

## “The Varieties of Economic Experience”

### Introduction

Welcome to the first Quarterly Report published by Kaleidic Economics – a London-based business roundtable that launched in August 2011. The purpose of these reports is to record some of the key points of discussion within the meeting, and to provide the general business community with a source of new and novel thinking.

The first meeting was devoted to methodology – to understanding the scenario method and begin our long-term efforts to build scenarios that capture important trends in the UK economy. This inaugural quarterly report will do three things: explain why we exist; why we use the scenarios; and what the key questions are that we intend to answer.

### Why we exist

All organisations that produce economic reports attempt to simplify the world they inhabit. The difficulty lies in the choice of methods by which we do so. Our concern is that the construction of economic models can *over* simplify, or at least simplify by means of abstracting from some of the important sources of complexity that should be confronted. Such models are part and parcel of the logically positivist mindset that characterised traditional economics. In this view “explaining and forecasting events are logically and methodologically identical. If you are able to explain then you are able to predict” (Paul Dragos Aligica<sup>1</sup>). However we take an alternative approach, focusing more on economics as a rigorous social science than as a pseudo natural science. In this case the purpose of analysis is not explanation, but *understanding*. And understanding does not imply the ability to *predict*. We do not intend to provide rival economic forecasts, and join a debate around whether next quarter GDP will be 0.5% or 0.8%. There is an important role for this, but our focus is on providing a framework for judgment that businesspeople can use to make sense of the world around them.

The practice of business forecasting has a tendency to underplay the role of uncertainty because quantitative techniques encourage people to think in probabilistic terms. Based on the work of Frank

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<sup>1</sup> Aligica, P.D., *Prophecies of Doom and Scenarios of Progress: Herman Kahn, Julian Simon and the Prospective Imagination*. New York: Continuum, 2007.

Knight<sup>2</sup> and Ludwig von Mises<sup>3</sup> we take the concept of uncertainty seriously. The vast majority of business decisions are played out in a sphere of fundamentally incalculable uncertainty. Attempts to characterise this with probability theory is not only theoretically flawed, but creates a real danger of blind spots and false confidence. Since uncertainty cannot be quantified, our empirical relevance is more focused on histories and analytic narratives. The experience of the past can be utilised to make sense of the present, whilst being conscious of the fact that it can be seemingly small differences in context that can have large explanatory power. Indeed,

“it is quite reasonable to agree with Heraclitus that you can’t step into the same river twice while at the same time agreeing with Ecclesiastes that there is nothing new under the sun.”  
(Richard E. Wagner<sup>4</sup>)

### Why scenarios

We feel that there is room in the landscape for other methods and other perspectives, in particular the construction of scenarios. As Ged Davis says, “At times, the world can look so complex and unpredictable that it becomes hard to make decisions. Scenario building is a discipline for breaking through this barrier.”<sup>5</sup> This is done by creating “alternative futures” - different plotlines that combine an array of political, economic, social and technological factors in order to order your perceptions. Rather than attempt to predict a most likely future, scenarios encourage practitioners to consider a broad array of possible futures and prepare for them all. This allows us to respond to the future as it emerges – making us prepared for the future because in some senses we have already seen it.

The construction of scenarios requires a hospitable climate in which people with diverse views share novel sources of information. The main goal is to separate the “predetermined elements” – outcomes that will come true in any conceivable scenario, with “critical uncertainties”. It is the identification of these uncertainties that can focus attention on how things develop, and prepare us for the future.

In some circles scenarios have a bad reputation, and as with any management fad it’s important to separate the core idea and the methods of implementation. We will desperately seek to avoid the common trap of constructing “optimistic”, “pessimistic” and “most likely” plotlines, and think creatively about the driving forces around us. Indeed we can consider the “stress tests” performed on the banks as a classic example of ineffectual scenario planning. Tweaking the parameters of a model based on slight deviations from a trend is not what we are trying to accomplish. If a banking meltdown fails to occur across a range of potential scenarios, then the scenario planning is incomplete.

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<sup>2</sup> Knight, F., *Risk, Uncertainty and Profit*, Hart, Schaffner & Marx, 1921

<sup>3</sup> Mises, Lv, *Human Action*, Yale University Press, 1949

<sup>4</sup> Wagner, R.E., “Finding Social Dilemma: South of Babel, not East of Eden” Mercatus Center at George Mason University, Working Paper 87

<sup>5</sup> See [http://www.shell.com/home/content/aboutshell-en/our\\_strategy/shell\\_global\\_scenarios/what\\_are\\_scenarios/what\\_are\\_scenarios\\_30102006.html](http://www.shell.com/home/content/aboutshell-en/our_strategy/shell_global_scenarios/what_are_scenarios/what_are_scenarios_30102006.html)

## Key questions

In order to start the process of building scenarios we discussed the types of questions that the roundtable intends understand. The key question, which Kaleidic Economics is focused on answering, is the following:

*What will happen to the UK economy over the medium to long term?*

This question is deliberately broad, and will be influenced by a multitude of factors. We'd rather confront a complex problem front on, than oversimplify it at the beginning. Therefore to make it more manageable we must consider a number of more detailed questions, each of which have their own sub questions, such as:

- *What will happen to the Euro?*  
If the Euro does collapse then how will this occur? Will the likes of Greece be forced to leave, or would the stronger countries like Germany depart? Would the project unravel so that countries return to their previous currencies, or would it go beyond this with regional currencies? Might leaving the Euro be like leaving the ERM, and possibly a blessing in disguise? How would this impact the banking system? What *type* of money might replace the Euro? Might we reinvent currency competition through new technologies?
- *What will happen to the EU?*  
Will the sovereign debt crisis lead to a break up of the EU or will it actually provide rationale for a fiscal unification?
- *Will the UK retain its reputation as a safe haven?*  
What would happen if UK gilts were downgraded by ratings agencies? How much leeway to policy makers have with markets – are they on the verge of abandoning the UK or can the UK emerge as a relatively safe haven within Europe?
- *How will technology changes affect the UK economy?*  
What is the potential for new technologies to influence the economy? Are we on the verge of innovation in energy to lead to the end of peak oil and reliance on unstable political regimes? Or might there be a negative shock such as an epidemic or stifling of innovation?
- *What kind of defaults will occur?*  
Will the government be able to maintain a policy of gradual currency debasement, or will inflation expectations being to rise? Will there be an outright default on debt, or more subtle forms of default such as maturity extensions, voluntary haircuts, or write offs?
- *Where are the opportunities for growth?*  
If the size of government has increased to such an extent that its choking growth, then there are massive potential gains from liberalisation. Can policy changes unleash the creative forces of entrepreneurship?
- *Will there be a double dip recession?*  
If tax receipts begin to fall and the OBR's expected growth fail to materialise what will be the political impact of a double dip recession? Will the credibility of the government's economy

policy be ruined? Or will this signal to those waiting on the sidelines that the adjustments are finally taking place?

- *How will the structure of the UK economy change?*

Will financial services be severely crippled by the banking crisis, or buoyed? Will populist policy lead to exodus of bankers from London or will it be seen as a haven? Will the increasing costs of SEC requirements lead to UK banks avoiding US clients? Will currency devaluation boost exports? Will manufacturing grow? Will new technology impact agriculture?

- *What will be the external policy influences?*

Will wider policy trends (e.g a Tobin tax, flat taxes, the Tea Party, etc) influence the climate of opinion in the UK? Given how dependent the FTSE100 is on profits earned overseas, how will policy responses in those countries influence the UK? What will happen to the trade balance? How will the carry trade respond to interest decisions by foreign central banks?

- *What will happen to the global economy?*

How will changes to the US or Chinese economies influence the UK? Where are the emerging markets going to come from? Will the rule of law develop in countries with vast economic potential?

There is no end to how much detail we can go down to, and at some point a trade off between applicability and usability needs to be made. But given that we are at the early stages of our scenario building, we will leave these as open issues that can be added to over time.

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Kaleidic Economics is a business roundtable that meets each quarter in London. For more information: <http://kaleidic.org>

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