

A psychoanalytic approach to explanation of the Housing Bubble: From individual to group

June 2011

Allan Compton, M.D*

Clinical Professor, Department of Psychiatry and Biobehavioral Science, UCLA

New Center for Psychoanalysis.

Sule Ozler, PhD**

Associate Professor, Department of Economics, UCLA,

New Center for Psychoanalysis.

Keywords: financial bubbles, group functioning, uncertainty, anxiety

*1081 Moraga Drive. Los Angeles, CA 90049. E-mail: alacpr@ucla.edu, phone: (310) 476-4228

** 944 9th Street #5. Santa Monica, CA 90403. E-mail: ozler@econ.ucla.edu phone: (310) 869-5994

We thank Linda Brakel, Morris Eagle and Linda Goldman for helpful comments.

A Psychoanalytic Approach to an Explanation of the Current Housing Bubble: From Individual to Group

June 2011

ABSTRACT

Can psychoanalytic thinking illuminate the recent housing bubble? Investment is carried out under uncertainty: we don't know. J.M. Keynes argues that under such circumstances individuals act on the basis of animal spirits (spontaneous urge to action) and rely on group conventions. In psychoanalytic terms uncertainty necessarily implies anxiety, an individual defends against anxiety in undertaking investment decisions. We suggest that a psychoanalytic approach based on conflict/compromise model put forward by Freud, then articulated by Brenner, and unconscious group functioning models integrated with Keynes's psychologically minded views can provide a framework towards explaining the recent housing bubble that cannot be explained by mainstream economic models. But the goal is to provide a synthesis of economic and psychoanalytic theories. The practical purpose of the paper is to promote the possibility of discussion between psychoanalysts and economists.

I. INTRODUCTION

Inflation adjusted home prices in the U.S. increased 85% between 1997 and their peak in 2006, then collapsed 32% by the beginning of 2009.¹ Academics and the general public all have an interest in understanding the dynamics behind such major, widely damaging occurrences.

Eventually we all realized that the experience in the housing market was a “financial bubble”²

The housing bubble and subsequent disruption of world economies provide present or potential data that offer an opportunity for integration between psychoanalysis and economics. This purpose requires that we go beyond the limitations of mainstream economic analysis.

Mainstream economics holds that markets are inherently stable, viewing capitalism as a near-perfect system, an idealized vision of a world in which “rational men” interact in perfect markets. This view neglects psychological factors, turning a blind eye to the limitations of human rationality. Few people outside of academic economics and certain areas of the business community find these ideas tenable. Any explanation of a socio-economic event that fails to include the role of conscious and unconscious motivation and conflict---that is, of human psychology--- as sources of economic activity is incomplete at best. One obvious reason for our emphasis on motivational and conflictual sources of behavior in investment settings is that investment decision are made under uncertainty, defined as not knowing the future by the great

¹ Case /Shiller Index.

² It is sometimes referred to as a **speculative bubble**, a **market bubble**, a **price bubble**, an economic **bubble**, a **speculative mania** or a **balloon**. A simple *supply and demand model* may be helpful in explaining this notion. For example, demand for housing is determined by factors such as population growth and low interest rates. Supply may be determined by building costs. These factors together determine the intrinsic value of houses.

20th Century economist John Maynard Keynes. Keynesian uncertainty assumes that we do not even know the probability distributions of variables necessary to calculate the value of assets as is assumed in rational expectations models.³

Nevertheless, all of us make economic decisions, such as investing. Keynes proposed that individual actions are in part based on “animal spirits” (spontaneous urges), to which he referred as “unconscious mental action.” Decision in the face of uncertainty is an ideal situation for producing anxiety and other not-conscious mental behaviors that dominate decision making. These are important reasons for us to seek some broader integration of psychodynamics and economics. Keynes further argued that we rely on the judgment of the average, anticipating what average opinion might be. Basic concepts for the formation and nature of economic groups which readily articulate with psychoanalytic dynamics of integrated economic group formation and function will help us to understand bubbles.

In the buyers-only focus on the housing bubble, as used by us in this paper, the conflict and compromise formulation model can help to produce a framework for explaining aspects of the rise and collapse in prices and the switch between the two. We argue that in the presence or even in the absence of externally triggering events, the psychodynamic framework offers an explanation of internal mechanisms that contribute to the rise and eventual collapse of prices.

The work closest to ours is the pioneering study of Tuckett and Taffler (2008). They suggest that people form emotional relationships not only with other people and animals but with physical objects of which “assets” are an example. A phantastic object is “a mental representation of

³ See Farmer (2010) for a recent analysis of swings among various schools of economic thought and an adaptation of Keynesian principle that markets do not always work well.

something (or someone) which in an imagined scene fulfils the protagonist's deepest desires to have exactly what she [or he] wants, exactly when she [or he] wants it" (p. 396).

As in Tuckett and Taffler (2008) our practical purpose is to provide an interdisciplinary framework that uses the insights from human psychology. We also see that "...since standard psychoanalytic thinking significantly differs from other ways of understanding human psychology, it may have a unique contribution to make." (p. 389).

We have elected to use the psychoanalytic model of conflict and compromise formation (Freud, 1896; Brenner, 1982) a choice, rather than a stimulus, made on the basis of utility of the model in general and especially in stressful decision-making situations. Plausible hypotheses about the relations of individuals in and out of groups in mass economic events can then be proposed.

Obviously, our approach is not a unique way of thinking as evident from the work of Tuckett and Taffler. By providing another framework, however, we illustrate the usefulness of an alternative approach.

Another recent study that employs a psychoanalytic approach to financial crises is by Morante (2010). The author argues that the psychological factor underlying the crisis was the collective need to escape reality and find an escape in the ownership of money and property.

The rest of this paper is organized as follows. In Section II we provide a description of the housing bubble. Section III contains Keynes's fundamental concepts relevant to behavior under uncertainty. In Sections IV and V we describe Freud's approach to group functioning and the conflict compromise model, respectively. A synthesis of the aforementioned theoretical approaches to understand the rise and downswing of the bubble is contained Section VI. Finally, in Section VI we provide a discussion of this paper.

II. HOUSING BUBBLE

Acclaimed financial historian Charles Kindleberger (Kindleberger and Aliber, 2005) presents a lively description of what happens in a bubble. They state that bubbles emerge because people buy assets---securities, commodities or real estate--- not because of the expected rate of return on the investment but in anticipation that they can be sold to someone else at an even higher price. They call this phase “mania”, meaning a frenzied pattern of purchases. Markets at this point are in a state of what has been called “irrational exuberance.” “There is a pervasive sense that it is ‘time to get on the train before it leaves the station’...” (p. 12).

Periods of “panics” and “crashes” follow manias in this account. Kindleberger and Aliber refer to real world events such as a government policy change, or a failure of a major firm as potential sources of a pause in asset price rises. Since most of the investments before the downturn, however, were financed with borrowed money, the investors find themselves making larger interest payments than the returns they get on their investments and become distressed sellers. “Their distress in sales leads to sharp decline in the prices of assets and the panic and crash may follow... The rush to sell these assets before prices decline further becomes self-fulfilling and it resembles a panic.”⁴ (11)

The most commonly used data compilation on housing prices has been developed by Karl Case and Robert Shiller known as the Case-Shiller Index. Home prices, as well as some fundamental variables that might be relevant for housing prices are illustrated in Figure 1. As Shiller (2008)

⁴ Kindleberger and Aliber, relying on Minsky (1975) explain the cycle of manias and panics as a result of pro-cyclical changes in credit supply. In good times the credit supply increases rapidly, and in bad times credit supply declines sharply.

argues, based on the following diagram, the housing price changes were not a consequence of changes in economic fundamentals.

If the fundamental economic variables do not explain the bubble price increases, what other factors might explain it? This question is addressed by Nobel Prize winner George Akerlof and Robert Shiller (Akerlof and Shiller, 2009). They focus on how human psychology drives the economy by highlighting the importance of Keynes's "animal spirits" (briefly defined as "spontaneous urge to action." See next section for a fuller exploration).

Akerlof and Shiller's psychologically driven explanations serve as a useful starting point. They tend, however, to use behavioral interpretations of the phenomena they address, rather than to explore the role of conscious and unconscious compromise choices people make. Keynes's ideas, as presented in the next section, are useful premises for a dynamic, psychoanalytic undertaking.

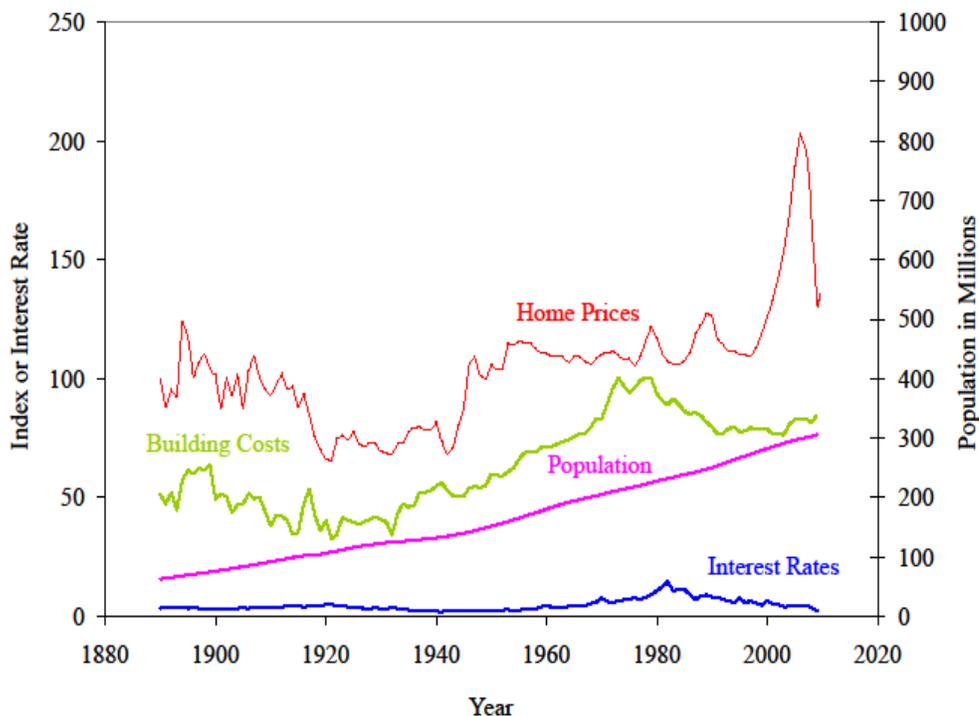


Figure 1: Source: Robert Shiller-online data

III. ECONOMIC UNCERTAINTY AND INVESTMENT

All economic activities are carried out by people. What the motives are and in what way they produce various economic outcomes are points of central interest. Investment is one of the key economic activities. Uncertainty about future returns of investment is a crucial determinant of level of investment and as such an important building block for the topic under investigation. If there were no uncertainty about future returns of today's investments, there would not be asset bubbles. Uncertainty is also a fundamental building block in our analysis of the interaction of individual psychologies and group behavior. What is called "uncertainty" in the economic

world is called “anxiety” in the world of individual psychology and affects. How an individual wards off anxiety either on his own or by reliance on groups is key to the understanding of individual or group behavior under uncertainty.

The mainstream “**rational expectations**” (RE) models have important knowledge requirements. Two important building blocks of RE models are the following. First, individuals know the probability distribution of all relevant variables. Using all the information available, they can calculate the expected future values of variables (like prices of houses). Second it is assumed that the model individuals use in making their forecasts is the correct one: that is, the economy behaves in ways predicted by the model. In finance, the **efficient-market hypothesis (EMH)** asserts that financial markets are “informationally efficient”, or that prices on traded assets (*e.g.*, stocks, bonds, or property) already reflect all available information, and instantly change to reflect new information.

Keynes tells us a very different story. He states, that “Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible.” (Keynes, 1936, 162) Moreover, Keynes emphasizes that uncertainty cannot be tamed or reduced via the calculus of probability: “By uncertain knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette in this sense is not subject to uncertainty.....The sense in which I am using the term is that which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence....About these matters there is no scientific basis on which to form any calculable probability whatsoever. *We simply do not know.*” (Keynes 1937 p. 213-214). (Emphasis added) Nevertheless, Keynes thinks “...as living and moving beings we are forced to act. Peace and comfort of mind require that we should hide from ourselves how little we foresee.” (Keynes

1973, p. 124). Clearly, Keynes was emphasizing the basic importance of human emotions in the drama of economic events.

How then does an individual facing uncertainty of prospective yields of assets make an investment decision? In answering this question Keynes uses three important concepts: **conventions, confidence, and animal spirits**. In Keynes's view conventions are "rules of thumb" that are fundamental in guiding an individual investor "...to behave in a manner which saves our faces as rational economic men..."⁵ (Keynes, 1937, p. 214). The rules of thumb Keynes identifies are the following: a) Ignoring the prospects of future changes about which we know nothing, we take the present as a guide to the future. b) Our opinions do not change until some new information becomes available. c) We fall back on the judgment of the average.⁶

According to Keynes, the level and the state of economic activity are highly dependent on **conventions**. Davis (1994), in his insightful interpretation of conventions, tells us that conventions structure different individual's varying psychological propensities in relation to one another. He also clarifies that average opinion is taken to be correct except when an investor finds his own special circumstances to think otherwise. Individuals act upon their expectations thus helping to determine new average expectations. Thus, the concept of convention is also crucial in building bridges between individual psychological propensities and groups' psychological propensities.

⁵ The concept of "rationality" used in Keynes is in reference to making "reasonable" judgments.

⁶ According to Keynes, valuations of existing investments are established in the Stock Exchange. It is the average expectation of those who deal in the Stock Exchange, as revealed in share prices, which guides the expectations of investors.

Keynes thinks that the “...conventional method of calculation will be compatible with a considerable measure of continuity and stability in our affairs, *so long as we can rely on the maintenance of conventions.*” (Keynes, 1936, 164) Keynes views changes in the *mass psychology* an important determinant for precariousness of conventions: “A conventional judgment which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a *sudden fluctuation of opinion* due to factors which do not really make much difference to the prospective yield...” (Keynes, 1936, 166). (emphasis added). This statement clearly illustrate that Keynes was well aware of group psychology. He was also well aware that defenses against unpleasurable feelings are prone to being fragile.

According to Keynes, **confidence** in our forecasts is a crucial determinant of investment decisions under uncertainty. He defines confidence as “...how likely we rate the likelihood of our best forecast turning out quite wrong. If we expect large changes but are very uncertain as to what precise form these changes will take, then our confidence will be weak.”⁷ (Keynes, 1936,160). Davis (1994) highlights that individuals share a confidence with other traders when they enter the market in anticipation of a certain change. Confidence has a special role in explaining movement in the market. It is the shared confidence (by dominant groups, such as the “bulls” or the “bears”) regarding the direction of the movement in the market that determines the movement in the market

⁷ The dichotomy between conventions and confidence mirrors Keynes’s earlier distinction between probability (best estimate of the future outcome or highest degree of belief, not necessarily a mathematical expression) and weight of the argument (how highly we rate our forecast to be wrong, or an evaluation of evidential basis for belief) (see Gerrard 2003).

Keynes defines **animal spirits** as “a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.” (Keynes, 1936, 174). Elsewhere, he writes:

“To avoid being in the position of Buridan’s ass, we fall back, therefore and necessarily do so, on motives of another kind, which are not rational in the sense of being concerned with the evaluation of consequences, but are decided by habit, instinct, preference, desire, will, etc. (letter to H. Townshend, 1938; CW XXIX, p 294) Carabelli (1988).

It has been noted that Keynes has referred to animal spirits as “**unconscious mental action**” (Carabelli 1988, 298). He clearly sees animal spirits as a feature of human nature that gives a positive impulse to investment. Animal spirits arises in individuals’ responses to uncertainty: “...since the basis for making...mathematical calculations does not exist and that it is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best as we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance”⁸ (Keynes, 1936,175).

Keynes established an approach to investors’ behavior that makes clear the interplay of the emotions of the individual and the community of interest of which the investor is a part.

Exploration of how that community of interest and individual investors affect each other will be our next step.

IV. GROUP PSYCHOLOGY

Keynes linked individual economic activity under uncertainty to aggregate behavior by the concept of conventions. The field of group psychology provides its own broader base for

⁸ Gerrard (1994) argues that when confidence is low, animal spirits are lacking.

understanding the formation of groups. An example of mass group phenomena in an economic setting is found in the rise, panic and crash of a housing asset bubble, as illustrated in Akerlof and Shiller's (2009) emphasis on stories that drive group thinking.

Freud was interested over his entire career in groups of one sort or another (1913, 1939;) Some important changes in individuals who become part of a group are mentioned in Freud's summary of the earlier writers (Freud, 1921) The crucial questions for Freud were: What is responsible for the changes that occur in an individual in the process of becoming part of a group? What is responsible for the cohesion of a group? It is as if in groups individuals are combined into a unity with a "collective mind. ...there must be something to unite them, and this bond might be precisely the thing that is characteristic of a group" (p 73).

Before group formation occurs, Freud says, there must be a purpose, interest, object or emotion (p 84) that provides the nucleus of bonding. The group forms by members developing emotional ties to a leader and to each other. These ties are always ambivalent, that is, they include both affectionate and hostile attitudes in the bonding (for example, Freud, 1923; Stoller, 1975).

The emotional ties involved in bonding processes largely take a form that is a compound of loving and hating, called **identification**, a form of being or wanting to be like someone else, in ways of thinking, feeling, looking or moving, a sense of identity shared with someone else, or with a group of others (Compton, 1985).

Additional features of groups are cruelty and intolerance toward those who do not belong to the group, an aspect of the hostile side of emotional object ties, a method of dealing with the

hostility in the bond by protecting it away from group members at the cost of outsiders, a second crucial feature of group formation and the adherence of its members.

Bion's (1961) work in the context of *therapy* groups offers another important step in the direction of how groups function differently from one another. He describes two kinds of groups that form spontaneously, "work groups" and "basic assumption groups". The work group is attuned to reality (rather than predominantly unconscious wishes) and to some conscious purpose or direction. The basic assumption group on the other hand, is subject to wishful thinking, which takes over from reality based thinking.

To summarize, to form groups is characteristic of people. Economic agents form groups, and may participate in multiple groups simultaneously. Groups form in economic life in the same ways as they form in all other aspects of human life: through a sense of a common belief; bonded by emotional ties, identification of the group members with each other and a leader (or the ideal that symbolizes the cause); and the projection of hostility onto people who are not group members. People often do not realize that they have become part of a group and are acting in accordance with that group's purposes. Unconscious mental activity is prominent.

V. CONFLICT/COMPROMISE MODEL

The segment "individual state of mind" is to this point the least developed of this series of Keynesian/ Freudian perspectives. It is relatively easy when viewing the whole bubble and crash process to infer at least association, in the relationship between events external to individual minds. The standard idea is that mass economic events function with their own dynamics. An explanation of such events based on someone's feelings, impulses, fantasies and the

interdependencies with other individuals and groups is certainly not in the mainstream of economic thought. Can one add to the existing ideas about economic bubbles an individual perspective from a psychoanalytic/ psychological point of view that would be of service in understanding and dealing with bubbles? The psychoanalytic approach, of course, includes *unconscious* ideas, feelings, wishes and conflicts, as well as conscious ideas and states of mind.

The conflict/compromise model is a psychoanalytic framework useful for understanding how the omnipresence of anxiety and other unpleasure affects in the human mind is produced or countered by wishes for pleasure. This model is also useful in explaining the roles of individual mentation in mass economic events, such as the upswings and the downswings of bubbles. The *conflict/compromise model*, introduced by Freud in 1896 and later used extensively by him (SE 1939, pp. 76, 78, for example), then most clearly articulated by Charles Brenner (e.g., 1982), is useful in the present context and relatively easy to comprehend. Conflict, of course, refers here to mental rather than social events, and consists of an interplay of wishes (drive derivatives), affects (an affect is a sensation plus and ideas), defenses against affects as well as against wishes that seem threatening and factors stemming from aspects of the conscience (superego). There are, as well, organizational forces that pursue adaptation to reality (the “external world”).

An important feature of the conflict and compromise formation model is that there are *no particular functions* serving *only* as defense mechanisms. Any psychic function may be used as a defense against any other psychic function, and the positions may reverse, depending on the context of the psychic conflict and the external circumstances. Brenner (1982) says: “.... what compromise formation means today is that the human mind always functions so as to achieve as much pleasurable gratification as it can, while at the same time avoiding as much as possible of any associated unpleasure. “

In Section VI we shall further describe the role of psychic conflict. It may be of help to say, here, that all decisions to invest (or any other decisions) are compromise formations, that is, the outcome of psychic conflict.

VI. PSYCHOANALYTIC FORMULATION OF THE ROLE OF PSYCHIC CONFLICT IN THE RISE AND FALL OF AN ASSET BUBBLE

Given that someone wants to make an investment in circumstances of uncertainty, how does he/she “decide” which course of action to take? How do these parallel and fundamental economic, group psychological and individual psychological concepts help us to formulate an understanding of housing bubbles? In this section we provide a synthesis of the theoretical frameworks described above.

Synthesis: Rise of a Bubble.

“Rise of the Bubble” refers in particular to the recent irrational exuberance in housing prices, from the effects of which we are all still suffering. It is important to realize that all of us had some role in producing the excessive exuberance, even though the roles differed in many ways. In this communication only what happened from the investor/borrower/homebuyer’s viewpoint is considered. Second, we shall be proceeding by making what are, according to the data we have, plausible hypotheses, that might apply to at least a number of people as stated here in a general form. We are aware that not everyone participating in an economic wave thinks or feels or fantasizes in the same way at the same time and also that without directly clinical data we are limited to assumptions in the most crucial circumstances.

The individual who experiences an urge to pursue gratification by investment in the face of uncertainty becomes anxious. Often, there is something perceived as danger threatening from the

real world that stimulates anxiety which may be relieved by action; but also there may be anxiety from internal sources of danger, threatening punishment or humiliation if the action is undertaken. (Compton, 1980) The individual may be able to ward off the anxiety by wishful thinking about the potential benefits of this investment or by a variety of other defensive efforts. Someone may feel, for example, that no matter what the risks are, to buy stocks or to invest in a home *now* is a good decision (and therefore, not to buy is a bad decision). The exercise of animal spirits may serve as a defence against the anxiety of uncertainty. It may also produce a pleasurable step toward owning the home and, depending on the context and the character structure of the individual, producing new anxiety as well. In any event, the decision is a compromise formation between conflicting mental forces.

In situations in which an individual is not able to ward off his anxiety, he may turn to others, or to a father figure (paternal object) which serves the function of containing his anxiety. A context such as the availability of easy funding of investments may be perceived as permission to go ahead. The group of like-minded investors may serve to license the behavior of its members, so long as the behavior is compliant with the group direction. The established convention becomes, for example, that home prices will continue to rise, which in turn *leads to* rising prices as more and more people enter into what becomes a euphoric stage of buying, disregarding risk, regressing to pure optimism (belief in wish fulfillment no matter what) The confidence that prices can only go up increases the pressure to buy. Group psychology begins to predominate; individuals regress, losing their ability for reality testing (assessing risk even in elementary ways) and identify with what is now a mob of buyers.

As an example: at the beginning of the "dot-com" boom, the term "new era" gained credence proclaiming the rise of a wisely optimistic economic outlook (Shiller 2005, 107). This was a

story that was widely believed. Akerlof and Shiller (2009) argue that the human mind is built to think in terms of narratives. Psychoanalysts think the same way: we tell stories and retell stories to ourselves and to others, in the media, in our daily conversations. Stories are an important means through which conventions are established. Repetition of the same stories by many people increases confidence in the conventions. Confidence and convention then become motivators of human action and move markets, thus becoming facts. That amounts to saying that stories can be analyzed according to the concepts of convention, and confidence, both in their public and mental representations as well as in terms of their conscious and impulse driven unconscious fantasies. The rise of a bubble is a period when the (Keynesian) convention is that housing prices (This time is different!. See Reinhart and Rogoff, 2009) will continue going up, always! Confidence is high. Animal spirits are unleashed. Unconscious fantasies in the form of interchanged stories influence decisions by inhibiting reality testing and warding off anxiety; warding off of anxiety comes at the price of suspending some degree of reality testing, denying the risk that is building.

A group becomes more excited by new converts who in turn further the group expectation. Kindleberger names what happens as “mania”. Shiller (2005), following Alan Greenspan, calls it “irrational exuberance” Tuckett and Taffler (2008) call it a “manic defense” in operation, referring to the fact that men and women seen earlier as reasonable and thoughtful people are regaling the group and outsiders, saying that “We are in a new economy/” or “The old rules don’t apply any more”, or “Real estate prices will always go up.” This seems to have to do with the metabolism of greed and aggression, in the form of growingly ruthless competition and a need not just to win but to humiliate and hurt one’s competitors. Behavioral characteristics of

arrogance and overconfidence result from fantasies of omniscience and omnipotence. Tuckett and Taffler (*ibid*) call all this falling in love with a “phantastic object”.

The millions of people who invest in such ways as to be part of a bubble and its crash do not simultaneously or always experience the sets of feelings we are describing, but we posit that the frequency, intensity and breadth of those feelings and especially the role of excitement that drives the rise of the bubble and will soon drive the downswing of the bubble. In fact, greed and excitement may be the most prominent psychological factors in producing asset bubbles.

Synthesis: Downswing

One would suppose that at some point a conscious realization must set in and begin dampening exuberance, a realization of unprotected exposure to risk (a new compromise formation). All of the “unpleasure affects” and their derivatives may be brought into play through realistic appraisal and through fantasies of poverty, humiliation and punishment. Fear of loss, shame about “being so stupid” and guilt about hurting one’s family or corporation or charity begin to be undeniable (compromise formation). Alternatively, episodes of wanting to hurt and humiliate others instead of being the victim may come to dominate. In this downward phase or crash, the group can no longer contain the anxiety. Its constituent individuals, as we noted above, experience directly the emotions and fantasies that were successfully warded off during the upswing (compromise formation).

The regular occurrence of sharp and severe downturns that follow the rise of bubbles may occur because the ties ensconced in the leader or leading idea and identification with him/her or it, as an authority; and the identifications with other group members as loving and protective of one another begin to fall apart. Ruthless and hostile impulses, previously directed to people outside

of the group now turn toward other members of the group and the disappointing leader, further disrupting its nature, or at least its previous nature. Such impulses then turn more and more toward the self.

Fear itself may be an organizing force for a new group, identifying with each other in terror as all race down the mountain. Although not a conventional way of looking at groups, there would seem to be no reason to exclude fear from the forms of emotional ties that bind individuals into a group. In fact, this latter view would be more consistent with a Keynesian interpretation of conventions: at present, housing prices are falling, and since we don't know any way of predicting the future except by projecting the present to the future, we will believe the housing prices will continue to fall. Everyone acts accordingly, tries selling before prices fall even further. This behavior, of course, produces the crash.

Not everyone, however, is trying to sell relentlessly. There have "always" been short sellers---those whose bet is that a rising stock or a market will collapse. At least this time, there are big banks making sure that those betting to win will lose as much as possible---even though they sold to their own customers the investments that they expect will lose value.

What happens in the mind of individuals involved when group support starts to fade? Individual arrogance, omnipotence and sense of invulnerability also fade. The other side of these narcissistic features of bubble inflation is to try to regain exaggerated self-esteem by putting others in the place of self-perceived degraded object through sadism, humiliation and other denigrations---to be in the place of the powerful (parental) one by making someone else the victim--- as well as to find someone to blame for the whole mess.

Another emotional factor that plays a major role is depressive affect. Loss, failure, defeat---all are conducive to identification with a bad or degraded object. The power of aggression moves from the view of oneself in relation to the world, and is transferred to one's conscience which becomes an agent of self attack.

As we indicated before, anxiety maybe a contributing factor leading to certain actions or it may function as a defence against the same actions. It implies a new set of compromise formations, with the same ingredients in different roles. It is also plausible that these unpleasure affects may serve to defend against pleasurable wishes which have now become dangerous, at least for investment.

VII DISCUSSION

As Krugman convincingly argues concerning the housing bubble and its after effects, most economists got it wrong (2009). Blinded by their belief in rational economic actors, and perfect markets, the perceived power of sophisticated mathematical models, and the invention and expanding use of exotic financial instruments intended as risk ameliorants, and the inherent stability of markets, potentials for catastrophic failures in the market economy were ignored.⁹

In order to explain financial instability in efficient markets where behavior is rational, some market imperfection is required, for example, taking the form of imperfect information.

Alternatively, financial instability can be explained by introducing some element of irrationality

⁹ The roots of the belief in trusting markets to be efficient can be found in Adam Smith, The Wealth of Nations (1776), where he spoke of the now famous "invisible hand" that guides markets. This idea, hard to characterize as something other than a magical or religious belief, has persisted and been influential ever since Smith adapted one of the tenets of his mother's stern, religious dicta to his invention of capitalism (See Ozler, 2010 for a recent study).

in the market. Tversky and Kahneman (1974) demonstrated that choices actually made deviate from the axioms of rational decision making, sparking off a large literature in behavioral economics. In this approach, however, the causal process behind behavior is not a subject of inquiry. The task of exploration of psychological motivation, i.e. a theory of the mind, is left out.

In our opinion the most likely candidate for that task is a truly explanatory, dynamic psychology. Psychoanalysis is the foremost such discipline. Unlike the mainstream, neo-classical economists with their roots in Adam Smith's work, John Maynard Keynes (1936) included in his basic economic writings many psychological concepts which also have economic meanings: not only the social effects *conventions and confidence*, as described above, but also *animal spirits* “ a concept clearly in the realm of human psychology, and similar to the sequence of psychoanalytic ideas concerning instinctual drives, drive derivatives and wishes or impulses: “a spontaneous urge to action”.

There are many economists besides Keynes who have made constructive and non-metaphorical use of psychological concepts.¹⁰ Approaches to systematic exploration of the role of people's affects and motivations in economic life and crises have been offered recently. Akerlof and Shiller, for instance, in their book, *Animal Spirits* (2009), organize chapters around their interpretations of Keynes' idea of animal spirits as “a spontaneous urge to action” (p. 3). They suggest that the term “animal spirits” “...is now an economic term, referring to a restless and inconsistent element in the economy. It refers to our peculiar relationship with ambiguity or

¹⁰ Dow (2008) makes an important attempt to provide an overview of psychology of financial markets incorporating some discussion of psychoanalytic concepts in the context of her discussion of Keynes and Minsky's works.

uncertainty” (p. 4). Their list of what comprises animal spirits, as now defined by them, is: “confidence, fairness, corruption/antisocial behavior, money illusion, and stories” (p. 5).

Development of these concepts in the work of Akerlof and Shiller is largely along the lines of behavioral psychology. The psychoanalytic approach to the conscious and unconscious dynamics of the mind is a different pathway. The basic Keynesian idea of animal spirits as impulses of individual (investors), as we have said earlier, aligns with the psychoanalytic concept of drives-drive derivatives-wishes. The concept of “stories” aligns” very well with dynamic unconscious fantasies translated into conscious stories that carry a strong emotional valence. Fairness and corruption/antisocial behavior are moral concepts in the sense of the formation of conscience or its deformation in the presence of group psychological identifications and excitement. Thus, even as defined by Akerlof and Shiller, these concepts are, again, ambiguous in a way which permits interpretation in both psychological and economic senses. “Money illusion”, which seems to be understandable primarily as a conscious, decision-like behavioral idea can be interpreted as a publically accepted form of defensive denial. Akerlof and Shiller agree with Keynes that there is a relation of animal spirits to ambiguity and uncertainty, whether conceptualized behaviorally as in markets or psychodynamically. Ambiguity and uncertainty are constantly present and influential as psychological factors in economic activity---that is, they are not appropriately to be considered as factors present only in anomalies..

A key question for this paper and this discussion is: Do psychoanalytic hypotheses have any real, practical application in economics and, particularly, in understanding economic instability?, There are several comments that will address this issue, though we do not presume to answer the question in any final way. First, both the rise and the fall of bubbles, including manias, panics and crashes, irrational exuberance, animal spirits, confidence are traditionally seen as emotion

ridden and given affective names or even psychopathological names. This is already a testimony to the face validity of the idea.

Second, psychoanalysis has many applications, for example, in anthropology, archaeology, politics, astrophysics and neuroscience. Psychoanalysis is a theory of the functioning of the mind/brain. What is often thought of as “psychoanalysis” is really another application of the theory, this time to clinical situations. As the most common application, clinical treatment forms the primary testing ground. Among the other applications, convergent validity is particularly evident between neuroscience and psychoanalysis. In addition to the overlapping names, psychological/psychoanalytic comments are frequently employed in the work of, among others, Tuckett and Taffler (2008), concerning the stock market or “dot com” bubble of 1995 through 2000; and by Shiller (2005; 2008) in regard to both the dot com bubble and the subprime mortgage crisis. There is, thus, already considerable evidence of the “clinical relevance” of psychoanalysis to economics.

There is considerable overlap between these two fields, both concerned with explanation of human beings and what human beings do. To build a common vocabulary, discussion and further develop mutual interest are central ongoing concerns.

One other topic deserves at least brief attention in this discussion. Affects and their expression are pertinent to psychoanalysis, economics and essentially everything else that involves groups and transmission of information.

There is very robust evidence, including evolutionary evidence that affect expression spreads rapidly or even instantaneously in groups. The commonest expression of this idea is that anxiety is “contagious”, a phenomenon that is regularly discernable in everyday life. Affect

expression is perhaps the most frequently employed the most intense form of information transmission. The same basic informational function that anxiety expression performs is true of other affects as well. Anger is information that stimulates anger or fear. Shame seems to provoke distancing reactions or sometimes pity in observers, probably as defenses against sharing the shame. Depressive affect induces depressive affect or the opposite in companions. Sexual attraction produces responding attraction (sometimes). People experience excitement of all types as “contagious”: affect expressions in general are social signals of pleasure and/or unpleasure experiences. The affect can spread almost instantaneously to other people; and ripple effects to other situations and groups rapidly occur. Today, with people much more out of direct touch with each other, newspapers, magazines, radio, television, the internet, social networks--- all can communicate through words or tones or images to millions of people in seconds, and more than make up for the physical distance.

The informational function of affect transmission is enough to override the regressive effects of group membership, at least initially, though the group regression may (or may not) exaggerate the intensity of the affects subsequently. This may be true even when the affects arise in a complex framework of attitudes and drive derivatives. The expression that markets run on greed and fear is cogent, however popular it may be.

REFERENCES

- Akerlof, G. A. & Shiller, R. J. (2009). *Animal spirits: How human psychology drives the economy, and why it matters for global capitalism*. Princeton: Princeton University Press.
- Bion W (1961) *Experiences in Groups and other Papers* Sussex: Tavistock Publications.
- Brenner, C. (1982). *The mind in conflict*. Madison: International University Press.
- Carabelli, Anna M. 1988. *On Keynes's Method*. New York: St. Martin's.
- Compton A. (1980) A study of the psychoanalytic theory of anxiety, III: a preliminary formulation of the anxiety response. *Journal of the American Psychoanalytic Association*, 28: 739-773.
- Compton A (1985) The concept of identification in the work of Freud, Ferenczi and Abraham.. *Psychoanalytic Quarterly*, 55: 200-233.
- Davis, J.B. (1994). *Keynes's Philosophical Development*. Cambridge: Cambridge University.
- Dow, S. (2008). The psychology of financial markets: Keynes, Minsky and emotional finance. Conference paper presented at the University of Roskilde and the University of Stirling.
- Eisold K (1985). Recovering Bion's contributions to group analysis. In *Group Relations Reader* 2, Colman AD and Geller MH, eds. AK Rice Institute Series, Jupiter, Florida, pp 37-48
- Farmer R. (2010). *How the economy works: Confidence, crashes and self-fulfilling prophecies*. Oxford: Oxford University Press.
- Freud S (1961) Further remarks on the neuro-psychoses of defense. In *The standard edition of the complete psychological works by Sigmund Freud (Vol.23)* (J. Strachey [in collaboration with

A. Freud & assisted by A. Tyson], Trans.) (pp. 162-185). London: Hogarth Press. (Original work published in 1896)

Freud S (1961) Totem and taboo. In *The standard edition of the complete psychological works by Sigmund Freud* (Vol. 13) (J. Strachey [in collaboration with A. Freud & assisted by A. Tyson], Trans.). (pp. 1-161). London: Hogarth Press. (Original work published in 1913)

Freud S (1961) Moses and monotheism. In *The standard edition of the complete psychological works by Sigmund Freud* (Vol. 23) (J. Strachey [in collaboration with A. Freud & assisted by A. Tyson], Trans.) (pp. 7-137). London: Hogarth Press. (Original work published in 1939)

Gerrard, B. (1994) Animal spirits, in: P. Arestis & M. C. Sawyer (Eds) *The Elgar Companion to Radical Political Economy*. Aldershot: Edward Elgar.

Gerrard, B. (2003), Keynesian Uncertainty: What do we Know? in *The Philosophy of Keynes's Economics*, Runde, J. and S. Mizuhara eds. London: Routledge.

Keynes, J.M. (2009). *The General Theory of Employment, Interest and Money*. Hamburg: Management Laboratory Press (original publication date 1936).

Keynes, J.M (1937). The General Theory of Employment. *The Quarterly Journal of Economics*, 51, 209-223.

Keynes, J.M. (1973) Some Economics Consequences of a decline in Population, in *The General Theory and After: Part II, Defence and Development, The Collected Writings of John Maynard Keynes*, vol. XIV. London: Macmillan for the Royal Economic Society.

Kindleberger, C.P. & R. Aliber (2005). *Manias, Panics and Crashes*. Hoboken: John Wiles and Sons.

Krugman, P. (2009). How did Economists get it so Wrong? The New York Times Magazine (September)

Minsky, H.P. (1975). *John Maynard Keynes*. London: Macmillan.

Morante, F. (2010). Omnipotence, Retreat from Reality and Finance: Psychoanalytic Reflections on the 2008 Financial Crisis. *International Journal of Applied Psychoanalytic Studies*. : 4-21.

Ozler, S. (2010) Adam Smith and Dependency. Unpublished manuscript, UCLA Economics Department.

Reinhart, C. M. and K.S. Rogoff (2009). *This Time is Different*. Princeton: Princeton University.

Shiller, R.J. (2005). *Irrational exuberance*. Princeton: Princeton University Press.

Shiller, R.J. (2008). *The Subprime Solution: How Today's Financial Crisis Happened, and What to do about it*. Princeton: Princeton University Press.

Smith, A. (1981). *An Inquiry into the nature and causes of the wealth of nations*. (R. H. Campbell & A. S. Skinner, Eds.). Indianapolis: Liberty Fund. (Original work published in 1776)

Stoller R (1975) *Perversion: The Erotic Form of Hatred*. London: Karnack Books, 1975

Tuckett, D. and R. Taffler (2008). Phantastic objects and the financial market's sense of reality: A psychoanalytic contribution to the understanding of stock market instability. *International Journal of Psychoanalysis*, 89: 389-412.

Tversky A, and D. Kahneman. (1974) *Judgment under Uncertainty: Heuristics and Biases*, Science, Vol. 185.