Psychology, Financial Decision Making, and Financial Crises

January 01, 2009

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How could the current financial crisis have happened? While fingers have been pointing to greedy banks, subprime-loan officers, and sloppy credit card practices, these are not the only contributors to the economic downturn. A new report examines the psychology of financial decision making, including the role of risk in making economic choices, how individuals behave in stock and credit markets, and how financial crises impact people’s well-being.

Risk taking is a very important component of financial decision making — If we take out a big loan, will we be able to pay it back? Should we buy shares of a company that is unknown but has potential for great success? When it comes to making decisions under uncertainty, people tend to be more influenced by perceived risk than by objective risk. People who are extraverted and high in sensation seeking are likelier to take more and higher financial risks than are people high in conscientiousness and anxiety. Stock market investors are prone to cognitive biases (such as overconfidence), which are reinforced by affective and social influences, and these may contribute to several phenomena observed in stock markets (e.g., volatility of stock prices due to excessive trading). Credit use involves many different stages of decision making, including deciding whether or not to purchase a product using credit and determining a strategy for paying back the borrowed money.

Financial crises take a large toll not just on people’s wallets, but also on their behavior. Consumer confidence affects spending and saving. Individuals cope with financial crises in a number of ways, for example by shopping in cheaper stores and eating out less. Making lifestyle changes (e.g., selling the car, making their own clothing) is very difficult for most people and is often a last resort to dealing with economic troubles—these changes clearly signal to themselves and others that they are struggling financially.

Are financial crises inevitable? The authors argue that bringing about change in financial institutions may not be easy, but they offer suggestions for improving economic decision making. For example, educating consumers — by offering economics courses to children in school and teaching consumers how to appropriately handle credit — and by making financial institutions more responsible (e.g., banks offering Web-based programs to assist with budgeting).

Editorial: The Crisis in Economics, a Challenge for Psychology

Fritz Strack

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