Herd Behaviour and the Current Crisis October 12, 2008

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Recent events have reminded many people -- including central bankers, home buyers, investors and economists -- of the risks inherent in an economic system. We have all learnt a little humility (in 2003 and 2004 I argued that a large housing crash was likely, but I did not correctly predict its timing) and as economists we have to accept part of the responsibility for what has happened. It is the job of experts to prevent crises in the domains in which they are meant to be expert. In this sense, economists have let down the country.

The Financial Times website records the views in early 2008 of two dozen of Britain's economists. These were given to Chris Giles in response to his annual survey. They make interesting reading. Probably the consensus position was that problems were coming but would be slow to develop. We underestimated their speed.

Commentators seem currently to have forgotten one point. It is that herd behaviour began the credit crisis. Downward overshooting by the herd is now the prime danger.

Why do herds form? They happen when relative position matters. People paid extraordinarily high prices for houses, even though not justified by fundamentals, because they felt they were trailing behind the Joneses. Brokers sold unsound mortgages because they had to keep up with rival brokers. Money managers -- remunerated on their relative performance against other managers -- traded shares with the same motive.

Yet conventional economics contains no recognition of such action. The word 'herd' does not appear in leading textbooks. In consequence, those texts do not offer an intellectual framework that could have predicted, or can help policy-makers in, our current dilemma. The research journals are little different. Since 1970, on an electronic count, only 3 out of the last 8000 articles in the Economic Journal discuss herd behaviour; 2 out of 2000 articles in the Quarterly Journal of Economics; and 4 out of 1500 articles in the Journal of Financial Economics. It would be difficult to prove that this is why the world is in a mess. But common sense suggests that the lacuna is a powerful contributing factor. Just as before the Great Depression, economists and central bankers have been using the wrong model of human behaviour.

It will be necessary to rewrite standard economics. We must bring the idea of relative comparisons and herd behaviour into the centre of our thinking. A good place to start is William Hamilton's article on defensive herding in the 1971 Journal of Theoretical Biology, and work by Andrew Clark and others in, for example, the 1998 Journal of Public Economics.

In a world with herd behaviour, there exists a natural intellectual case for government intervention to internalize the externalities created. The cool-headed individuals of our unrealistic traditional textbooks do not need to be regulated. Herds do.

Extract from the Financial Times Survey of Economists in early January 2008

Andrew J Oswald, Warwick University: I think we will survive fairly well but yes there are risks and we should be concerned.

The key risk is a domino-like decline in savers' confidence in the western nations' banking institutions.

Especially in the UK, we have grown complacent. Human beings' willingness to leave their pound notes in banks is the ground floor of a financial system. But history tells us that in choppy times that willingness is intrinsically fragile. With one shadow of doubt about the safety of their deposits, savers don't care about another per cent or so on their deposits; they just want out. Governments simply cannot guarantee unlimited amounts. This, potentially, is the wild card in the current crunch.

One or two more Northern Rocks would thus start an unravelling of confidence in a way we have not seen since World War II. Once is happenstance; three times would appear to savers like enemy action. This is not likely, just a possibility.

A contraction in savers' confidence would cause a retrenchment, ultimately, in everyone's ability to borrow for their next widescreen TV and sports car. This could be tricky for us as policymakers. If that happened, Keynes -- who emphasised 'multipliers' and the importance of psychology -- would have the last *laugh on modern macroeconomists and their emphasis on the assumption of cool-headed rationality.*

Most of the time, of course, such cool-headedness is a good description of life. But it is instructive to remember that before the Great Crash, and the Keynesianism that came after, the prevailing theory of economics was, bar mathematical detail, just like that dominant today. Probably most economists under 40 don’t know this.