.g. the Volcker Rules, the Vickers and Liikenen Report. I have attached a paper setting out some of my heretical views on this. ("Narratives of the Great Financial Crisis (GFC): why I am out of step").

Inflation and Financial Stability

Inflation is a monetary phenomenon and monetary policy cannot affect real variables in a permanent way. Central banks should aim basically at controlling inflation. Over the medium and long run, this is the only task they can be responsible for. Inflation targeting (IT) relies on these principles. Since the recent financial crisis did not affect the validity of these principles, the merits of IT have been kept intact. The crisis made clear, however, that we should care as much about financial stability as we care about macroeconomic stability. And there seems to be a revival of the idea that to achieve two objectives we cannot rely on a smaller number of instruments. In this case, the traditional policy instrument of the IT regime (the interest rate) would continue being managed to achieve macro stability, while macro-prudential instruments would take care of financial stability, aiming at asset prices, credit growth, etc. Speaking generally, since there are many instruments of that sort, do you think they can effectively work within the IT framework? Are we close to understanding how the "separation principle" proposed by Tinbergen can be applicable to monetary policy?

Turning to your queries about macro-prudential instruments, I think that in theory they could work within the inflation targeting framework. Indeed, the general idea currently is that price stability is managed through interest rates adjustments, while

financial stability is managed through macro-prudential instruments; and that that should deal with the two objectives, two instruments problem. Of course, macro-pru and monetary policy cannot be fully separated, with many of the instruments of macro-pru, e.g. sectoral capital requirements, impinging on the costs of intermediation, and equally some of the monetary policy instruments, such as QE having an effect on financial stability. Even so, this is no worse that the interaction between fiscal and monetary policies, and should be do-able. But there are other problems with macro-pru; for example, how do you undertake expansionary macro-pru in a depression after a financial crisis, when the micro-prudential authorities will be tightening severely? Also, macro-pru has more direct distributional effects on individual markets, e.g. the housing market, and it may be both politically difficult, and potentially damaging to central bank independence, to take measures which affect some particular financial markets rather than others.

Finally, macro-prudential instruments have not been used much in developed countries until now. With these instruments being untried and their effects uncertain, there is a danger that the monetary authorities may use these initially too timidly to have much effect.

The Funding-for-Lending Scheme

Last year, in an article published by the Financial Times, you showed concern with "the increasing desire of officials to tie monetary policy to real outcomes". That trend was "understandable", but the risk was the abandonment of the hardly-won lessons of the 1970s. A better strategy, you said, involved improving unconventional instruments of monetary policy. The article appeared some six months after the joint initiative of the Bank of England and HM Treasury to launch the funding-for-lending scheme. The banking industry had practically stopped lending to households and firms. The idea then was to stimulate such lending, by assuring funding at below-market rates to banks which effectively increased their loans. You showed sympathy for such program. If we look at the

behavior of bank credit since that time, it doesn't seem that it has been revived. After all, the stock of credit has recently grown at less than 1.0% per annum. Does this mean that that scheme has not been as successful as originally expected? Is the above-mentioned rate of credit growth a poor basis for evaluating the program? Are there lessons to be drawn from this British experiment?

As to your question about Funding for Lending (FLS), I think that it is true that FLS had less effect in encouraging bank lending to the private sector in the UK than some of its proponents, including me, had hoped. But it can always be argued that, without FLS, such lending would have declined much more steeply. Since we can never do the counter-factual of what would have happened in its absence, we can never be absolutely sure that it had less effect than had originally been hoped. Since then, bank lending to the private sector in the UK has begun to expand more rapidly, but in the shape of mortgage lending to persons, largely under the influence of the Help to Buy schemes, but not lending to SMEs; so much so has mortgage lending recovered, that FLS has now been dropped for mortgage lending, and is now only usable for SME lending.

One of the reasons why lending to SMEs has been so slow to recover is that capital requirements on such lending have been increased dramatically, as part of the exercise to raise CARs very sharply since the GFC. With such SME lending being highly risky, and requiring a lot of capital behind it, banks have been unwilling to expand such lending rapidly, except in cases where they are highly confident that they will get repaid and where the spread makes the exercise profitable. Even after the housing crash, mortgage lending in the UK is a better bet for banks than SME lending.

I do not think that policy makers or regulators handled policy, after the immediate crisis in 2008/9 had been defused, very well. I attach a final paper for you setting out my reasons for saying this. ("Why Monetary Policy has been Comparatively Ineffective?'.

External Member of the MPC

In a not so distant past, decision making in monetary policy used to be in the hands of individuals. The US is an exception, since the Federal Open Market Committee (Fomc) was created in the mid-1930s. Nowadays decision making by committee is the norm. In the case of the UK, the power to conduct monetary policy was given to a committee – the Monetary Policy Committee (MPC) – at the same time the Bank of England acquired operational autonomy, in May 1997, at the initiative of former Chancellor Gordon Brown. The MPC has an interesting structure. There are five internal officials and four external members. These four members do not have executive functions. As far as I know, such a structure is not found elsewhere. With the benefit of being a former external member of the MPC (1997-2000), how do you evaluate such an arrangement? What other activity can an external member hold while taking part in the Committee? Do you consider this an exportable idea?

There is quite a lot of literature on the optimal size of a committee; in particular Anne Sibert has written on this subject (you could look up the reference if you want to do so). For those central banks where there are a large number of participating members, i.e. the FOMC with the Reserve Bank Presidents, and the ECB with the NSB Governors, there is clearly no room for further (external) members.

In several other countries externals, commonly in the form of economists, either academic or business economists, are co-opted onto the decision-making committee, but in such cases they frequently are also given some degree of internal executive function. Examples are the Bank of Japan and the Riksbank. In other countries where the decision-making is more narrowly held, e.g. Canada and New Zealand, the Governor will frequently assemble meetings, including outsiders, to take advice prior to the Governor's decision.

The Bank of England is only unique therefore in having externals who have no other function. My own experience suggests that this duty only takes up about half of one's

time, more than half in the month in which a forecast is being made, and less than half in the non-forecast month. Even so, meetings are frequently arranged, or rearranged, at short notice, which the external really needs to attend, and that makes it very difficult to undertake any other allowable activity, because one is so often having to reschedule. Indeed it would be impossible to do so unless one lived and worked close to the Central Bank.

Because of confidentiality, allowable outside work is really limited to non-commercial activities such as teaching, charitable work or various kinds of administration. I continued to teach at LSE while on the MPC, partly because LSE was so close to the Bank; but Willem Buiter, who was then teaching at Cambridge found that impossible. Since my time, I believe that no other external has continued with part-time academic work, though some have been able to do various work on behalf of government; I think that Kate Barker did her report on the housing market for the Labour Government while still a member of the MPC. Of course externals do undertake, and are sometimes expected to undertake, economic research while serving on the MPC. A good example of that is David Miles' article in the Economic Journal a couple of years ago on the optimal regulatory capital.

There are advantages and disadvantages in having externals without any other executive function in a central bank. It enables the externals to play a much larger role in forecasting, which otherwise would probably fall primarily to the staff. Note that the Bank of England's forecast is the responsibility of the MPC, not of the Bank's staff; whereas in most other central bank committees the forecast is that of the staff, not of the committee. On the other hand it provides an imbalance in the forecasting process between the externals, who can play a larger role, and the internals who are otherwise preoccupied with their executive duties. Furthermore, it does not fully utilise the available time of all external members; though note that no external has ever chosen to depart, because they were not fully used.