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The Financial Crisis

The origins of the current financial crisis lie in the United States, gaining clear shape and form towards the end of the summer of 2007. Years of low interest rates made borrowing in the US extremely inexpensive. Indeed, as Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, noted in July 2010, "Exceptionally low rates, while perhaps not the single cause, played an important role in creating the conditions leading to our recent crisis." As a result, average Americans found themselves knee deep in debt. We are now all too aware of the consequences. Share prices and the price of real estate increased at lightning speed to unprecedented levels. The bubble of unlimited capital growth and economic expansion ultimately exploded with a loud bang at the end of 2007. Saying that the greatest financial collapse since the Great Depression was not to be foreseen seems a bridge too far. In fact, Mid-December 2006, the following email circulated in Wall Street: "Let's hope we are all wealthy and retired by the time this house of cards falters." Some people saw it coming, many more realized the bad behaviour in the system and all of us suffered from its consequences. Even today, the consequences are still being felt round the world. The present financial crisis is in fact, using the words of the former FED (Federal Reserve System) chief Alan Greenspan's in testimony before the bipartisan Financial Crisis Inquiry Commission, the "most virulent global financial crisis ever."

As can be expected, in these times of financial crisis, we are constantly bombarded by news reports about unethical behaviour and distrust. The lead players are often the banks, the government and citizens. Most remarkable is that these discussions are not as rational as you would expect from an economic point of view. Despite a wealth of new insights from the world of psychology, economists tend – all too often – to hold onto the image of rational *homo economicus*, who is well-informed and can hold his own in the midst of global market forces. However, all the news reports reveal that banks, organisations, clients and citizens generally change their behaviour more often than you would expect of such rational entities. It would appear that decisions and behaviour during this financial crisis are determined primarily by emotions and errors in reasoning. In a similar vein, Akerlof and Shiller, in their popular book "Animal spirits", also argued that when it comes down to economics animal spirits almost drive everything.[1]

My intention with the present book is to offer you – in a straightforward and easy way – some first insights into the psychology of the financial crisis. You will see how it is possible for everyone – yes, indeed, all of us! – to nonetheless take decisions which eventually lead to unethical or even corrupt situations. These insights are gaining popularity very quickly and are referred to as the field of behavioural ethics with its applications to organisations and management.[2] These insights represent a new approach for those in business ethics to interpret human decisions. Until now, the traditional approach to business ethics used the assumption that you can simply teach leaders, followers and organisations what is right and wrong by using philosophical theories as guidelines to people's decisions and actions (i.e. a *prescriptive* approach). Put differently, the transfer of a list of moral values ought to be sufficient to behave in a responsible way. Quite a few MBA students and top executives have been trained in this way. However, new insights based on behavioural ethics show that, despite this knowledge, people still display unethical behaviour. Knowing that there are codes of conduct, moral duties and obligations is not doing the trick when it comes down to fighting fraud, corruption and many other instances of unethical behaviour. It is, therefore, very much needed to start applying our newly acquired insights into human behaviour and to communicate them so that future managers, politicians and entrepreneurs can develop a moral compass that they can understand and use themselves (i.e. a *behavioural* approach).

How can it be that people consider absurdly high bonuses to be normal? Why do banks completely disregard public sentiment? How can it be that some decisions have led to the current financial malaise? Does ethical leadership actually exist in a world view dominated by the financial market? The present book provides illustrations of the possible answers for such questions. Based on a series of published columns and opinion pieces, I examine international examples taken from the financial and political crisis and clarify how human psychology plays a role in how easily moral conflicts can emerge. Note that each of these pieces were written at time specific events happened between 2008 and 2010. As such, this booklet does not present an updated historical overview but rather a selection of events that happened in this time period and that illustrate how psychological processes played an important role in the escalation of moral values during the financial crisis.

Rethinking our Paradigms

As a society we often fail to provide sufficient insights into the behaviours that are displayed in political, corporate and financial settings. The result of such lack of knowledge is that the emergence of crises is generally speaking poorly understood. Consequently, once recovery sets in we simply do not know why. This is a simple outcome of a simple idea: If one does not know why something happened how is it possible then to solve the resulting problems? Insights are thus needed to arrive at a better understanding of what drives human behaviour in times of crises. We need to understand motives of human decisions better in order to avoid future bad behaviour or at least to be better equipped to manage future crises. To arrive at such understanding, I argue that we need to step outside of the paradigms that we have used to analyse events at the political, financial and society level. The current dominant paradigm (as I will elaborate on later in this book) is based on human rationality and assumes that our systems are controllable and predictable. As we all know (and as we are once again reminded when dealing with the outcomes of the financial crisis), this view does not fit with reality. Therefore, we need to understand what drives humans when it comes down to making decisions, constructing judgments and evaluations. In the present book, I apply this kind of thinking to the financial crisis and how the dominant economic paradigm failed in important ways.

The end of Adam Smith's invisible hand?

Adam Smith, who published "The Wealth of Nations" in 1976, is considered by many as the founding father of the discipline of economics. In this influential book, Adam Smith spelled out the mechanism on how our economic society should operate. According to Smith, each individual strives to become wealthy or, in other words, to pursue his own self-interest. The existence of a self-interested motive requires that we possess resources, services and products that are valuable to others and therefore those others are willing to engage in exchanges and negotiations about these commodities. In other words, we need a free market in which labour and other valuable assets can be allocated in ways that advance the public and societal interest. Why? The pursuit of one's own self-interest should be the main regulating principle that brings our society (as dominated by the free-market) prosperity. With this idea in mind the principle of the invisible hand was created.

Smith provides a famous and excellent example to illustrate the principle of the invisible hand: "It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."

Interestingly, Smith was quite a religious person and therefore regarded the "invisible hand" as a mechanism that could be used by God to regulate and maximize the happiness and prosperity of humans. One thing that many people tend to forget, however, is that Smith added a few assumptions necessary for the invisible hand to work effectively. First, pursuit of one's own self-interest could lead to collective prosperity if all actors are rational human beings who know that all of us are striving to maximize own interest. The idea that we are perfect rational human beings is an idea that has its own problems (as I will elaborate on later in this book). Second, and adding some moral flavour to the discussion, Smith also reasoned that a strong sense of moral awareness should be present, making that people would adhere to moral norms that communicate, for example, that theft, corruption, manipulation of prices, misrepresentation of information and so forth is prohibited. However, as I will discuss later on in this book, we are not always ethical people and often misjudge our own morality for the sake of our own self-interest. One of the basic claims of the present book is in fact that the invisible hand idea suffers from great shortcomings when it comes down to the ideas of rationality and morality.

Despite these shortcomings – that became apparent again in the present financial crisis – the basic presumption of "neoclassical" economics (named after the late-19th-century theorists who elaborated on the concepts of their "classical" predecessors) was clear and pervasive: We should have faith in the market system! This belief was, however, challenged a first time by the Great Depression in 1929. To maintain their strong intrinsic belief that anything that goes on in the market cannot be wrong and that the economic insights based on the workings of these markets are valid, economists tried to deal with this major economic depression. In that view, the work of John Maynard Keynes proved to be invaluable. From a historical point of view, his work in a sense has to be seen as contributing largely to the search of a solution for the Great Depression rather than the widely shared assumption that the work of Keynes was primarily focused on challenging the free-market system fundamentally. In a way, Keynes wanted to fix capitalism rather than simply replacing it by the government. Despite his search for a solution, he nevertheless considered the workings of a short-term focused financial market as problematic and did argue for active government intervention such as printing more money – something that has been proven to be quite a popular tool nowadays in the US when looking at Ben Bernanke's decision to print an extra 600 billion US dollars – and supporting public works to ensure significant drops in employment.

But like many stories, they do not last. Pretty quickly the memories of the Great Depression faded, and economists embraced again the idea of an economy in which rational individuals interact in perfect markets. Both politics and the urge to pursue financial incentives in an unlimited manner fuelled the falling in love again with the neoclassical assumptions further. The most famous example of this neoclassical revival was the work of Milton Friedman of the University of Chicago. He stated that neoclassical economics is the way to go and should deserve much confidence. Even more, he reasoned that only a very limited form of government intervention is needed to prevent economic depressions to emerge. Central banks are needed to maintain the money supply and keep circulating the sum of cash in a steady manner.

The field of economics in distress?

Although we experienced a Great Depression and we were aware that we may have fallen in love too quickly again with the unregulated free-market idea (i.e., the invisible hand seemed just too popular as illustrated by the observation that regulation clearly failed so horribly in the lead-up to the present financial crisis), why did economists and society at large fail to anticipate a financial crisis of this magnitude. It is clear that some wrong assumptions were made. In fact, late 2008, Alan Greenspan, the former Federal Reserve chief, noted during a Congressional hearing that he had "found a flaw" in the foundations of his economic understanding. But what is this flaw?

The idea of a free-market in which all individuals are rational human beings is the major flaw! Due to this romanticized image of the perfect "homo economicus", economists – and in a way all of us – ignored the fact that when it comes down to human beings and their habits things can quickly escalate and go wrong. A blind eye was turned to the limitations of human rationality that makes so many things unpredictable. Ironically, however, our tendency to stick in a stubborn way to this idea of perfect rationality is a human error. We are infamous to look for evidence to support our cherished assumptions and to avoid facts that counteract our dominant ideas; a tendency referred to as the confirmation bias.[3] Thus, our limited rationality allowed us to fool ourselves and for that reason alone we need to come to grips that a paradigm shift is required. We need a paradigm that is realistic in nature and presents us the world as it really is: humans that make mistakes and we need to understand the how and why of it to make our financial systems work more efficiently.