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News release

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What Fates Impose: Facing up to Uncertainty - Speech by Mervyn King at the Eighth British Academy Annual Lecture, 2004

In his lecture, Mervyn King, Governor of the Bank of England, discusses why it has proved difficult in collective decisions to understand, explain and manage risk. He says that risk, luck, fate, uncertainty, probability theory - all are reminders that most decisions in life involve risk. We accept that luck has a part to play in our personal lives. But in our collective life the role of probabilities only rarely takes centre stage. Yet it is difficult to imagine an informed and useful discussion of most public policy issues without a careful analysis of the risks involved.

The Governor says: "Whether in policies for health or transport, matters monetary or meteorological, in times of war and peace, decisions should reflect a balance of risks. Yet policy debates continue to be permeated by the 'illusion of certainty'." He adds: "Transparency and honesty about risks should be an essential part of both the decision-making process and the explanation of decisions."

Later in the lecture he says: "Although it is often impossible to be precise about the risks surrounding a decision, it is vital that policymakers resist the temptation to communicate a false sense of certainty. Two key principles should govern the communication of risks to the public. First, information must be provided objectively and placed in context so that risks can be assessed and understood. Second, experts and policy-makers must be open about the extent of our knowledge and our ignorance. Transparency about what we know and what we don't know, far from undermining their credibility, helps to build trust and confidence in policy-makers." He adds: "That is the spirit in which the Monetary Policy Committee was created and continues to function. The challenge is to extend that spirit to other areas of policy."

The lecture notes evidence of how poorly basic concepts of probability theory are understood, and cites miscarriages of justice related to probabilistic statements about cot deaths and DNA profiling, and also major mistakes in the forecasting of the spread of AIDS.

The Governor then takes as a detailed example the importance of analysing carefully pension provision in the United Kingdom. He asks: "what are the risks incurred in pension provision and how should they be shared among us? It is not my intention to make any recommendations. That is for the Pensions

Commission next year, and the Government in its turn. But I do want to show that risk is at the heart of the issue."

He adds: "There are two ways in which government involvement can, in principle, improve risk-sharing. First, collective schemes, whether compulsory or employer-based, avoid the costs of adverse selection associated with individual provision. Second, by combining taxes on current employees with deficit finance (i.e. taxes on future employees), state-funded pensions can transfer risks across generations in ways private markets cannot. Alternatively, the government could issue its own longevity bonds. Private annuity providers could use them to hedge aggregate longevity risk. By assuming longevity risk the government would make it possible for the private sector to purchase such bonds and in turn support a private market in annuities."

"We do not, of course, start with a clean slate. Existing government institutions - whether by design or default - already have important risk-sharing properties. Means-tested pensions and other benefits, as well as the National Health Service, already give the government a major role in the sharing of risks." He adds: " But in reforming our pension system, it is important to separate two issues. First, how should we pay for the cost of present pension commitments? Second, what is the right structure for our pension system: which risks should be borne individually and which collectively? A debate is needed over whether present arrangements imply too much or too little sharing of risk."

The lecture concludes: "Recognising and modelling risks means understanding the limits to our present knowledge. Communicating risk is about transparency. When information on risks is provided to the public, it is often in a form that is hard to assess. Thinking carefully about communication is important to the level of public debate. The quantity of information is less relevant than its quality - sometimes less is more. And managing risk means making choices - collective choices - on the basis of a rational shared assessment of the risks involved.

We cannot avoid uncertainty. So let us face up to it."

Key Resources

What Fates Impose: Facing up to Uncertainty? - Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2004/speech234.pdf