



A ringside view of the financial crisis

The continuing effects of the financial crisis demand a combination of introspection and radical thinking from the world's economists, an audience at GEP has heard.

David Fenton, Senior Economist at the Royal Bank of Scotland, admitted experts around the globe "failed to join the dots" in the run-up to the meltdown of four years ago.

He also suggested that radical potential solutions – including the concept of debt forgiveness – might have to be considered if a sustained recovery does not take hold.

Mr Fenton visited GEP on the day it was revealed UK Business Secretary Vince Cable has floated the idea of RBS becoming a dedicated lender to British businesses.

Mr Cable claimed the bank, which was bailed out by the Treasury in 2008, would thus help tackle the lack of finance being made available to small businesses. Mr Fenton pointed out that last year RBS accounted for 48 pence of every pound lent to small businesses.

Delivering a Leverhulme Globalisation Lecture, Mr Fenton, who joined RBS 10 years ago, admitted he had experienced RBS's "glory days and not so glorious days".

The first question when reflecting on the crisis, he said, was famously posed by the Queen when she visited the London School of Economics in 2008: "How did everybody miss it?"

He told a packed audience: "Let's consider where we were at 10 years ago. The world had just had 9/11, the dotcom bust, the Enron crisis and the Argentinean crisis.

"Even so, quite a few people had the nagging suspicion that the interest rates from the world's Central Banks were too low – that the Greenspan 'put' was a shot in the foot."

Mr Fenton said applying the Taylor Rule, which seeks to guide Central Bank policy, showed rates had been "too low for far too long" – particularly in the US.

He added: "I don't want to suggest for a moment that the crisis was purely down to Central Bank interest rates. They eventually began raising them.

"But at about the same time banks began reducing their margins. They were moving in completely the opposite direction, which was blunting the impact."

Mr Fenton argued that one of the fundamental failings that allowed the housing bubble to develop and the debt crisis to build was "the whole notion of the Great Moderation".

He said: "We were swept up in the idea that we'd got so much better at monetary policy. It encouraged the view that there had been a paradigm shift – we hadn't got rid of boom and bust, but things were more stable.

David Fenton

David Fenton is a Senior Economist with the RBS Group, based in Edinburgh. He joined the Group in 2002, having previously worked for Ernst & Young's Project Finance team in Manchester. He has a Masters degree in Economics from the University of Glasgow.

7 March 2012

“What we’ve seen since is that the Great Moderation was a bit of an illusion. The notion that we vanquished the business cycle has clearly been dispelled.”

The use of mean-reverting econometric models was also a key contributor to the general failure to predict the severity of the crisis, claimed Mr Fenton.

He said: “The models we had back then were really poorly suited for the kind of stress-testing that was needed. They also attributed almost no role to credit flows – they were very much founded on the real economy.

“That was a massive blind spot to have. We were scanning the horizon, looking for kitchen sinks coming our way. In the end the trigger was something much more subtle – the US sub-prime market”.

Mr Fenton said the entry into the euro of nations such as Greece, which were soon able to “borrow as if they were Germany”, also fuelled the meltdown.

He added: “As economists, we perhaps shouldn’t be too tough on ourselves. I think we saw quite a lot of the risks. But what we failed to do was join the dots.”

Mr Fenton said the likeliest scenario now – and one on which most forecasts agree – is a period of extremely gradual, U-shaped recovery over the course of many years.

The speed of that recovery in the UK, he suggested, would depend heavily on “significant movement” in surplus among non-financial companies and the rest of the world.

He explained: “That’s what’s needed if government debt is to be reduced. That’s not economics – it’s simple arithmetic, because the flow of funds is a zero-sum game.

“Unfortunately, falling demand in the eurozone has hurt us. And we don’t export much to the emerging economies, for the simple reason that we don’t make what they want.

“It therefore seems fanciful to me to expect a significant decrease in this surplus. That means austerity is going to be with us for five, six, seven years.”

Mr Fenton warned that the UK economy currently bears alarming similarities to that of Japan in the mid-1990s – a situation he described as “quite frightening”.

He said: “I’m not saying what happened to Japan is our fate, but if it is then we would need a complete rethink of macro policy – and we really need to get quite radical.”

This, he said, might include a huge fiscal stimulus and debt forgiveness. “There’s a massive moral issue here. How do we feel about ‘forgiving’ countries that took on too much debt and will never be able to pay it all back?”

Asked if it might now be a slightly more hopeful case of “the darkest hour before the dawn”, he added: “I’m crossing my fingers, but I’m not holding my breath.

“Of course, I’m an economist and Scottish, so I’m naturally pessimistic – but let’s not kid ourselves that this is over.”

He concluded: “There needs to be some introspection among professionals and academics about the lessons we can learn.

“Mean-reverting models are great in normal times but not for scenario-planning. We have to find new ways to reflect on what these tension points are trying to tell us.

Globalisation and Economic Policy Centre (GEP)

Based at the University of Nottingham in the UK and primarily funded by grants from the Leverhulme Trust, GEP is the major centre in Europe studying the impacts of globalisation and economic policy.

In January 2008 it opened GEP in Malaysia at the University of Nottingham’s purpose-built Semenyih campus, 30km from Kuala Lumpur. In November 2008 it launched GEP in China at the University of Nottingham, Ningbo, China.

GEP is keen to promote its research work and is committed to communicating its expertise. Its academics have advised the Treasury, the OECD, the World Bank and the WTO.

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“It’s also going to be more challenging for banks to generate the profits they’ve been used to. To succeed we need to be focused on our customers. We are spending huge amounts of time and energy and money taking cost out of the business and reinvesting that cost in improved customer service.

“This has to be our focus for decades into the future and will be the key to the job that we have to do for society.”

GEP’s Director, Professor Daniel Bernhofen, thanked Mr Fenton on behalf of the Nottingham School of Economics and described his lecture, entitled A Ringside View of the Economic Crisis, as “very insightful”.

GEP lectures

GEP hosts a number of public lecture series.

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