

Financial and Economic Horizon-scanning

MADAM,

On 22 July 2009, the British Academy wrote a letter to you following its forum held on 17 June 2009, which had been devoted to answering the question you had posed at the London School of Economics the previous November about why nobody had noticed that the credit crunch was on its way.¹ In that letter, we mentioned an intention to convene another British Academy forum on financial and economic horizon-scanning capabilities, to examine what your Crown servants could do 'so that you never need to ask your question at LSE again'. Your Private Secretary kindly wrote back to us on 30 July, indicating your interest in our project. A second forum was held on 15 December 2009, and this letter is an account of the flow of thought and debate.

Horizon-scanning is distinct from forecasting. As we have seen in recent events, the challenge is about understanding discontinuities, and forecasts cannot cope with that. Creating scenarios has a role to play in emphasising that there are genuine uncertainties which cannot be quantified. But, for this to be effective, it is absolutely essential to ask the right questions and to have sufficient imagination. Effective horizon-scanning has both cultural and institutional components. There is a need to develop a culture of questioning in which no assumption is accepted without scepticism and a sufficiently broad

In December 2009 a British Academy Forum considered what steps might be taken by government agencies to anticipate and prepare for any future shocks to the financial system and the global economy. The two convenors of the Forum, Professor Tim Besley FBA and Professor Peter Hennessy FBA, summarised the discussion in a letter sent to Her Majesty The Queen on 8 February 2010.

array of outcomes is considered. But that comes to nothing unless the process is institutionalised within a body that pulls together these ideas and is responsible for drawing general lessons and concerns.

It is evident from our answer to your earlier enquiry that the UK had not been well-served by warning signs on the road to events of 2008. For example, the Standing Committee staffed jointly by the Treasury, the Bank of England and the Financial Services Authority (FSA), whose purpose, as one of our participants put it, was 'to spot risk coming down the track and act upon it', failed to do so. The FSA, we were told, 'spent much of the decade looking at the conduct of business issues. The Bank of England was very focused on monetary policy and indeed pared back its financial stability wing ... [and] ... the Treasury, which was ultimately responsible for bringing all this together, and therefore should have been able to spot the risks, failed to do so as well.'

Besides the Treasury, the Bank of England and the FSA, other organs of government were voicing their concerns about unfolding events. In their major analysis of *Strategic Trends* published in 2003, the staff of

Figure 1. Professor Tim Besley FBA and Professor Peter Hennessy FBA, the two signatories of the letter sent to The Queen on 8 February 2010. Photo: David Graeme-Baker.



the Ministry of Defence's Joint Doctrine & Concepts Centre at Shrivenham (since re-labelled as the Development, Concepts and Doctrine Centre) warned: 'The relative risks of economic shocks having major detrimental impacts on states is likely to increase. This is one of the potential perils of globalisation. Difficulties in one part of the global system will have a wider impact due to deepening integration



Figure 2. At the British Academy Forum in December 2009, Sir Nicholas Macpherson, Permanent Secretary to the Treasury, contributed a frank 'on the record' critique of some of the lessons learned by Britain's financial authorities during the current crisis. Photo: David Graeme-Baker.

but equally the room for error in domestic policy decisions will reduce due to more mobile capital and more transparent information on national policy and performance. The impacts of such crises are likely to be increasingly severe in terms of national prosperity and potentially more likely to precipitate knock-on consequences for other closely dependent states.' And in a 2006 paper 'Financial Fragility Exposed by a Sudden Interest Rate Shock', the Horizon-Scanning Centre of the Government Office for Science (now part of the Department for Business, Innovation and Skills) examined the dangers of 'the explosive growth of the global capital market on the back of securitisation and derivatives which has meant that regulators have found it hard to keep up with the multitude of new instruments and the attendant risks involved.' But, as we emphasised in our earlier letter, it is not enough to see the problem. It is essential to understand the timing and magnitude of likely consequences and to have a proper response to these difficulties prepared. And without an institution to draw together intelligence across relevant institutions, there was little scope for a complete picture to be formed.

To be fair to the Treasury/FSA/Bank of England Standing Committee, they did mount a dry-run in 2005 of what would happen if a bank failed, although the legislation needed to improve the existing bank-failure regime was not regarded as a priority and did not materialise. Since the onset of the crisis, the Standing Committee has concentrated powerfully on horizon-scanning. However, the unprecedented nature of the events has made it very difficult to do so with any precise analysis of the likely prognosis for the economy. The Treasury too has reviewed its capabilities and its managing director on the international side now chairs a group which brings together all of its risk-management/horizon-scanning elements. The Treasury also has taken steps to increase in-house challenge to existing assumptions and analyses.

The British Academy forum reflected a consensus on the need for improvement. However, when it comes to the economy one has to be realistic about what can be achieved. Economies are inevitably unstable and it is a dangerous conceit to believe that economic cycles can be eliminated. However, it is essential for the organs of government to be readied and armed with the best intelligence.

Those who emphasised cultural change argued that the best chance of avoiding the need to repeat your LSE question lies in quickening the sensitivities and states of mind of those charged with trying to anticipate what economic and financial shocks may occur in future. This can only happen where there is an environment which provides sufficient criticism of assumptions and is open to considering a wide range of possibilities. The hierarchical structures and histories of our many organisations provide a major challenge to making this work effectively. It was even suggested that there should be a rule that allows nobody to work in a particular position of responsibility for more than eight years.

Others thought the lessons of the past – not least the difficulty the Cabinet Office's Joint Intelligence Committee has had over several decades with the acquisition, handling and dissemination of economic information – suggested that a more bespoke institutional arrangement might help in future; perhaps a Unit or Group charged with pulling together all the relevant information from the existing wider institutional churn. Some saw merit in a combination of cultural and institutional reform.

All recognised the difficulty of scenario building in this area and the particular sensitivity of financial information. This has long bedevilled the wider dissemination of the most delicate economic information, for fear of both leaks and the consequences of such leaks (precipitating precisely those events the horizon-scanners and policy-makers most feared, in terms of runs on the currency or institutional failure). It is for this reason that the Bank of England's monthly *World Risk Briefing* does not pass beyond its formidable walls. The age of freedom of information adds still more peril. Nonetheless, your senior Crown servants at the forum professed a willingness to try.

To be candid, Your Majesty, your Ministerial servants were seen by some as an extra cause of anxiety. It was often very hard to persuade them to become properly involved in horizon-scanning. Some found it too gloomy; others saw the contingencies covered to be too remote. Sometimes involving Ministers in exercises related to horizon-scanning and the resultant contingency planning helped, but not all were keen to devote time to these. Attracting and retaining the attention of busy senior policy advisers and decision-takers remains a perennial problem.

There was a general reluctance at the forum to endorse a proposal to produce a regular horizon-scanning summary, drawing on all providers for the purpose of making maximum use of the information and the thought swirling around in the various parts of your Crown services. Nobody volunteered either individually or institutionally to lead this task and there was scepticism about the ability to institutionalise such activity within government within current structures.

In the end, the major challenge is to make institutions and organisational cultures work together. This means also getting the right people involved who see the task as a central part of their role in government. One can have as much scenario planning as one likes, but if there is no buy in from the people who will be taking the decisions in a crisis, then it is probably counterproductive. As you can see, there are no simple answers.

So, we end with a modest proposal. If you, Your Majesty, were to ask for a monthly economic and financial horizon-scanning summary from, say, the Cabinet Office, it could hardly be refused. It might take a form comparable to the Joint Intelligence Committee's 'Red Book', which you received each week from 1952 until 2008 when it was abandoned. And, if this were to happen, the spirit of your LSE question would suffuse still more those of your Crown servants tasked to defend, preserve and enhance the economic well-being of your country.

We have the honour to remain, Madam,

Your Majesty's most humble and obedient servants

Professor Tim Besley, FBA

Professor Peter Hennessy, FBA



Figure 3. This cartoon by Kipper Williams from the 'Guardian' website represents an extreme interpretation of the proposal that The Queen should ask for a monthly economic and financial horizon-scanning summary, as a way of concentrating the minds of government officials. Image: guardian.co.uk, 10 February 2010.

British Academy Forum on 'Financial and economic horizon-scanning: developing an early warning capacity'

Full list of participants:

Alex Allan (Joint Intelligence Committee)

Professor Tim Besley FBA (London School of Economics)

Professor Richard Brealey FBA (London Business School)

Gareth Davies (Strategy Unit, Cabinet Office)

Dr Jon Davis (Queen Mary, University of London)

Alun Evans (Department for Business, Innovation and Skills)

Sir John Gieve (formerly of the Bank of England)

Ian Ginsberg (HM Treasury)

Dr Simon Griffiths (British Academy)

Dr Catherine Haddon (Institute for Government)

Professor Peter Hennessy FBA (Queen Mary, University of London)

Rosaleen Hughes (Queen Mary, University of London)

Dr Gregor Irwin (Foreign and Commonwealth Office)

Sir Nicholas Macpherson (HM Treasury)

Paul Mayo (Department for Business, Innovation and Skills)

Dr Lynette Nusbacher (Strategic Horizons Unit, Cabinet Office)

Professor George Peden (University of Stirling)

Jonathan Portes (Cabinet Office)

Peter Riddell (*The Times*; Institute for Government)

Sir Adam Roberts (President of the British Academy)

Lord Turnbull (former Secretary of the Cabinet)

Dr Harry Woodroof (Department for Business, Innovation and Skills)

Note

1 The text of the July 2009 letter to The Queen was published in the *British Academy Review*, issue 14 (November 2009).