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BRITISH ACADEMY

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MADAM,

When Your Majesty visited the London School of Economics last November, you quite rightly asked: why had nobody noticed that the credit crunch was on its way? The British Academy convened a forum on 17 June 2009 to debate your question, with contributions from a range of experts from business, the City, its regulators, academia, and government. This letter summarises the views of the participants and the factors that they cited in our discussion, and we hope that it offers an answer to your question.

Many people did foresee the crisis. However, the exact form that it would take and the timing of its onset and ferocity were foreseen by nobody. What matters in such circumstances is not just to predict the nature of the problem but also its timing. And there is also finding the will to act and being sure that authorities have as part of their powers the right instruments to bring to bear on the problem.

There were many warnings about imbalances in financial markets and in the global economy. For example, the Bank of International Settlements expressed repeated concerns that risks did not seem to be properly reflected in financial markets. Our own Bank of England issued many warnings about this in their bi-annual Financial Stability Reports. Risk management was considered an important part of financial markets. One of our major banks, now mainly in public ownership, reputedly had 4000 risk managers. But the difficulty was seeing the risk to the system as a whole rather than to any specific financial instrument or loan. Risk calculations were most often confined to slices of financial activity, using some of the best mathematical minds in our country and abroad. But they frequently lost sight of the bigger picture.

Many were also concerned about imbalances in the global economy. We had enjoyed a period of unprecedented global expansion which had seen many people in poor countries, particularly China and India, improving their living standards. But this prosperity had led to what is now known as the 'global savings glut'. This led to very low returns on safer long-term investments which, in turn, led many investors to seek higher returns at the expense of greater risk. Countries like the UK and the USA benefited from the rise of China which lowered the cost of many goods that we buy, and through ready access to capital in the financial system it was easy for UK households and businesses to borrow. This in turn fuelled the increase in house prices both here and in the USA. There were many who warned of the dangers of this.

But against those who warned, most were convinced that banks knew what they were doing. They believed that the financial wizards had found new and clever ways of managing risks. Indeed, some claimed to have so dispersed them through an array of novel financial instruments that they had virtually removed them. It is difficult to recall a greater example of wishful thinking combined with hubris. There was a firm belief, too, that financial markets had changed. And politicians of all types were charmed by the market. These views were abetted by financial and economic models that were good at predicting the short-term and small risks, but few were equipped to say what would happen when things went wrong as they have. People trusted the banks whose boards and senior executives were packed with globally recruited talent and their non-executive directors included those with proven track records in public life. Nobody wanted to believe that their judgement could be faulty or that they were unable competently to scrutinise the risks in the organisations that they managed. A generation of bankers and financiers deceived themselves and those who thought that they were the pace-making engineers of advanced economies.

All this exposed the difficulties of slowing the progression of such developments in the presence of a general ‘feel-good’ factor. Households benefited from low unemployment, cheap consumer goods and ready credit. Businesses benefited from lower borrowing costs. Bankers were earning bumper bonuses and expanding their business around the world. The government benefited from high tax revenues enabling them to increase public spending on schools and hospitals. This was bound to create a psychology of denial. It was a cycle fuelled, in significant measure, not by virtue but by delusion.

Among the authorities charged with managing these risks, there were difficulties too. Some say that their job should have been ‘to take away the punch bowl when the party was in full swing’. But that assumes that they had the instruments needed to do this. General pressure was for more lax regulation – a light touch. The City of London (and the Financial Services Authority) was praised as a paragon of global financial regulation for this reason.

There was a broad consensus that it was better to deal with the aftermath of bubbles in stock markets and housing markets than to try to head them off in advance. Credence was given to this view by the experience, especially in the USA, after the turn of the millennium when a recession was more or less avoided after the ‘dot com’ bubble burst. This fuelled the view that we could bail out the economy after the event.

Inflation remained low and created no warning sign of an economy that was overheating. The Bank of England Monetary Policy Committee had helped to deliver an unprecedented period of low and stable inflation in line with its mandate. But this meant that interest rates were low by historical standards. And some said that policy was therefore not sufficiently geared towards heading off the risks. Some countries did raise interest rates to ‘lean against the wind’. But on the whole, the prevailing view was that monetary policy was best used to prevent inflation and not to control wider imbalances in the economy.

So where was the problem? Everyone seemed to be doing their own job properly on its own merit. And according to standard measures of success, they were often doing it well. The failure was to see how collectively this added up to a series of interconnected imbalances over which no single authority had jurisdiction. This, combined with the psychology of herding and the mantra of financial and policy gurus, lead to a dangerous recipe. Individual risks may rightly have been viewed as small, but the risk to the system as a whole was vast.

So in summary, Your Majesty, the failure to foresee the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole.

Given the forecasting failure at the heart of your enquiry, the British Academy is giving some thought to how your Crown servants in the Treasury, the Cabinet Office and the Department for Business, Innovation & Skills, as well as the Bank of England and the Financial Services Authority might develop a new, shared horizon-scanning capability so that you never need to ask your question again. The Academy will be hosting another seminar to examine the 'never again' question more widely. We will report the findings to Your Majesty. The events of the past year have delivered a salutary shock. Whether it will turn out to have been a beneficial one will depend on the candour with which we dissect the lessons and apply them in future.

We have the honour to remain, Madam,
Your Majesty's most humble and obedient servants

Professor Tim Besley, FBA

Professor Peter Hennessy, FBA

British Academy Forum, 17 June 2009

The Global Financial Crisis – Why Didn't Anybody Notice?

List of Participants

Professor Tim Besley, FBA, London School of Economics; Bank of England Monetary Policy Committee
Professor Christopher Bliss, FBA, University of Oxford
Professor Vernon Bogdanor, FBA, University of Oxford
Sir Samuel Brittan, *Financial Times*
Sir Alan Budd
Dr Jenny Corbett, University of Oxford
Professor Andrew Gamble, FBA, University of Cambridge
Sir John Gieve, Harvard Kennedy School
Professor Charles Goodhart, FBA, London School of Economics
Dr David Halpern, Institute for Government
Professor José Harris, FBA, University of Oxford
Mr Rupert Harrison, Economic Adviser to the Shadow Chancellor
Professor Peter Hennessy, FBA, Queen Mary, University of London
Professor Geoffrey Hosking, FBA, University College London
Dr Thomas Huertas, Financial Services Authority
Mr William Keegan, *The Observer*
Mr Stephen King, HSBC
Professor Michael Lipton, FBA, University of Sussex
Rt Hon John McFall, MP, Commons Treasury Committee
Sir Nicholas Macpherson, HM Treasury
Mr Bill Martin, University of Cambridge
Mr David Miles, Bank of England Monetary Policy Committee
Sir Gus O'Donnell, Secretary of the Cabinet
Mr Jim O'Neill, Goldman Sachs
Sir James Sassoon
Rt Hon Clare Short, MP
Mr Paul Tucker, Bank of England
Dr Sushil Wadhwani, Wadhwani Asset Management LLP
Professor Ken Wallis, FBA, University of Warwick
Sir Douglas Wass
Mr James Watson, Department for Business, Innovation and Skills
Mr Martin Weale, National Institute of Economic and Social Research
Professor Shujie Yao, University of Nottingham