In the financial markets, the 2008 crisis was partly caused by banks losing control of their balance sheets in a mad dash to make higher profits. The scramble was fuelled by ever more complex financial ‘products’, and the cycle fed itself until complete meltdown was only averted by government action – or so we hope. Clearly the finance industry’s method of doing business was faulty, but why did it go so wrong? And could Systems Thinking have foreseen it?

Hedge Fund Billionaire George Soros, in his recent book The Credit Crisis of 2008, blames a misguided reliance on over-simplistic thinking.

Fashionable economic theories postulate that markets have become more ‘perfect’ and transparent. In other words, the participants have detailed knowledge about their investments, they can objectively assess prices and they will trade at these sensible prices. Ultimately no one will pay too much and no one will pay too little.

These theories assume that markets will reach a state of rational equilibrium and therefore be stable. Cause-and-effect thinking is a cornerstone.

Soros, on the other hand, believes that this is entirely errant. His theory of ‘Reflexivity’ incorporates the view that misconceptions and misinterpretations play a major role in shaping the course of markets, and of history as a whole.

On the one hand investors seek to objectively understand the value of an asset, and on the other hand they seek to subjectively change that value, either up or down. These two functions are opposed to each other and necessarily interfere with each other. Outcomes are influenced not only by ‘facts’ or ‘fundamentals’ but also by intentions, emotions, expectations, judgements and manipulations.

As so many participants with differing motivations are involved, the resulting is turmoil, not in equilibrium. Systems thinking and Chaos theory describe it more accurately than Newtonian cause-and-effect mechanics.

More generally, Soros notes that our understanding of the world is inherently imperfect as we are part of the very world that we seek to understand. We have preconceptions and points of view that we seek to promote to others, or impose on others. He sees this as a formidable obstacle to the management of human affairs. He reasons that loyalties, political bias and vested interests cripple our ability, as a society, to be fully objective.

Those who were profiting so much during the past few years became convinced that it could continue indefinitely - the incentives to try to optimise their own small part of the system were very powerful.

Upton Sinclair, the American writer and social reformer noted that, “It is difficult to get a man to understand something when his salary depends on him not understanding it”. In turn, Soros argues that large parts of the 21st Century financial system are founded on an unrecognised erroneous paradigm.

The disciplines that will transform banking are the same as the ones needed to transform any organisation

Many thousands of people had a hand in building our financial institutions, some being influenced by what they could get out of it personally. The contradictions and risks were called out many times over many years, but the momentum proved unstoppable whilst so many appeared to be winning. No one was able to call a halt whilst the going was good, so the demise became inevitable.

However, now that the system is so fundamentally broken, it may be a historical moment for us to adopt a new paradigm - a more holistic and sustainable one. Systems thinking.

So how could the financial system be reinvented?

The process must start with a painful period of reflection. The sentiment that “a problem from the US caught up with us”, is not an adequate starting point. We must recognise that the system was fundamentally flawed, short-term and contradictory despite the fact that the people involved did their best. Now we must emerge out of the crisis - not just by best efforts but by adopting better methods.

Interestingly some of the thinking that Soros identifies as being missing in banks is the same as that which Deming identified as being fundamental to the sustained success of any organisation. These include an appreciation that financial institutions, governments, business and the public are in an inter-connected system and that we must all work with a common purpose to create wealth for all.

The way that people make decisions, particularly those with most gain, must be in line with the long-term aims of society. Those decisions must recognise the vagaries of the business cycle and that the fact that stability is not permanent, and that trends certainly are not. Ultimately the peaks and troughs of the business cycle were not understood and the lessons of history were ignored.

An understanding of this variation needs sit along side systems thinking and psychology to guide leaders in the transformation and sustained development of their organisations. This would surely have given us a very different financial industry. Probably one without the spectacular short-term profits, but one with a more predictable and sustainable future.

As the financial industry puts itself back together again and government works out how to pay for its response, there are lessons for all of us as we seek to rebuild our own small part of the world.

Written on behalf of the North of England Transformation Network, NET2, by James Crawford, a Director of Touchpoint Change Consulting.
James.Crawford@TouchpointChange.co.uk