

## **Crisis what crisis?**

Andrew Haldane, my old friend and colleague for many years on the Bank of England's Monetary Policy Committee, seems very worried about the "crisis" in economics. ("Economists hit back at Haldane amid search for answers to forecasting woes", Financial Times January 7<sup>th</sup>-8<sup>th</sup> ). But what is this "crisis"? Did it manifest itself in a failure to predict a real crisis, that in the financial sector that came in 2007-08?

If existing economic theory told us that such events should be predictable then maybe there is a crisis. But it is obvious that economics says no such thing. In fact, to the extent that economics says anything about the timing of such events it is that they are virtually impossible to predict; impossible to predict but most definitely not impossible. Any criticism of "economics" that rests on its failure to predict the crisis of 2007-08 is no more plausible than the idea that statistical theory needs to be re-written because mathematicians have a poor record at predicting winning lottery ticket numbers.

Existing economic theory is based on the idea that people respond in their own perceived best interest to the incentives that their economic environment creates. This basic idea does a good job in explaining the financial crisis, though not its precise timing. Banks, and some other financial institutions, perceived correctly the advantages to them of very high leverage (or gearing) in a world where their shareholders had limited liability to face the consequences of losses and where the tax system favoured debt. Regulators – faced with uncertainty about the precise nature of risks and strong political pressure not to increase bank capital (reflecting intense lobbying of politicians) – set low requirements and hoped for the best. While the best lasted, economies did well and politicians in charge looked wise. Then the best stopped happening.

There is no need to re-write economic theory to account for all this. The Nobel prizes had already been handed out long before to economists who worked out the tendency towards excessive risk taking that high leverage and shareholder limited liability creates. The textbooks were full of accounts of how bank runs could happen as people responded perfectly sensibly to the possibility of losses in banks that had high leverage. And there were numerous books and articles on the incentives to lobby and the ways it affects the decisions of public officials with limited time horizons and no more than average determination and courage.

The idea that economic theory said that market outcomes were always efficient and that financial crises would not happen is so far removed from reality as to not even be in a distant universe. Economics textbooks have for decades devoted massively more pages to analysis of market failures and fluctuations in economies than to showing that market outcomes can be efficient and growth stable. For fifty years Nobel prizes have largely gone to those whose main work was in exploring the ways in which free market outcomes can sometimes generate poor results.

As regards the more recent and parochial issue of the Bank of England's central forecast underestimating the strength of the UK economy since the referendum, this is really a non-

event. If there is any lesson it is to acknowledge that forecasts of the short-term impact of an event whose ultimate impact on the economy is very hard to know are not to be relied on. But who exactly did not know that already?

So my colleague Andy Haldane should worry less about a crisis in economics and instead enjoy reading the best of it that has been written. I certainly found it rather useful when I was on the mpc and I hope he will too.

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