Referee report on
"Addressing the Psychology of Financial Markets"
by David Tuckett
(Economics Discussion Paper Nr. 2009-37)

David Tuckett argues in his contribution that financial markets are inherently unstable since human beings are boundedly rational and thus not able to cope with the complexity of these systems[1]. Therefore, we repeatedly observe bubbles and crashes. Moreover, an effective regulation of financial markets has to take the psychology of markets seriously into account.

Overall, Tuckett points out a number of interesting aspects. There is, in fact, a lot of empirical evidence showing that human beings are boundedly rational and thus display some kind of rule-governed behavior or a subject to behavioral biases. For instance, extrapolation of trends, observed in many experiments, may harm financial market efficiency in the sense that if a sufficient number of speculators relies on such a routine a larger self-fulfilling up-and downward price movement may emerge.

However, I have some serious problems with this (rather lengthy) contribution. In my view, this contribution is more an essay than a "hardcore" scientific paper (but maybe here different professions have different views about what is right and wrong or good and bad). Essentially, the author tells us a story - partially supported by empirical evidence - which is interesting, yet not really compelling. One may easily tell such a story more in this or that direction, and thus give it a different tick, and therefore I don't see what we can really learn from such an exercise.

Note that in the last couple of years several theoretical models have been put forward which take the psychology of markets formally into account and there are by now a number of survey papers on behavioral finance. This line of research is buffeted by empirical studies and laboratory experiments. These works are essentially not cited, but in my view much better suited to show us how to think about the functioning and regulation of markets.

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[1] There is some overlap between Tuckett's arguments and Shiller's concept of "new era thinking", as expressed in his book on "Irrational Exuberance".