



SCHOOL OF POLITICS & ECONOMICS

SPE STORY: APPLICATIONS OF BEHAVIORAL FINANCE TO THE INTERNATIONAL ARENA

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The two most popular views of the behavior of international financial markets are that these markets are highly efficient or that they suffer frequent bouts of wild irrationality. The empirical evidence demonstrates that both of these views are wrong and that the truth lies somewhere in between. But different intermediate views of how the markets behave can have quite different implications for both investment strategies and government policies. For example, during the Asian crisis many governments claimed that they were the innocent victims of the instability of international financial markets. Our detailed analysis of the Asian crises suggests, however, that the large capital outflows during the crises were due more to prior excessive international lending and borrowing based on incorrect assumptions or mental models that there would be no major changes in exchange rates rather than to irrational panic.

When the Thai crisis broke out in 1997 this caused borrowers and lenders to recognize that their models had been wrong and led to a quite rational rush for the exits. Our work does not support the view that the markets were fully efficient, however. International investors had focused too much on the strong aspects of the Asian economies and had paid insufficient attention to weakness in their financial sectors. As a result, they did not give the discipline and early warning signals of mounting problems that many had assumed would occur. [For more on our research on currency and financial crises, international capital flows and currency regimes see [\(link\)](#)]

The Russian crisis of 1998 provides another example of the breaking of widely held mental models leading to substantial global repercussions. Our analysis suggested that these cases of international contagion were based on quite special circumstance and that as a result the widespread fears that we had entered into a new era of global contagion were greatly exaggerated. The much less severe international repercussions from the subsequent crises in Argentina, Brazil, and Turkey suggested that our analysis was correct. Our analysis did point to the prevalence of sudden turn-arounds in financial capital flows and suggested that in the absence of basic reforms of the operations of the International Monetary Fund, emerging market countries needed to invest in substantial levels of international reserve as a form of self-insurance.

Our approach to these issues was typical of the SPE way of doing policy research. We paid careful attention to the facts and drew on a wide range of theory including economics, political economy, and psychology and neuroscience. Much of the problem of instability in international capital flows we found could be traced to problems of rational responses to perverse incentives such as moral hazard coming from the public sector and difficulties in the private sector in designing compensation schemes for investment managers to take appropriate account of risks and to avoid incentives for herd behavior. This part of the analysis drew on the literatures in political economy and the new institutional economics. We found also, however, that as is emphasized in the emerging fields of behavioral and neuroeconomics and financial uncertainty, cognitive limitations and psychological biases also played important roles. We found that many lenders had placed excessive reliance on sophisticated mathematical models of risk management that failed to distinguish sufficiently between risk and uncertainty and put too much faith in the use of popular models that focused excessively on a few macroeconomic considerations. In the terminology of risk management, they had paid insufficient attention to stress testing.

Work in behavioral and neuroeconomics has led to the emergence of a new field of behavioral finance that draws on psychology and neuroscience as well as economics. To date, however, almost all of the applications of behavioral finance have been to

domestic issues. We have been leaders in the application of this approach to the international arena.

Our research in this area is still in an early stage, and there is much more to be done, but our early work has been quite fruitful and strongly suggests that this will become an important research area. In addition to faculty publications, in recent years we have had several dissertations successfully completed on various aspects of behavioral finance and international capital flows and their implications for international financial policies including more now in progress. Most of these dissertations have resulted in one or more publications, frequently joint with faculty. This broad-based research agenda has been incorporated as a major part of our PhD field in international money and finance and we are now working on plans to incorporate it into our PhD fields in neuroeconomics and in business and financial economics. We are also working on developing a new course on behavioral finance and risk management that would make this approach available also to our MA students and those in the MBA and financial engineering programs.