Theoretical and Applied Economics
Volume XX (2013), No. 3(580), pp. 147-152

Liberalisation and regulation in the financial crisis – is behavioural economics a solution?

Liviu-George MAHA
Alexandru Ioan Cuza University of Iaşi
mlg@uaic.ro
Paula-Elena DIACON
Alexandru Ioan Cuza University of Iaşi
diaconpaula@gmail.com
Gabriel-Andrei DONICI
Alexandru Ioan Cuza University of Iaşi
gabriel.donici@gmail.com

Abstract. *The causes of economic crisis are a subject of intense debate, most opinions of economists ranging from the liberalization of the market to its regulation. We believe that usually there is "sufficient state" and that a change in its level does not have the expected effects. Although on the long term the reduction of the state presence would be preferable, on the medium and short term this would have negative effects, such as the reduction of the number of employees. One solution would be abandoning the simplistic neoclassical economic models, and replacing them with models developed in behavioural economics that would allow state and companies to develop more effective strategies.*

Keywords: financial crisis; liberalization; government intervention; behavioural economics; homo oeconomicus.

JEL Codes: D03, G01, K20.
REL Codes: 5K, 17E.

1. Introduction

The economy, like the rest of the social sciences, is concerned with the study of the most spectacular and unstable element: the human being! The particularities and uniqueness of the subject does not allow the creation of a valid general theory. The diversity of human beings makes the analysis even more difficult because unlike the exact sciences we cannot make observations in the laboratory. This is why there are difficulties in explaining real situations using various economic theories.

This article aims to constitute a brief insight into the structure of the complex phenomena of financial crises. The paper also seeks to understand if feasible solutions can be found both on traditional neoclassical branch, and the new branch of thought in economics, namely behavioural economics.

2. Approaches on the fundaments of the current crisis and potential solutions

In principle, regarding the financial crisis of recent years, in the scientific world there are two major views (Braun, Rallo, 2011):

- Of the economists who believe the crisis is caused by excessive government regulations. Whether we speak of the libertarians or the liberals, the view is the same: the excess of state stifles free market and hence entrepreneurs' initiatives. This is because:
  - The excess of regulations hampers the initiatives of entrepreneurs;
  - Public companies (of the so-called public interest) that disrupt the distribution of resources (problem compounded in the case of scarce resources) and prevent "optimal development"(1) of the market supply are protected by the state.

The solution proposed by the proponents of this idea is to limit the state and increase market freedom.

- The economists who believe that the insufficient public intervention is precisely the causes of the crisis. Thus, economists from neo-Marxist and Keynesian schools of thought believe that the crisis is another proof, to those of the past(2) that the economy cannot function without state intervention. Guilty, in their opinion, is the free market and the solution to this problem is to increase the role of the State, by implementing expensive programs designed to create artificial demand in the market. Interestingly, in most cases when this solution fails they don't seek an alternative but to increase public spending.

Discussions regarding this dispute seem to have no purpose and as written literature for and against these views are generous enough not to dwell on these issues, we will focus below on our issues of interest.

The fact that none of the visions did succeed to impose itself as irrefutable dogma encourages us to bring into question as a direction and possible solution to these shortcomings, behavioural economics. We believe especially that it can be a viable solution in the elaboration of strategies for both private firms and government.

Our conviction is based on the belief that the statist and the liberal vision are wrong by attitude to individuals. This is, for most theorists, followers of one of the two directions, a standard unit, deprived, largely, of the characteristics that distinguish it from the masses.

An interesting example for the analysis of relations between the two directions and behavioural economics is precisely the role of individuals in the economic crisis (Murphy, 2008, pp. 2-3). It was established that bubbles caused by toxic products in the financial market led to the crisis of recent years and that, in general, representatives of the two visions have accepted this and focussed their discourse on one major direction, as follows:

- Interventionists considered that the world states must direct their efforts to save the financial institutions that are too big to fail. For this purpose they appealed to financial programs of hundreds of billions of dollars, without taking into account the effects that could generate inflationary pressures on the economy. And without a serious concern about the fact that, in this case, those who end up bearing the costs are individuals;
- On the other hand, most followers of liberalism have relied on the fact that these institutions are unhealthy results of State intervention and that their failure would be preferable because it would allow a faster healing the economy and it would not affect individuals in the same extent.

Cases where individuals have benefited from aid for survival the crisis period are very rare. Why chose helping financial giants at the expense of individuals, while the latter policies were those that generated the power crisis? Any answer is elusive. Products of these institutions made the individuals negligent and to borrow amounts of money that they could not allow returning. Somehow the individual was the victim of the system created by the state and the financial institutions.

Although individuals were most affected by the crisis, government efforts were directed towards rescuing all those who manipulate the market, leaving individuals to pay for it, because the great rescue programs are paid for by increases in taxes, depreciation of currencies national and so on, resulting in a spiral that does nothing but affect actual purchasing power of individuals.

Publicized rescue programs of national economies did not have the desired effect. Saving companies "too big to fail" was not sufficient to cause individuals to act on the market. Saving banks and budgetary limitations affected the income of individuals in such an extent that they significantly changed their behaviour, assuming far less risk (Scherer, 2010). In part this behaviour is explained by the decrease in purchasing power and the realization that they cannot forecast future income trends.

Concerned with salvation and hastening the bankruptcy of financial institutions, followers of the two visions have omitted a major factor of the crisis: the individual. Interestingly, although financial institutions were those that offered individuals unhealthy financial instruments that allowed them to live in an unsustainable manner (Crotty, 2008), they cannot be considered absolute guilty because they have not used force to sell their toxic products.

3. Homo oeconomicus in search of satisfaction

We believe that the economy should be concerned to explain widespread non-economic behaviour of the period before the crisis, to explain why individuals have indulged in behaviours that are not within the rules of *homo oeconomicus*, why they were suitable actions that are not economically rational.

If individuals acted reasonably (not even perfectly rational) they might have sought to restrict the loans and would have avoided to increase the amounts borrowed at a level that would have allowed him to support. Reality is different because many risk their safety to get instant gratification. However, in the acceptation of von Mises (2002 [1966]) the individual is rational because it acts in order to satisfy their needs.

From the perspective of behavioural economics we can accept the idea of a rational individual if we reformulate it and accept that the *homo oeconomicus* of neoclassical taught, when seeking to maximize utility, does not seek to achieve the highest possible monetary(3) compensation at the end of the day, but the highest satisfaction possible (Etzioni, 2011). It is therefore natural to see individuals who give up successful careers to activities that make them happy.

In principle we can accept that individuals are rational in the short-term but this is not always valid for a longer period. Even if people choose, at present, the actions that bring them maximum satisfaction (for example, to enjoy a home involving a 30-year mortgage) their effects can reduce future satisfaction (mortgage payment after the loss of employment). This happens because individuals have a limited ability to forecast (Camerer, 2005, pp. 8-10), and they cannot really predict how many years they will work, how will evolve their revenue, when will they retire or lose their job or when will they die. Often, this limited capacity of forecasting makes them act irrationally on a long-term and commit to loans to enable them achieving major satisfactions in the shortest time possible. So their behavior is not based on a realistic forecast but one idealistic.

Even though it may seem extreme, our belief is that individuals who acted without taking into account the real financial power are guilty, along with financial institutions. But unlike the latter they deserve another chance because after all they are "too small to fail". Knocking out on the basis of economy, individuals who dictate the market proved to be aggravating the crisis. Thus, all forecasts, to date, on the global economic recovery were denied because individuals simply do not have enough purchasing power.

Both liberalism and interventionism in economic models are based on some abstract individuals: selfish and perfectly rational, on the one hand, and free of any trace of selfishness, always ready to sacrifice for the welfare of society, on the other. In fact, the real individual is captured better the vision behavioural economics, where he is a complex person, with actions that are reflected in failures, and behaviour incomprehensible to the economy (Berg, 2010, pp. 861-863). It is true that this complex individual hampers economic development models, but its use would allow a real reduction of the revealed lacks of these models.

Does behavioural economics allow us to determine individuals to stop risky loans? Certainly not, for all that can be done is to facilitate the identification of certain patterns of behaviour that allow a better explanation of economic problems and finding more appropriate solutions.

Conclusions

Behavioural economics is not a miracle solution that has the ability to replace Keynesian or liberalism, but its use can improve the theories and models of both schools of thought. Rethinking theories and strategies in accordance with the essential features of individuals allows a major change of vision. Now, the discussion has shifted decisively from somewhat dry concepts of state and market to the one of individual.

It should be noted, however, that the Liberals, with eternal homo oeconomicus, are those who were closest to the individual vision Behavioural School. Later von Mises was able to provide a much more realistic picture of the economic individual acting not to obtain financial compensation but to increase its satisfaction, whether it is expressed or not monetary.

In the long-term behavioural economics is a solution to contemporary economic problems. It is characterized by the concern for the individual and for his role in gearing the economy. A model of economic integration, of the real individual, would increase the realistically part of this science.

Notes

(1) By optimal development we mean the maximum demand that could be achieved in the absence of government intervention in a market.
(2) In principle, most crises from the imposition of liberalism until today have been attributed to the excess of freedom.
(3) A perfectly rational homo economicus would always be informed and able to choose the optimal route actions to assure the highest possible monetary benefits.

References

Berg, N. (2010). *Behavioral Economics*, in Free, R.C. (editor), *21st Century Economics: A Reference Handbook*, Vol. 2, Part VII – Emerging Areas in Economics, California: Sage Publications, pp. 861-872, accessed on November 2012 at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1677026

Braun, C.R., Rallo, J.R. (2011). *O criză şi cinci erori*, Editura "Alexandru Ioan Cuza", Iaşi

Camerer, C.F. (2005). "Behavioral Economics", *World Congress of the Econometric Society*, London (Unpublished), accessed on November 2012 at http://authors.library.caltech.edu/21990/2/worldcongress05v18.pdf

Crotty, J. (2008). "Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture'", University of Massachusetts, Department of Economics, *Working Paper*, accessed on November 2012 at http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1017&context=econ_workingpaper

Etzioni, A. (2011). "Behavioral Economics: Toward a New Paradigm", *American Behavioral Scientist*, Vol. 55, No. 8, pp. 1099–1119, accessed on November 2012 at http://icps.gwu.edu/files/2011/09/Beh-Ec-New-Paradigm.pdf

von Mises, L. (2002[1966]). „Acţiunea Umană", *Institutul Ludwig von Mises România*, available on http://mises.ro/43/, pentru versiunea în română 2002 Institutul Ludwig von Mises - România, traducere în română după Human Action, Henry Regnery, 3rd rev. ed., Chicago, 1966

Murphy, A. (2008). "An Analises of Financial Crises of 2008: Causes and Solutions", accesat în noiembrie 2012 la http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1295344

Scherer, F. M. (2010). "A Perplexed Economist Confronts 'To Big To Fail'", *Harvard Kennedy School, Faculty Research Working Paper Series*, accessed on November 2012 at http://web.hks.harvard.edu/publications/getFile.aspx?Id=547