Innovation and the global financial crisis – systemic consequences of incompetence

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Synopsis

The article applies the concept of incompetence by Polanyi (1962) and the concept of unintended consequences by Merton (1936) to explore the development of a radical financial innovation: securitisation.

Massive data were collected by banks to a) develop the new financial products; b) by investors to predict the outcome for their investments, and; c) by the regulators in order to monitor of the markets. All three failed. Why?

The innovation changed the context for all actors in the financial industry so rapidly and to such a degree that a) the statistical models used for product development rapidly became outdated; b) the systems of data collection were based on yesterday’s industry structure. Hence, even the highest regarded experts, (for instance, Nobel award laureates) repeatedly made prediction errors and unwittingly led the banking industry to global meltdown. The negative effects of prediction errors gradually increased since 1980 until today when even a single individual decision by a portfolio manager may risk global financial mayhem.

They had become what I call temporarily incompetent. Societies are still six years after the crash living with the unintended consequences of their prediction errors.

The conclusion is that despite the massive data available and collected, financial innovation has become a lot riskier than is commonly appreciated in economic theory and practice. Our limited ability to foresee the consequences of our actions are fundamental to innovation and product development. Unintended and undesired outcomes should be acknowledged as an untapped resource for improving the net effects of innovation. The article suggests approaches to deal with the risk.