The Science of Business: Britain's under-siege economy shaping up for a double hit

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Having attended July graduation ceremonies and witnessed wave after wave of talented and enthusiastic new graduates leaving with their certificates, it is difficult to feel anything other than uplifted and optimistic.

But July is also the month that the Credit Management Research Centre (CMRC) produced its third-quarter forecasts of insolvency in the corporate sector and economic outlook.

The forecasting model tracks monthly trends by sector and region in company insolvencies and company defaults on debt payments.

Our projections suggest that about 35,000 companies will fail (ie, enter administration, liquidation, receivership) during 2009 (up from 28,000 in 2008) and that this relatively high level of failure will continue into 2010 (another 32,000).

Ten months ago, the message of the Monetary Policy Committee was that the recession would be short but sharp, a V shape. As economic statistics started to catch up with real events, this view had to change, and the V became a U – the recession would be deep and more prolonged than originally anticipated. Our data suggest that the shape is likely to be a W or double U!.

Company insolvencies translate into unemployment, and the now rapid rise in unemployment in a stagnant economy puts further pressure on indebted and financially stressed households and further strain on the banks.

This will potentially incubate another crisis in the economy by the late autumn, hence the double-dip (W).

It is difficult to envisage how a recovery will emanate from Britain's debt-bloated economy. It won't come from consumer spending nor a housing boom. It might come from Britain's culture of creativity, innovation, technology and enterprise – if the banking sector can move back into making sound investments in companies new, small and large and away from gambling.

The recent Walker Review highlighted corporate governance and risk management as the major contributors to the financial crisis and made many other statements of the obvious in its recommendations, eg, banks should "identify and manage risk" and equip decision-makers with the "right skills". I wonder what they were doing before?

As a Professor of Credit Management, I have observed developments in the credit and financial services industry, from the inside and outside, and over a long period.

The last 10 years have been characterised by a shift from "relationship lending" – where lenders had contact with borrowers and were able to make a considered assessment of

borrower risks and prospects – to one of "automation" where decisions are made by algorithms, eg, scoring models and fed by a growing information infrastructure managed by rating and reference agencies.

In theory, the system works fine, scoring models estimate the risk at the point of the lending decision, sophisticated risk management models calculate the lender's exposure, banking inter-connectedness and global capital and derivatives markets facilitate the hedging and managing of risk and create liquidity.

The essential problem was that the "sophisticated financial system" rapidly outgrew the infrastructure that supports it and key decision-makers were oblivious to the serious flaws and "informational asymmetries" inherent in the system.

I was always told as a statistics student that it doesn't matter how sophisticated your analysis technique is if the underlying data that you feed it is poor – garbage in – garbage out.

For example, in the UK and US, borrowers in the consumer credit market could continue to over-borrow. Lenders made decisions primarily on the basis of how well current debts are being serviced and not on the borrower's debt/income profile and prospects. A borrower facing financial stress could just borrow more in order to repay debts, and the credit information system could not keep up with the pace of activity.

By 2007, the ratio of household debt to personal income in the UK had reached more than 160 per cent.

Debt in the household sector, and spiralling government debt, continue to put a drag on the prospects of recovery.