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News release

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Patience and Finance - Paper by Andrew Haldane

In a paper to be presented at the Oxford China Business Forum in Beijing on 9th September, Andrew Haldane - Executive Director for Financial Stability - discusses the roles of patience and impatience in financial decision-making, drawing on lessons from economics, history, psychology, neurology and sociology.

He highlights how both patience and impatience have neurological roots. Both can be self-reinforcing, with patience unlocking growth and prosperity but impatience generating over-trading and under-investment. Andrew Haldane explains that patience is likely to have been a key factor in the evolution of economic and financial systems. He says: "At root, banks and capital markets are simply a means of matching saving to investment. They are about realising the benefits of patience and thus growth. There is strong evidence for such effects. Financial deepening is known to be an important determinant of long-run growth.financial intermediation increases the returns to patience, thereby encouraging thrift and promoting growth".

But the virtue of patience is accompanied by an opposing tendency towards impatience and a demand for immediate gratification. He highlights how experimental evidence has shown that preferences can alter as distant outcomes become closer to the present - so-called hyperbolic discounting. He says: "The patient planner becomes a spontaneous doer when outcomes are within reach. The cautious saver becomes a reckless spender when nest eggs are close to hatching. The long-term investor becomes a short-term speculator if assets can be cashed. As temptation beckons, the devil on one shoulder whispers more seductively than the angel on the other."

In this way, impatience can have important implications for economic and financial systems: under-saving, with adverse implications for long-run capital accumulation and growth; over-borrowing, as credit allows spending to be brought forward, with adverse implications for indebtedness; and over-trading, with adverse implications for asset price volatility and misalignment.

Andrew Haldane goes on to consider how these two traits have evolved and influenced the financial system. Financial innovation has shaped this evolution through greater information and liquidity in financial markets. In some respects, these will have generated a self-improving cycle of improved market efficiency and hence growth. But in other respects, liquidity and information may actually have been counter-productive, amplifying self-destructive forces in markets. For example, improved liquidity may unlock the temptation to liquidate and thereby promote shorter-horizon investment decisions. So he asks which trait has dominated finance in practice - has bad money driven out good or the reverse? ;

There is ample evidence of self-improving financial cycles, of which China is a current example. But there is also evidence that financial systems can overshoot onto the impatient path, with excess trading, credit and volatility. In the US and UK this is revealed, for example, by increasing evidence of excess volatility and misalignment in asset markets, short-term speculators having achieved better returns than longer-term investors, assets being held for shorter periods over recent decades, high dividend payout ratios being maintained irrespective of variations in profits and discount rates implied by asset prices being excessively high. He concludes there is evidence that: "The public good of information and liquidity may unleash the public bad of myopia and volatility."

Considering potential public policy implications, Andrew Haldane suggests that countries, like China, embarking on financial liberalisation need to walk a fine line and ensure careful sequencing of financial reform to guard against impatience. He also suggests it might be sensible to curb impatience by providing incentives which encourage longer holding periods by investors and by promoting financial pre-commitment devices, such as trust and pension funds. Institutional devices, such as delegation of policy to long-horizon institutions such as central banks, also have a role to play.

In conclusion, Andrew Haldane states: "Just as patience can ward off great disaster, impatience can ruin a whole life. Generations of dieters and addicts are testament to that. So too is finance, not least in the light of the crisis. It is important finance sticks to the patient evolutionary path. To do so, the fidgeting fingers of the invisible hand may need a steadying arm."

Key Resources

Patience and Finance – Full paper
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech445.pdf