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The Crisis in Economics, a Challenge for Psychology

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On September 15, 2008, Lehman Brothers declared bankruptcy. The event is noteworthy because it was the starting point of the greatest economic crisis since the Second World War. This crisis was caused by developments in the financial sector, in which loans for houses suddenly dropped in value and created enormous losses for banks and their customers who had these loans as assets in their portfolios. Because many banks were of systemic importance for the national economies, governments had to spend taxpayers' money to rescue these financial institutions and tremendously increase governments' debts. Moreover, economic growth decreased with an increase in unemployment.

This sketch of the crisis is far from complete, and it is important to note that the crisis affected not only economies but also people's faith in economic theory. Because the crisis was not predicted by the prominent mathematical models, and because the corrective influence assumed to be exerted by the efficiency of financial markets failed to prevent the "housing bubble" from bursting, doubts about economics' explanatory power spread fast. As a consequence, psychological mechanisms underlying financial decisions drew increased attention, and deviations from the doctrine of rational choice received growing interest as important accounts of economic behavior.

The present monograph by Tommy Gärling and his colleagues is a response to this increasing demand for psychological explanations of financial decision making, and it does a truly admirable job in reviewing the available evidence. The authors first focus on what is perhaps the most basic parameter in such decisions, the assessment of risk, and describe its psychological and sociological determinants. They then identify the most important judgment biases in the context of financial decision making. Having laid this groundwork, the authors are ready to move on to the two most important domains of financial decision: the stock and credit markets. Although one may wonder why they did not choose the same psychological categories as substructures for both domains, the authors succeed in identifying an enormous number of important phenomena, ranging from "overreaction to news" to "repayment experience." The authors devote the remainder of the report to some psychological consequences of the financial crisis and analyze it from a social psychological perspective.

While the reader profits from an exceptionally thorough review of the literature, the authors, like others in the field, refrain from integrating the reported findings into a single conceptual model. The sequential account they propose distinguishes two phases of decision making (pre-decision and post-decision) but is not sufficiently specific to describe the interaction between cognitive and affective processes in generating judgments, decisions, and behavior. This is exactly the criticism that economists bring forward in defense of their model of rational choice. They often argue that psychologists and behavioral economists may have discovered important anomalies but that they are unable to propose a coherent model that could replace or extend the dominant rational choice account. Such a model must be able to integrate the cognitive mechanisms involved in assessing utility with affective influences and behavioral impulses. Such attempts that exist in both economics and psychology have resulted in dual-process or dual-systems models that try to capture the affective components of economic decisions and thus extend the model of rational choice. Although the present report does not make such an attempt, it may promote such a conceptual integration by revealing its necessity.

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