David Tuckett: 'Addressing the Psychology of Financial Markets'

This paper summarises and develops David Tuckett's earlier ideas on emotional finance and applies them to policy recommendations. This is potentially a highly fruitful line of research, addressing the basis for behaviour in financial markets from the perspective of psychology, something which is attempted in economics by behavioural finance. The paper is therefore a welcome addition to the economics literature. My comments below are addressed to ways in which the paper might nevertheless be strengthened, particularly in terms of successfully communicating with economists (both mainstream and non-mainstream). My comments are therefore addressed primarily to issues that arise from the paper on the interweaving of economics and psychology.

Emotional finance focuses on a series of core psychological perspectives on behaviour which can contribute to behavioural economics, but which also pose particular challenges. First, there is the notion of a divided state of mind. Second there is the notion of the subconscious. Third there is the notion of assumption groups. Fourth, emotion is a 'driver of our capacity to live' rather than 'eruptions of irrationality' (p9).

It is very difficult to see how formal rational choice theory can be adapted to encompass these perspectives. Thus for example, while it could be argued that herding theory captures the essence of assumption groups, the theory is still couched in terms of rational choice which involves conscious, goal-oriented behaviour which is optimal given the available information set. But Tuckett argues that, for assumption groups, information is 'like background noise' (p5), and 'information that should create anxiety is blocked' (p6). As Tuckett notes at the end of the paper, psychology has instead tended to be applied to (mainstream) economics in terms of the conventional split between rational and irrational behaviour (ie accounting for irrational behaviour). For all its acknowledgement of psychological factors, behavioural finance normally constrains itself to treat rational behaviour, as both defined and expressed by conventional decision theory, as the benchmark.

The paper therefore also illustrates the perils of interdisciplinary work in that 'deep background' as well as explicit methodologies, theories and definitions differ. (This also applies within economics, although to a lesser extent.) Thus for example the use of the word 'rational' has to be treated with more care, with some prior discussion of relevant differences between the disciplines. Further, since Tuckett's psychological account does not lend itself to formal representation, this too could usefully be addressed explicitly, since behavioural finance is constrained by the formalist methodology of choice theory. I agree with the conclusion that interdisciplinary theory of financial markets is necessary for effective design of regulation. But there is a great need for much ground-clearing before the necessary interdisciplinary communication can be fully effective. There are some interesting ideas on this, noted briefly at the end of the paper, which might be more fully developed. But I am suggesting that some issues of interdisciplinary communication need to be addressed much earlier in the paper in order to engage a wider readership as the theory is presented.

There is a need too for economists to communicate more effectively with psychologists. And these final comments are offered in this spirit. First, a considerable body of work in economics (notably that drawing on Keynes and Minsky) takes a different view of rationality from choice theory and emphasises the uncertainty of knowledge - not just at particular times (Tuckett, p10) but more generally. The Keynes/Minsky literature has focused particularly on knowledge issues as being central to financial market behaviour, not least because of the integration of emotional factors, such as response to uncertainty. But Keynes used the concept of animal spirits differently from what is implied here (abstract and p.3). Keynes argued that a rational optimiser (in the choice theory mould) would never act (ie make a choice) since there is never complete information (including information about risk); action therefore requires the exercise of animal spirits. So Keynes saw animal spirits in a positive light, as part of how we overcome uncertainty. But it requires further discussion to consider animal spirits as something to be mitigated, as here.

Indeed there has been a longstanding engagement with the conventional wisdom in economics by those arguing for a different way of theorising, eg about behaviour, and for different methodologies. It didn't just begin with Akerlof and Shiller (Tuckett p.18). For a variety of reasons, such as that this kind of work has tended not to be published in the leading mainstream journals, not only mainstream economists but also interested researchers from other disciplines have tended not to be aware of it. This lack of awareness has become apparent particularly in public discussion of the current crisis.

One further economic point: there is reference (abstract and p.3) to the managing of savings. But particularly in the current crisis should there not also be reference to managing debt?