

# Psychological Causes of Economic Crises

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## Three Theories on the Psychological Conditioning of Economic Crises

### Nicholas Barberis's theory

**I**N HIS essay, "Psychology and the Financial Crisis of 2007-2008", Nicolas Barberis discusses some ways in which ideas from psychology may be helpful for thinking about the financial crisis of 2007-2008. He focuses on three aspects of the crisis: the surge in house prices in the years leading up to 2006; the large positions in subprime-linked securities that many banks had accumulated by 2007; and the dramatic decline in value of many risky asset classes during the crisis period. He reviews a number of psychology-based mechanisms, but emphasizes two, both of which have already been extensively studied in behavioral finance and behavioral economics: over-extrapolation of past price changes and belief manipulation<sup>1</sup>. While financial innovations can be useful in preventing psychological factors from leading people astray, the discussion above suggests that the same psychological factors can make certain innovations dangerous. This may be particularly true for innovations that are *complex*<sup>2</sup>. Initially, these ideas were first put forward in September 2002 by Nicholas Barberis and Richard Thaler, in their common essay "A Survey of Behavioral Science", published in *The Handbook of the Economics of Finance*, edited by George Constantinides, Milt Harris, and Rene Stultz.

**Anat Bracha's and Elke U. Weber's** theory is presented in their paper, "A Psychological Perspective of Financial Panic", which essentially refers to the following issues: in spite of a large number of financial crises, often depicted as episodes of financial panic, the notion of panic in financial markets is not very well understood. Many have argued that in order to understand financial crises, and in particular panic events, we need to go beyond classic economic arguments. This paper is an effort in that direction, in which we attempt to give a psychological account of panic and of panic in financial markets in particular, by discussing uncertainty, the desire for predictability and control, the illusion of control, and confidence. We suggest how one might incorporate these psychological insights into existing economic models<sup>3</sup>.

Adam Szyszka's theory is presented in his article "Behavioral Anatomy of the Financial Crisis", and mainly refers to the following issues: in view of the challenges facing the neo-classical paradigm of economy, behavioral finance which offers an alternative way of looking at the processes taking place in capital markets is growing in importance. By referring to psychology and pointing out the imperfections of a human mind, it reveals mistakes committed by both individual and professional investors. In the 2008 financial crisis, behavioral inclinations affected not only the investors but also market-supporting entities and regulatory institutions. This article presents a brief macroeconomic background and then focuses on the behavioral aspects of the recent market turbulence. The findings of the paper may help avoid the psychological traps associated with investing and are important for both investors and the regulatory institutions responsible for securing the stability of financial systems<sup>4</sup>.

## Ways to Understand an Economic Crisis

"IS THERE an Ariadne's thread to help us find our way out of the labyrinth of whirlwinds, crises, and disasters?" wondered academician Mircea Malița<sup>5</sup>. And he himself replied: "If we keep at one end the idea that crises are created by man, we can begin to unwind the thread. If they are created by man, what exactly is his fault? It is his mind which did not work properly, of course. Yet, it is the same mind that looks for and finds solutions. Therefore, it is useful to review the knowledge about how the mind works. When it works well, we call its owners wise, rationalist and intelligent. These are different qualities... Rationalists have impeccable judgment, but when they start from false premises, they fail... but we also have the sad appearance of Man the Cheater, *Homo Fraudens*<sup>6</sup>. It is this man that we find everywhere in turbulences"...

### Human Fraud—Origins and Endurance

MAN'S MANIFESTATION as *fraudens*—cheater, from lying to stealing or preying (hence, *homo praedator*)—says Professor Ana Bazac, expresses some innate inclinations of man, namely, the ability to respond to stimuli in the environment, to judge them and to rationally find the best solution, therefore, the rational capacity, but also the capacity to strive to maintain existence (*conatus*)<sup>7</sup>. Sketching the portrait of *Homo Fraudens*, Academician Mircea Malița underlines the fact that our reason allows us and asks us to reject the sacrosanctity of dogmas, and what follows the exercise of reason is the *new* that underlies development. From among the emotional states reviewed in connection with fraud, illusion, ambition and love are viewed as the positive sense of "fraud": this makes such states appear disenchanting, often in the mirror; illusion—splendid understanding—is "contrary to disappointment. It is, in fact, the confidence in seeing something fulfilled, regardless of the proof of reality... it is a true motor that drives people"<sup>8</sup>.

Such a fraud occurred in the global crisis that started in 2007. The complexity of the phenomenon involves multiple frauds and authors, including psychological traits (greed and pride), obsession with supreme power, fraudulent doctrines (neo-conservatism and neo-liberalism), a breach of the "social contract" by "dominant cliques and their asso-

ciates”—which lead to a counter-reaction of the citizens demanding their country back—plundering of other countries through “diplomatic” means (countries that become entirely captive)<sup>9</sup>. Academician Mircea Malița shares with us his *concern* about the extreme credulity of man: “He believes with remarkable ease and pleasure absolutely everything he sees or is told. This is related to his inclination to fraud. However, he is not so much the author of fraud, but its victim... He adopts and fixes his deception by others in durable self-deception. It is worth paying attention and preventing such risk...”<sup>10</sup>

### The nationalization of losses

THE PURPOSE of a central bank is to be a lender of last resort to commercial banks that are faced with cash withdrawal by depositors. In time, the role of central banks expanded, because governments set up insurance deposits. Then, central banks were given other roles, too. The US Federal Reserve, for example, was tasked with minimizing inflation and unemployment, under the Humphrey-Hawkins Act passed by the US Congress. However, neither the Federal Reserve’s charter, nor the Humphrey-Hawkins Act says that the American central bank must stabilize the Stock Market by buying bankrupt companies’ stocks.

The Federal Reserve is prohibited from buying equities by the Federal Reserve Act, but an amendment in 2010 allowed the Federal Reserve to buy AIG stocks, saving *in extremis* the biggest insurance company in the world from bankruptcy, a company that, prior to 2008, had a AAA (triple A) credit rating. This amendment created a loophole for the Federal Reserve to lend money to entities that can then use it to buy stocks.

Some observers believe, for example, that the Swiss National Bank is an agent of the Federal Reserve, because in the past few years the former purchased important stocks for the USA at critical times, in order to stop their price from going down and to give the impression that the US economy is doing fine. The Swiss Central Bank—namely, the National Bank of Switzerland—purchased 3,300,000 Apple shares in the first quarter of 2015, and another 500,000 shares in the second quarter. The Swiss Central Bank, in addition to its Apple stock, also holds stocks with values ranging from 250 to 637 million dollars, in other big American companies: Exxon Mobil, Microsoft, Google, Johnson&Johnson, General Electric, Procter&Gamble, Pfizer, Chevron, Merck, Facebook, Pepsico, Coca Cola, Disney, Valeant, Gilead, and Amazon.

## Ways to Generate an Economic Crisis

### Consumption stimulated by emerging countries

ACCORDING TO some surveys conducted by the World Trade Organization (WTO), between 1980 and 2015, developing or emerging economies raised their share in world exports from 34% to 47%, and their share in world imports from 29% to 42%<sup>11</sup>. Moreover, in the last 35 years, world trade has grown, on average, twice as fast as world production, as new players have played a prominent role in world trade. These reports reveal a very clear aspect, namely, the importance of trade in development. “Predictions do not, however, foresee an inversion of globalization”, declared the Director-General of the WTO, Pascal Lamy.

The WTO reports highlight a number of factors that shape world trade, such as: 1) demographic changes; 2) investments in infrastructure; 3) technological innovations; 4) access to energy and other natural resources. Furthermore, trade is also shaped by social issues such as: a) income inequality; b) unemployment, or c) environmental concerns. In the next two decades, the USA and the European Union should remain the leading players in world trade, the problem being how much ground these two entities will lose to emerging economies, first to China, and then to India. According to the WTO, in 2035, China would control 25% of the world trade, while India's share would double compared to 2015, up to 5%. But these are just predictions, and we know that no prediction model is 100% realized, because the model equations are always disrupted by psychological, social or political factors other than those that are taken into account...

### **The behavior of economic operators**

SPECULATIONS RELATED to an unprecedented restriction of stimulus measures by developed economies have shaken the currency and bond markets of emerging countries. The meetings of the ministers of Finance of the EU countries or G20 highlighted their calls for coordination of their economies before ever more obvious psychological fears. Bond yields increased, and shares dropped, after the Chairman of the Fed, Ben Bernanke, announced in June 2013 that the American central bank could scale back its bond purchases, which at the time amounted to 85 billion dollars a month, or after the new Chairman of the Fed, Janet Yellen, announced in October 2015 the end of the *quantitative easing* program.

### **Change in psychological perceptions**

HERE ARE two statements that show us how people's psychological perceptions evolve and, in particular, change:

A. "I think that there is a bright future for Europe, and there is a bright future for the euro zone and for the euro. This is predicated on continuation of the structural reforms, the strengthening of the European architecture, particularly with the European banking union project. We should not forget that most currency zones took a lot of time to reach not just currency union, not just banking union but fiscal union" said Christine Lagarde, IMF Managing Director, at the debate held by the University of Vilnius (Lithuania), on July 18, 2013.

B. At the beginning of 2016, Europe's economy seemed to be in the best shape of the last six years, even though progress in the recovery was slow, declared Tidjane Thiam, CEO of the Swiss bank Credit Suisse: "I think Europe is in the best position it has been since 2010. I have never been optimistic on Europe. I'm actually quite on the record as a Euro bear, so I think that the fact that I swing to the positive here, I hope is meaningful".

Actually, the eurozone economy grew 0.3% in the third quarter of 2015, a slowdown from the 0.4% growth rate recorded in the previous quarter. A persistently low oil price is not beneficial to the world economy, because it has changed all previously accepted equilibria. In EU countries, economy is improving slowly, but political issues continue to exist.

### **Another set of political risks**

IN 2016, investors have to acknowledge an entirely new set of risks related to concerns that go far beyond the borders of traditional geopolitical hazards and have the potential to seriously disturb economic activity and financial markets. The conjunction of new and old political risks threatens to undermine the progress made in recent years and fuel conflicts between and within nations. Traditional geopolitical risks such as armed conflicts and new socioeconomic risks, like income inequality, threaten to intersect in an environment where global growth is stagnating while public expectations are high, and government capacity to make changes through reforms is low. One example is the situation in Syria, where a civil war has turned into a crisis that politically affects Europe.

### **A new set of social risks**

FORBES MAGAZINE, in the January 2015 issue, comments: “There will always be work for those who live to work (which is to say, those who do something they enjoy), while those who work to live (doing something they don’t enjoy just to get enough money to do other things), will find themselves out of work in the coming years. In a world in which the basic needs are only covered for the rich, some people will spend their time doing useful things, engaging in creative activities, while others will opt for a life of leisure. An education adapted to our times is, at the end of the day, the best way to maintain and increase our freedom in this life.”

And education, shows a report of the World Economic Forum dated January 2016, should focus on what will be sought most tomorrow. “Speed is the currency of business”, says Marc Benioff, Salesforce CEO. “Future belongs to the fast”, adds Meg Whittman, HP CEO. Or, the professions in demand on the market are those which can help improve speed more and more. The future belongs to the very agile companies, which focus on cooperation, work flexibility and new technologies. There will also be limitations: we cannot do things faster than we can think.

In Davos, there were predictions on progress for the coming years. After all, this meeting brought together political and business elites from developed, not developing countries, the latter being the ones that will feel most the shock of changes. Professor Ian Gordon, of Oxford University (England), compared this new industrial revolution to the Renaissance. These years represent an era of great scientific discoveries and of reinterpretation of man’s relationships with the world, today we rediscover space, subatomic particles, Google replaces large encyclopaedias, and the Internet leaves behind printing. However, the parallel stops here, without reminding anything of the evils of the Renaissance period—the Inquisition, religious wars, geopolitical clashes—which seem to be spreading nowadays, as well, in their current forms...

A survey conducted by PricewaterhouseCoopers for the 2016 World Economic Forum held in Davos, on 1,400 CEOs in 83 countries, found that just 27% of CEOs think that economic growth will improve in 2016, 10% less than in January 2015; most pessimistic are American CEOs—the low economic growth is already due to the deflationist effects of technological progress, effects that cannot be well quantified yet.

## Conclusions

**A**T THE start of 2016, after thousands of years of applied economic construction, after 300 years of theoretical economic construction, after so many big or small economic crises, we do not know whether: a) the slowdown in China's economy can be kept under control; b) the collapse of global financial markets is temporary; c) the deep refugee crisis in Europe will bring EU member countries closer together or contribute to their irreparable separation. At the start of 2016, under the appearance of security and optimism, there is still fear that the politicians, diplomats and central bankers who attended the World Economic Forum in Davos (Switzerland) are at the crossroads of geopolitical and economic forces that they cannot control.

At the top of a long list of fears lies the psychology of Europeans, whose leaders have strategies that make them deeply divided on the issue of solving the refugee crisis, at a time when the European bloc faces a number of other threats, ranging from Islamic extremism and the rise of far-right populists, to a possible British exit from the EU. Therefore, we simultaneously have three political crises and, in addition, two economic crises: the financial crisis and the bank and currency crisis, as well as an economic slowdown crisis.

“You’ve had deadly crises in Europe from day one and we’ve overcome them. However, we always had one crisis at a time. Today we have about five”, declared Josef Joffe, publisher-editor of the German weekly *Die Zeit*, at the beginning of February 2016. Just by analyzing the construction of this sentence, we clearly have before us the postulate that at the heart of economic crises are psychological causes, determined by fear, mistrust, pessimism...

Our advice is to be optimistic and change—through intelligence and creative adjustment—your own way of thinking and acting; thus, you will have a part in the new human outlook on crises: they are useful to us and they help us progress!



## Notes

1. This essay is written in preparation for *Financial Innovation and Crisis* (MIT Press, Michael Haliassos, ed.). It is based on an invited talk at a conference in 2009 on the occasion of the awarding of the Deutsche Bank Prize in Financial Economics to Robert Shiller, p. 1
2. Idem, p. 13
3. Anat Bracha & Elke U. Weber, *A Psychological Perspective of Financial Panic*, Public Policy, Discussion Paper, no. 12-7, Federal Reserve Bank of Boston. Anat Bracha is an economist in the research department at the Federal Reserve Bank of Boston. Elke U. Weber is the Jerome A. Chazen Professor of International Business at Columbia Business School and Professor of Psychology and Earth Institute Professor at Columbia University. See the site: <http://www.bostonfed.org/economic/ppdp/index.htm>, version of September 2012.
4. Adam Szyszka, *Behavioral Anatomy of the Financial Crisis*, in Journal of Centrum Cathedra, Department of Management, Poznan University of Economics. See the site: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1806037](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1806037)



5. Mircea Malița, *Mintea cea socotitoare. Eseuri*, Bucharest, Editura Academiei Române, 2009, pp. 12-13
6. Mircea Malița, *Homo Fraudens. Eseuri*, Biblioteca RAO, Bucharest, Editura RAO, 2012
7. Acc. to Ana Bazac, *Mircea Malița, Homo Fraudens*, in Noema, vol. XIII, 2014, pp. 387-395 (selectively)
8. Mircea Malița, *Homo Fraudens. Eseuri*, p. 44
9. Idem, p. 130
10. Ibidem, p. 218
11. Source: Agerpres Press Release of July 19, 2015

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### Abstract

#### Psychological Causes Of Economic Crises

People have not learnt enough from their economic experience of thousands of years and from about 300 years of theorization of this concept. In our opinion, the reasons for this situation are the psychological causes of human behavior. This behavior is written in the human DNA and can hardly be learnt, being most often inherited. For centuries, only those people who developed a learning behavior through their intelligence—which would make them winners in a crisis, and would not follow their innate (therefore, inherited) behavior, namely, that of losers—have had an optimistic outlook on economic crises.

### Keywords

psychological causes, economic crisis, developed countries, emerging countries, financial turbulence

**Classification JEL:** A12, F01