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The History of the Financial Markets Group

In 2017, the Financial Markets Group, founded in 1987 by Mervyn King and myself at the London School of Economics, celebrated its thirtieth birthday. To mark that occasion, Kathleen Tyson and I have produced an e-book, *A Brief Affectionate History of the Financial Markets Group*, (ISBN: 1986226328), with a huge debt of gratitude to the institutional memory maintained by David Webb, who was Director for many of these years, from 1991 until 2009, and for the support and Foreword of Lord King. The contents include chapters on 'The Running and Management of the FMG', 'The Researchers who Passed Through our Portals', and 'The Discussion and Special Papers' which were produced, some 750+ of the DPs and 230+ of the SPs. However, much of this will be primarily of interest to those directly involved with the FMG.

For everyone else, I would like to reprise two themes which I touched on briefly in the book. The first is the changing nature of academic research in finance and macro-economics; and the second is the widening divorce between finance and macro-monetary economics, a division which the FMG was partially founded to counteract. I left academic work at LSE in 1968 to join the Bank of England. Prior to that time, most research had been done by individual economists, working alone in their own time, financed by their basic academic salaries. Data were quite sparse and inconsistently recorded, and computing technology rudimentary, e.g. log tables; graphs and charts were used; simple correlations rather than multiple regressions. Offices for researchers, where they existed, would contain a calculating machine that passed physically across the table when doing long division, and universities had a single computer with turnaround times measured in days rather than seconds. The Internet and email did not exist. The preferred output was the single-authored book. A PhD was not a required entry card to an academic career in UK universities.

By the 1980s the research environment had greatly changed. Joint research efforts had become the norm, often a more senior academic, e.g. Professor or Senior Lecturer, working with a junior colleague, or, more often, a PhD candidate working under their supervision. A PhD degree had become a required entry card to an academic career. Data were multiplying rapidly; the shift from

sparse data to big data occurred over no more than five decades, and financial data reporting standards made aggregation and comparison practical to an extent previously impossible. Computer availability and capabilities were growing at an even faster rate. The personal computer was born, if not yet ubiquitous. Econometrics emerged as a distinct discipline.

Putting together a group of senior, junior and PhD research-level economists, with Information Technology (IT) and specialised econometric support, therefore became highly desirable, if not essential, as a way of enabling a productive research program, whose preferred output had by then become the specialised economic journal, whose relative rankings and prestige were widely observed. But such a group needed administrative support. Moreover, all this, the admin staff, the computers, the scarce room space, financial support for junior research staff, and some buy-out of teaching requirements for more senior staff, was expensive; so external funding was required, whether, or not, the university itself provided some assistance. So such developments led to the establishment of specialised economics research centres.

One of the initial objectives of the FMG was to encourage the analysis of linkages between macro-economics and finance, but in this goal we were only partially successful. This insistence on a link involved swimming against the wider mainstream current over most of these thirty years, or at least until 2008. In order to make the increasingly fashionable Dynamic Stochastic General Equilibrium (DSGC) models tractable, it was customary for economists to assume all financial frictions non-existent or irrelevant. No one in these models, usually comprising 'representative agents;' ever defaulted; the financial system worked so perfectly that it could be ignored. Quite how this was supposed to be consistent with plausible 'micro-foundations' and an expanding shadow banking sector was never explained. The model was favoured widely as it allowed the sole route for financial influence to run from a Central Bank, setting nominal interest rates according to a Taylor reaction function, to influence real interest rates, and thence the real economy, via wage/price stickiness, and inflation. The transmission mechanism via banks, and the data on credit and monetary aggregates, were increasingly ignored. Expectations of future interest rates and prices were assumed to respond to local conditions, despite rapid globalisation of markets for goods and labour, finance and banking.

After the FMG had been founded most of the issues of practical concern in the field of Finance, e.g. probabilities of default, asset pricing, financial intermediation, risk premia, market liquidity, financial

regulation, were quietly swept under the DSGE rug. Meanwhile, the financial economists of the 1980s, particularly those influenced by the Chicago School, promoted some grand and unrealistic simplifications of their own, in particular the Efficient Markets Hypothesis (EMH). Simplified and unrealistic models were used widely by bankers in financial markets to push an agenda of de-regulation and globalisation, with an assurance of benefits for all stakeholders under all conceivable conditions. The assumptions of perfect information and rational actors bore little resemblance to the opaque practices of investment banking or the operations of those working in financial markets. Central Banks at the time focussed almost exclusively on their price stability and public finance objectives, often running down the work of staff concerned with financial stability.

Those working in the academic field of finance generally still believed that their work had a wider macro-economic significance, but the macro-economic mainstream was disinclined to take notice, at least prior to 2008. Some Members in FMG tried to warn of the dangers of ignoring linkages, but the enthusiasm for ever-expanding deregulation, financial complexity and scale was difficult to counteract. The FMG tried at times to stand against the tide, particularly warning of the dangers of the Basel II Capital Accord methodology prior to its global adoption as policy, but our warnings were unavailing. It was entirely symptomatic of these wider trends that the involvement of macro-economists from the Economics Department steadily dwindled to almost nothing, so that the FMG became almost entirely focused on Finance and its faculty of economists were largely drawn from the field of finance. Massive government bail-outs in the Global Financial Crisis, and informal subsidies in the shape of unorthodox monetary accommodations such as Quantitative Easing in the decade since, have shown that macro-economic and finance linkages were always there, and were always dangerous to ignore.

As an elderly historian of the FMG's past, at most tangentially related to its present, and uninvolved in its future, it is not for me to say how the FMG will move forward. But we can hope that some lessons from a review of its successes and failures, can influence those taking up the baton for future progress. Fortunately, under the leadership of Professor Dimitri Vayanos, there is now a new brief for the FMG. Themes and responsibilities have been identified in 2017 on lines similar to the initial organisation in 1987, but addressing the challenges facing financial markets today:

i. Asset Management
ii. Brexit and the City of London

iii. Finance and the Real Economy

iv. Governance, Entrepreneurship & Management

v. Systemic Risk