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# Human behavior behind economic crises

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The economic crises are a recurring subject on the front pages of newspapers around the world. These crises have accompanied the capitalist system since its beginnings. In this sense, they have been widely documented, crisis like the tulip bubble in the seventeenth century in Holland, or the bubble of the South Seas, in the nineteenth century. We must say that bubbles are processes of intense speculation about a tangible or intangible asset that increases dramatically its price reaching to an absurd high level totally divorced with the price in a normal condition; the bubbles can make serious problems in the economy of a country taking it even to a crisis.

We will talk about the tulip bubble because is almost unbelievable to imagine a speculative euphoria around a flower. Do you imagine people investing fortunes in something so fragile? A real contagious madness was unleashed in Holland. In the case of the tulip bubble in this country there are several factors that explain the origin of the emergence of an economic bubble around these flowers. On the one hand, the success of the Dutch East India Company and commercial prosperity of the Netherlands, and on the other, the love for flowers, especially the exotic which became the object of ostentation and a wealth symbol.

According to what you can read in a Wikipedia article entitled tulipomanía in spanish:

> "In 1623 a single bulb could be worth 1,000 florins: a normal person in the Netherlands had an average annual income of 150 florins. During the 1630s it seemed that the price of the bulbs could grow without limits, and almost the whole country had invested in the speculative trading of tulips. Profits reached 500%. "

Speculative excitement around the tulips came to create a future market, this is a sort of contract of purchase and sale of a number of tulip bulbs on a future date at a specified price, exactly what today is done for example with oil or raw materials.

Moreover, there came a time that buyers of tulip bulbs that had no money, were financed by borrowing and the establishment of mortgages.

Finally, as with all economic bubbles, these explode. There comes a time when prices, and in this case the price of tulips reach a ceiling and buyers become just a few. The speculation is based on buying cheap and selling at a high price, but when the process of rising prices stops, the speculative profit becomes impossible. The price begins to drop because everyone does not want to lose or at least not to lose too much and everybody begins to sell. Those who were in debt and had to sell their tulip bulbs or the papers owned with a value based on the price of those, at prices well below the amount of the debt were ruined and dragged to ruin their lenders. This situation led to the bankruptcy of the Dutch economy.

Those involved in speculative euphoria of a bubble, they buy the asset that is experiencing a sustained rise in its price, they are motivated by greed and the confidence that the price will continue to rise indefinitely, so in the future they will be able to sell at a much higher price than the price they purchased, making an exorbitant profit without doing practically anything.

However, the bubbles have their days numbered, always come a time when sellers do not find buyers, and this will unleash a process of compulsive sales to get rid of the asset as soon as possible, with the inevitable process of falling prices. This situation will cause panic in the market and everyone will go to sell their stocks as soon as possible, which will accelerate the fall of the price. So we have a vicious circle. Falling prices is the cause of compulsive sales of the asset, and these sales stimulate a faster fall of the price. Therefore, many will be ruined by having to sell at a much lower price than they bought. The situation is further complicated if buyers financed their purchases through debts with banks, in this case, these institutions are not able to get the payment of granted loans, they can fall in bankruptcy and this can trigger a financial crisis.

According to economist Charles P. Kindleberger, the basic structure of a speculative bubble can be divided into 5 phases:

- Displacement: It means the increase in value of an asset
- Takeoff: speculative buying (buy now to sell in the future at a higher price and make a profit)
- Exuberance: Prices are rocketed
- Critical stage: buyers become scarce, price is not rising so fast, some asset owners begin to sell.
- Crash: There is panic in the market. Many sellers but nobody is buying. The price is dropping very fast.

The situation can be worse if the financial crisis unleash an economic crisis, meaning a crisis of the whole economic system; the crisis reaches the real sector of economy, production of goods and services. Troubled banks because they have financed speculative activities are unable to provide more credit to productive activities, resulting in lower investment and production, making the unemployment rise, leading to an economic recession.

In another aspect, economics as a science and in particular in the treatment of the economic and financial crises has lost its nature as social science and the connection with human beings,. The language of economics, talks about investment, inflation, deflation, housing bubble, etc. Also many economists take delight in creating simplified mathematical models (but very complicated for ordinary people) of a complex reality, ignoring the human and social character of the economy that cannot be expressed in a mathematical equation.

In this turmoil of numbers and statistics used by economists much more interested in a Nobel prize than to give simple explanation to ordinary people about economic phenomena, it is necessary an intellectual effort to try to see these numbers and statistics as products of decisions and actions taken by human beings, pointing that human behaviors in economic matters are not necessarily rational and may even be reprehensible in an ethical sense, greed and selfishness are examples of these behaviors.

The economic decisions of human beings that can create at any time an economic bubble may be motivated by greed and optimism when the bubble is in the boom phase. Note that bubbles are developed at a time when there is an economic prosperity in society; therefore, there is a general atmosphere of optimism about the future. In these circumstances, it seems that people are blind and deaf to any sign which may cast doubt on the future. In this environment, with plenty of money to invest, a speculative bubble will certainly appear. No one is clear about the mechanism how a bubble develops, however, the real estate industry seems very suitable for setting up a bubble, in fact, in Japan, there was an important housing bubble, also in Spain, and the last one occurred in 2008, in the United States.

For the financial sector is always good to lend money secured by real state. The prevailing optimism in society reaches individuals who tend to think that their particular situation will also improve in the future, and given the rise in real estate prices for example, there is always the possibility of selling it in the future with a good profit. At this point we can also point out that bankers and policymakers tend to give optimistic speeches about the economy, reaffirming in people a sense of confidence and security. It is a fact that policymakers are reluctant to declare an economy in recession although the evidence is clear, and when they admit the problem, they try to minimize it as a temporary misstep of the economy.

In the evolution of a bubble there is a time when asset prices are detached completely from the real value, and despite this, people are still buying and banks are lending money; running increasing risks that borrowers may not pay in the future. Here we note that we see an irresponsible behavior, in both, buyers and bankers. Of course, in the case of banking executives they are making good money with the bubble; responsible behavior would eliminate extraordinary profits obtained. And here appears the ethics behind the bubble, the bank executives do not behave in an honest way, they know that the consequences will be paid by buyers who put the savings of a lifetime in a negotiation that they believed safe and profitable. Moreover, the bankers know that if things go wrong, the government will launch a lifeline pumping money into troubled banks.

After the bubble euphoria, a time when the asset sellers cannot find buyers is reached. At this time, sellers begin to lower the price to find interested buyers, a new emotion fills the hearts of those who are holders of an asset (stock, real estate), the fear of not being able to sell at a higher price from which the asset was purchased. Then spreads panic among the holders of assets, everyone wants to sell and the law of supply and demand makes the price plummets.

As we can see , in the boom and crash of a bubble; decisions based on emotions are taken that have little to do with the classical view of homus economicus, an individual who makes financial decisions based on a strict rationality that moves him to increase his level of personal satisfaction. Of course, the rationality of individual economic behavior, is subject to the availability of full information, this is what it says classical economic theory, which in practice does not occur.

People tend to accept what policymakers say in the time of booming economy and tend to trust banks. Once the bubble crashes and many people lose their savings and their homes, and they may also lose their jobs; emerging emotions such as anger, sadness and distrust, loss of self-esteem, anxiety and depression.

The psychological consequences of those affected by the crash of an economic bubble can be devastating, driving many people to suicide, and others to suffer various mental illnesses.

As we have seen the consequences of economic bubbles can be devastating, in fact, the consequences are not confined to the real estate market or the stock market, these can affect the whole financial system of a country, generating bankruptcies of financial institutions and forcing the government to use taxpayer money in order to secure people deposits and lending money to banks to avoid bankruptcy. Generally, the financial crisis ends also impacting the real economy, leading to recession. All this is quite serious, but because of globalization of economic activities; crisis are also worldwide. The housing bubble of 2008 ended up affecting the developed world because of the worldwide interconnection of financial systems, when American banks sold to other banks worldwide, securities based on subprime mortgages (subprime means high risk to get money back). These banks also sold these securities to their customers. Once the bubble crashed and many buyers of real estate in the United States could not afford mortgages, mortgage-backed securities became trash.

Also noteworthy is the role of shadowing bank in triggering the 2008 crisis. The shadowing bank are institutions that are not banks themselves and therefore are not regulated as banks, and they are dedicated to obtain money from the public and invest it in various assets (real estate, stocks, raw materials, currencies), offering to customers much more attractive rates of interest than those offered by banks. This shadow banking purchased a significant amount of securities based on subprime mortgages because of the high profit they offered. Many people in America are looking for opportunities to invest the savings dedicated to future costs of college for children or for their own retirement, and are seduced by the profits offered by these pseudo banks.

As you can see irrational behavior leads to the emergence of a bubble, a gregarious behavior is developed; nobody wants to lose their share. If we see the neighbor buying a house and then he sells it earning 30% or more, why I cannot do the same. Even without money I can also join the party, a bank will lend me the money, although for me may be too difficult to pay the principal and interest of the loan, but I can always have the hope to sell my asset for more money in the future, paying the mortgage and obtaining a substantial profit, indeed, it would be foolish not to do it. This is the kind of reasoning that people do.

In the behavior of people who enters in the speculative game we find the imitation factor. I'll imitate my neighbor or friend who just made a fabulous business and here can also enter the envy as a motivator, and of course, finally greed. What people does not see very clear, only some very insightful, as Matsushita, a Japanese businessman who said that the important thing was not knowing when to join a business, but rather, knowing when to get out. Most people who are not used to the speculation art, does not know when the bubble burst will occur, but this also happens with experienced stockbrokers, and like the inexperienced many of them ends losing even their shirts.

At this point is important to use certain categories of analysis from economist Hyman Minsky, who said that in the emergence and development of the economic crises we were facing an internal phenomenon of financial system fragility. For Minsky the recurrent emergence of the economic crisis is inevitable, considering that during the periods of expansion of an economy, several factors are incubated that unleashed the crisis further. Thus Minsky speaks of three types of companies or individuals involved in the development of crisis. Minsky speaks of companies or individuals with hedge funds, those whose cash flow can pay their debts (principal plus interests). In the expansion phase of a crisis, most companies or individuals seeking funding to develop their productive activities have good hedge, and the financial system is robust. While the interest rate is less than the expected profit rate and there is a process of revaluation of assets (houses, machinery), companies or individuals tend to take a speculative position, which means that interests on loans can be canceled but not the principal. This leads to go to a renegotiation of the debt, which means increasing financing terms. Finally, companies or individuals can assume a position called Ponzi, in which there is no hedge for the payment of principal or interests. Those who assume this position are betting to the soaring price of the assets financed with debt that will allow them to pay the loan and get a good profit, it is a very risky behavior and could be defined as irresponsible and even fraudulent.

For Misky, continued credit growth leads inexorably to the rise of interest rate, until this reaches a position even above the normal business profit rate, making it unprofitable to borrow. Businesses and individuals with hedge funds can pay their debts, speculative and Ponzi may not, access to credit will shrink, and many companies and individuals must sell its assets to pay debts. A liquidity crisis occurs. This will ultimately impact the productive sector driving to economic recession. As you can see, in the scheme of Minsky's is inevitable the movement from a robust financial system to a fragile one and it is not necessary to look for external explanations to understand the recurrence of markets crisis.

From the analysis of Minsky, we can rescue from a psychological point of view the fact that companies or individuals with hedge funds begin to abandon a conservative position to the extent that earnings expectations far exceed the cost of financing, finally, prudence is being abandoned and increasingly financial risky positions are adopted. Notably, the risk is shared between lenders and borrowers, and often are the lenders, banks, who encourage speculative behavior of borrowers. When the crisis occurs, the interest rate rises, access to credit shrinks and asset prices plummet, people are invaded by loss aversion and begin the compulsory sale of assets causing the crisis deepens very fast.

We note that the economy as a social reality has a decisive influence on the lives of people; however, motivations, behaviors, attitudes, emotions and expectations of people also determine economic life. In an article I wrote some time ago that talked about inflation, I noted that in a country with high inflation also appears a phenomenon named self-induced inflation.  Faced with the expectation that any good in the future will cost much more, people buy on impulse immediately, though, the good does not satisfy an urgent need. These impulse purchases increase demand and therefore prices, fueling inflation in a vicious circle.

However, individual behavior seeking maximization of economic profit according with the ethics of capitalism itself is considered as normal and human. Therefore, from this point of view, trying to get the maximum profit at a time of booming economy is totally rational and laudable, and in a fully competitive environment absolutely justifiable. The problem is that individual behavior of today is based on expectations about the future, and this is totally uncertain. If my expectations are conservative and I do not take risks so I do not enter in the speculative market, but my competitor does, he will be maybe in a better economic position in the future, but he must be clever to know when to get out of the speculative market, the well-known success business key of Matsushita. But if he doesn't recognize the exact moment to get out, who takes a conservative position could be the winner. As we can see we are in the land of total uncertainty.

According to Minsky's vision, the capitalist system is doomed to suffer bubbles and recurring financial and economic crises due to its internal dynamics. Greed and profit in a boom economic phase will carry society to a further depressive economic phase, in which a conservative and loss aversion attitude will make the crisis deeper (impulsive sales of assets due to panic). Apparently, the only action that doesn't ensure the elimination of crises, but maybe contributes to its attenuation, would be strict government regulation of financial markets to prevent the irresponsible behavior of some financial institutions taking too many risks in the credit supply.

It is noteworthy that the solution is not centered to convince individuals to adopt a set of ethical values that move them away from selfishness, greed and the temptation to speculate. But rather the focus is centered in the regulation of banking where they get funds to speculate. And this control task is entrusted to the government, which is blamed for the financial deregulation (particularly in USA) that allowed the issuance by banks of financial derivatives that were a real fraud, and the outbreak of the global crisis of 2008, only comparable with the crack of 1929.

Are we the human beings in highly competitive capitalist system doomed to experience greed, and that our individual decisions to pursue profit, collectively become in the curse that will take us to the crisis and suffering? At this moment I remember a conversation with an entrepreneur who told me he was cheating with taxes, paying much less than what he really owed. His justification was that his business was in a competitive market, and if he had paid the correct amount of taxes he would finished in a bad position compared to its competitors if they effectively also cheated. He didn’t know if their competitors were cheating or not, but facing uncertainty he had to assume that they were doing it. This is a typical situation of the theory of games; the participants in a market do not have all the information available at the time they have to take decisions. The access to complete information is one of the unrealistic assumptions of the conservative theory about the way the markets work. This theory based in this assumption talks about the infallibility of markets for its ability to regulate itself.

In the boom phase of a bubble companies and individuals are compelled to take risks beyond what is reasonable , because they do not want to be in the future in a bad economic position compared to others, therefore, becomes relevant the uncertainty of the behavior of other individuals to set our own behavior.

Those who should stop this situation, in this case, the banks by tightening credit and being more rigorous in demanding requirements to borrowers, they do not do it for the same reason than their customers. Each single bank does not want to earn less than other banks that have a lax policy about loans.

Finally, over-indebtedness leads many individuals and companies to be unable to pay debts and may even lose their assets. This is something that may sound familiar to those who use credit cards, many individuals reach this state of over-indebtedness unwittingly, and are forced to refinance debts and cut its consumption which means a reduced quality of life.

The decision to speculate with our money or with borrowed money in a bubble market is absolutely ours, however, the only solution that economists give is that a third party (the government) must impose strict regulations on entities that handle credit (banking).

This somehow agrees that greed, selfishness, imitation, jealousy and competition are natural aspects of human behavior, at least in the capitalist system.

Somehow, Keynesian economists like Minsky facing conservatives who say that the best economic policy is one that does not interfere with markets, apparently accept the conservative Adam Smith's thesis that individual selfishness is the rule in market, but they argue that it must be contained in some way because there is no self-regulation.

However, this leads us to ask if in other types of societies, such as real socialism of the twentieth century, human behavior based on greed, selfishness, imitation, jealousy and competition also existed and had bad consequences on the economy.

The answer may be disappointing, it is known by everybody that in those countries there was a widespread corruption network, which culminated in a large black market. Speculation with essential goods was a daily reality.

There was a class of officials with some power who profited from the shortage of essential goods. Therefore, despite the supposedly socialist solidarity and cooperation among individuals, in the Soviet Union and other socialist countries of Eastern Europe, selfish behavior flourished seeking personal profit among the comrades of communist party.

Also, in ancient times and in the Middle Ages we find examples of speculation, we must note that speculation often occurs when there is a demand for a good, well above its supply. In those ancient times, greed and the profit motive were present in economic activity, though; usury was condemned by the Catholic Church. This would lead us to think that in the economic field at least, regardless of the economic system we are analyzing, the different races and the different cultures, the individual's behavior regarding money will be always dominated by the profit motive and greed, and this will often overcome ethical restrictions. As a business man told me a long time ago - “Money talks”.

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