

Summary of the report

The Financial Crisis – Lessons for Europe from Psychology

Henry Montgomery

This report discusses how psychology can shed light on the recent global financial crisis. The aim is to show how psychological knowledge can lay the groundwork for reforms (rather than commenting on specific reforms) that could mitigate future financial crises in the EU area.

Academic psychology has accumulated evidence for the existence of two modes of cognitive function. There is an *intuitive mode* (System 1), in which people make judgments and decisions quickly and automatically, and an *analytic mode* (System 2), which is deliberate and slower. Both systems may appear rational or irrational depending on the context in which they operate and also depending on how rationality and irrationality are defined. This means that it is possible to distinguish between four modes of cognitive function by combining System 1 and 2, respectively, with rationality or irrationality, or more precisely with an adaptive or maladaptive mode of cognitive function.

Adaptive intuitive (System 1) mode of cognitive function. System 1 thinking sometimes has good contact with reality in two different types of contexts. On the one hand, by having access to many thousands of patterns stored in long-term memory, System 1 thinking can quickly and automatically recognize and evaluate different objects. The ability to do so is an important ingredient in true expertise, including in the financial market. On the other hand, by using fast and frugal rules, laypersons may have an advantage over experts in utilizing the most important dimensions in the environment for making quick and relatively accurate judgments.

Maladaptive intuitive (System 1) mode of cognitive function. System 1 is associated with a local here-and-now oriented mode of thinking, where everything that is outside the focus

of attention is less real in some sense. This is true both for risk judgments and for how we evaluate and integrate information (prospect theory). In addition, System 1 may fool people – all of us, independent of our level of expertise – into seeing meaning where there is no meaning. We become “fooled by randomness”, as nicely expressed by the economist Nassim Taleb. These biases lead to overconfidence and are strengthened by a general confirmation bias. As a result, people, again including both professionals and laypersons, did not see the long-term dangers of the developments before the financial crisis and were seduced by the prospect of short-term gains. At the same time, there was probably a mismatch between commercial financial institutions and their clients with respect to the prevalence of certain cognitive biases, a mismatch that was exploited by the former and fuelled the imbalances that finally led to the outburst of the crisis.

Adaptive analytic (System 2) mode of cognitive function. The cognitive biases that contributed to the crisis could not have been removed simply by making people aware of them, although there exist some simple de-biasing techniques that may be useful. To remove the biases more thoroughly it is necessary to build up a new culture, one that favours System 2 thinking. In such a culture individual differences in cognitive styles should be recognized.

Maladaptive analytic (System 2) mode of cognitive function. Maladaptive System 2 thinking boils down to an excessively heartless and more or less immoral kind of rational thinking, which obviously occurred to a certain degree – including a few spectacular cases – during the financial crisis.

The driving force of the financial crisis was factors that operate on a collective level. Before the crisis occurred, there

The full report is available at www.sieps.se

was a relatively long period with an increasing number of actors running in parallel, a development that inflated the financial bubble. Typically such a development is described as herding behaviour. However, herding behaviour alone cannot explain the development of the crisis. It cannot explain the remarkable synchronization of behaviours of different groups of people that, as a result of a lack of competition between different views, led to a shared but misguided reality that involved seeing private homes as money machines and viewing CDO bonds as profitable financial instruments in which the risks had been balanced out in a sophisticated way. The growth of the financial bubble accelerated as a result of an increasing prevalence of ‘groupthink’, which emerges as a result of social identifications uniting parties that earlier had opposing interests, the emergence of salient norms and low self-efficacy. Groupthink resulted in the suppression of dissent, group polarization (implying that groups take greater risks than individuals), and self-censorship, which in turn resulted in an illusion of consensus.

The explosive bursting of the financial bubble was elicited by a rapid destruction of trust all over the world, not least in Europe. The parallel course of diverse actors was replaced by antagonism. A more critical attitude (in line with System 2) took over shaping a “moment of truth”, which created a possibility for taking measures against future crises. Distrust can be allayed and trust recovered by persons talking to each other, which indeed occurred after the crisis, to a large extent involving politicians within and between countries.

The different phases of the financial crisis can be seen as illustrating three different types of relationships between the individual and the collective level: The superbiased hyperindividual, where individual biases are added up on a collective level (the inflating of the financial bubble), the scattered collective (the bursting of the financial bubble), and the well balanced collective (the goal in attempts to restore the economy after the crisis). The present paper, I wish to emphasize, gives a cognitive account of the financial crisis rather than a non-cognitive account based on emotions and

herding behaviour alone, where the importance of shared reality is neglected.

The financial crisis has also been regarded as a crisis for economic forecasting. I have used forecasting data from Oxford Economics to find possible cognitive explanations of the failure to predict the crisis in Europe as well as in the USA. It appears that the forecasting failure was due to a general inability to predict more than one year ahead.

This report concludes that future crises could be counteracted by stimulating a positive spiral in which people develop their own thoughts, feelings and behaviour by influencing and being influenced by the economic environment. This goal cannot be attained by regulation alone. The following policy measures are recommended: (1) Governments and governmentally controlled companies as well as public sector organizations should provide a good example of appropriate economic conduct in their own behaviour. (2) Economic forecasts should be delimited and replaced by more openness to “black swans”, which implies taking seriously that the real economy in fundamental aspects is intrinsically unpredictable. (3) Innovative research in behavioural and financial economics should be stimulated. Several European countries provide sources for collecting valuable field data. (4) Measures should be taken to increase people’s understanding of financial matters and the private economy, including better awareness of risks for being susceptible to biases in their economic decisions. (5) A development should be stimulated that increases the transparency of financial products. Regulation may not be the primary road in such a development. Ideally, transparency should become an important factor in the competition between banks and financial companies. An example from a recent EU directive concerning rules for transparent information about investment products is critically discussed.

Finally, a utopian view is given of the economic life in a fictive country that has developed in line with the five recommendations described above.

The full report is available at www.sieps.se