The norm and animal spirits

All crisis have one element in common i.e. human behavior

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A view of how we got into the mess

- Who is to blame
- What went wrong
- Mistakes we all made
- The role of science and math
- How to get out of it

- Was it a perfect storm?

It was perfect, but not a storm

- Humans represent the largest systemic risk
- We behaved as if we were humans

A bit about the history:

- Once economics was part of moral science
- Moral science was about right and wrong
- Philosophy, ethics and economics were close
- They were one science untillllllllll

The famous Adam Smith (1793-1790)

- He was a philosopher and an ethics professor
- He was a famous economist
- He believed in free markets
- ~~Self-interest drives wealth of a community~~
- Markets know how to self correct
- No government interferences in markets
- He believed in virtues of mankind

- But his theories were highjacked in the sixties

Before Adam

- Moral science is about good and bad behavior and who sets the norm and who controls
- In today's world; who writes the rule book and who does the enforcement?
  - God (Christian norm)
  - Forefathers (Ancient norm)
  - Internal norm (Greek)
  - External verdict (Honor Ethics)
  - Nobody (Animal Spirits)

Thomas Hobbes (1588-1679)

- An English philosopher developed concept of “State of Nature”
- In “SoN” we all behave like animals; live is harsh; rude and brutal
- We want to survive in dignity, not possible in “SoN”
- We surrender part of individual freedom
- We accept authority by delegating power to an absolute Monarch
- Monarch sets the rules and enforces
- Monarch has to play an absolute role
- The start of the concept of social contract

After Adam Smith

- Economics became more and more a natural science
- Brownian motion as a concept
- The math became dominating
- Humans assumed to be norm people
- Science was about “is” not about “ought to”

Brownian motion

- Brown a Scottish botanist
- In nature (gas and liquids) particulars walk randomly
- Why wouldn’t stock prices do the same
- Stochastic process key in determining Future values of securities in a liquid market
- A new science was born; economic science

The birth of

- Efficient Market Theory; efficient portfolios; efficient frontiers
- Efficient markets based on liquid markets
- Black and Scholes Option Theory
- Regression from the past was the future
- The world fits in a mathematical model

- *Never heard about Systemic risk*
- *Never heard about Illiquidity*
- *Never heard about Humans*

Reagan and Thatcher years

- Kill role of big government
- Government is serving not leading
- Free markets are self-correcting
- The rediscovery of Adam Smith
- Theory about Free markets

Adam Smith’s highjackers

- Robert Merton
- Milton Freedman
- Paul Samuelson

- They preached the economics is about “is”
- They preached self correction of markets but
  - They forgot systemic risk
  - Forgot about mass communication
  - Adam Smith was misread

Keynes had another idea

- Introduction of animal spirit
- People have also non economic motives
- People not always rational in pursuit of economic interests
- Markets cannot solve consequences of Animal spirit
- Requires steady hand of Government; leading

- Corruption / bad faith
- Boom bust cycles
- Price volatility
- Trending of markets ; herd behavior

We explained it away

- Normal distribution with fat tales
- When it rains it pours
- The rare event fallacy
- Skewdness and asymmetry
- Randomness does not look to be random

- The birth of Black Swans

Who is right

- Markets have no ability to self correct
- People do not walk randomly but in a herd
- Animal instinct is prevalent; keep sight of the Exit
- Universality of action is a systemic risk
- Economics cannot assume a norm person
- Markets behave abnormal; models fail

Solvency problems Banks

- Capital adequacy bases on norm behavior i.e. models

- Capital need is based on animal spirits i.e. market prices (IFRS)

- The difference is a solvency problem

What about Alan

- He is a free market believer
- He believes in humans behaving normal
- He believes in Adam Smith's free markets

- Admission:
  - Could not believe systematic misjudgment
  - Continuous to believe in "is" and in models
  - So let's build a new model or tweak the old one

Economy is determined by people

- Abnormal behavior is largest economical variable; here to stay, was never away
- Behavioral economics is key
- Moral science has returned
- Ought to is not religious but practical reality
- Ought to is back and called “Financial Ethics”

Modern Tribes Men; the Coalition Man

- Humans in financial sector are egoists
- Selfish behavior does not add up to Wealth of Nations…… on the contrary
- ~~Selfish behavior can be destructive (-effect)~~
- Humans join forces for their own good
- Humans enter into many individual coalitions
- Corporate concept is past; tribe concept is future
- Different kind of Social Contract

Science from “is” to “ought to”

- What is your anchor to “ought to” questions?
- Behavior has to be sustainable

- That is:
  - From a social aspect acceptable long term
  - Environmental responsible
  - The trade from short to long

Direct lessons

- Animal spirit is real; beware of consequences
- Models are to help, not to dictate
- Know the assumptions of models and beware of them
- Models fail for large exposure
- Eliminate human behavior that creates systemic risk
- Bring capital adequacy in line with animal spirits
- Sustainability is “ought to” is key
- Use the test of long term sustainability