The Psychology of Financial Decision Making and Economic Crises

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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 in *Psychological Science in the Public Interest*, a journal of the Association for Psychological Science, 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? In this report, authors Tommy Gärling (University of Gothenberg, Sweden), Erich Kirchler (University of Vienna, Austria), Alan Lewis (University of Bath, UK), and Fred van Raaij (Tilburg University, The Netherlands) note that 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. "The general implication is that financial crises may have more serious consequences for people who are more likely to take financial risks," write the authors.

Efficient-market theory states that stocks should always be traded based on their real value. However, 5 minutes on the floor of the New York Stock Exchange reveals a different reality: Stock investors overreact to news (especially of events that threaten the world economy), selling winning stocks too soon while hanging on to losing stocks too long, and following other traders' leads in buying and selling stocks. According to Gärling and his colleagues, 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).

Many people rely on credit, not just the plastic card kind, but also in the form of automobile financing and loans from friends. 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. The authors observe that "many credit users are facing a complex task when they decide to take up credit and that they often fall prey to cognitive errors when anticipating their experiences with credit payback."

Financial crises take a large toll not only 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).