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Bubble and Burst: A Psychoanalytic Perspective on Financial Instability

Mohammad Abdul Washad Emambocus* and Gurjeet Dhesi**

This paper provides one potential theoretical explanation of bubbles and crashes in the market. It involves a psychoanalytic understanding of financial instabilities and the irrational behaviours of financial practitioners. We demonstrate that financial anomalies are ignified through the process of an 'emotional trajectory' related to four crucial stages derived from psychoanalytic literature. These stages involve 'Excitement, Domination, Euphoria and Panic and Blame' which provide crucial information on the behaviours of investors during the different phases. The pattern to which investors buy, sell or hold financial assets during period of uncertainty implies an ambivalent emotional relationship which was scrutinised. The property bubble and burst are used to investigate the behaviours of investors for the period of 2006-2009 for UK and U.S. In this line of thought, an inter-disciplinary theory which recognises the integration of emotional experiences is developed which might be crucial for financial and economic agents compared to traditional economic theories.

Field of Research: *Psychoanalysis, financial bubbles and market instability*

1. Introduction

The financial sphere has consistently been reshaped due to several determinant financial events. The growing frequency of these financial crashes has grabbed the attention of researchers and policy-makers where they have concentrated on understanding the reasons for financial bubbles and bursts. However, there deficiencies in the study of how bubbles in the markets are triggered, why they continue to be occurring and what are the elements that cause the detonation of mass hysteria in the market. These aspects are known as financial "enigmas" which need to be resolved in order to start the process of policy-making and regulations. This paper explores financial instabilities with the main aim of understanding them with the perspective of psychoanalysis theories and research. It focuses on analysing the "irrational" and "rational" behaviours of investors with a perspective on the property crisis both in UK and U.S.

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*Mohammad Abdul Washad Emambocus, PhD student, teaching assistant, London South Bank University, Faculty of Business, 103 Borough Road, SE1 0AA, United Kingdom; Tel: +44 (0)20 7815 7463; E-mail: emambocm@lsbu.ac.uk

**Dr Gurjeet Dhesi, PhD, Senior Lecturer, London South Bank University, Faculty of Business, 103 Borough Road, SE1 0AA, United Kingdom; Tel: +44 (0)20 7815 7090; E-mail: dhesig@lsbu.ac.uk.

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2. Literature Review

The first part concentrates on traditional theories that explain how investors' decision-making approach changes between bubble and burst of a hypothetical nature. These approaches are then critically analysed to determine whether it really projects a true picture of the behaviours of investors. Then, it elaborates on the theories surrounding psychoanalysis.

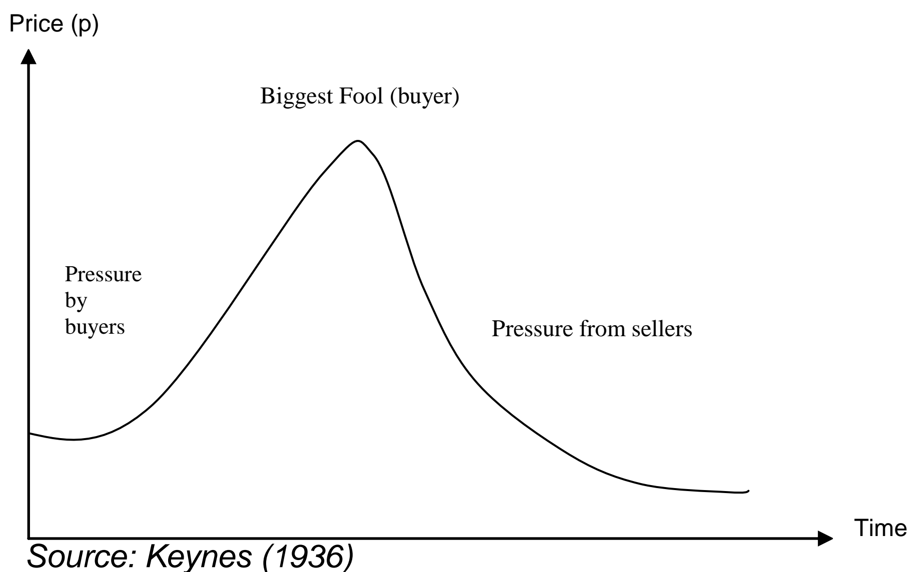
2.1 Efficient Capital Markets Hypothesis (ECMH)

ECMH (Fama, 1970) provides an understanding of the normal functioning of the markets; however it also states that markets may occasionally behave irrationally. These irrational instances experienced in the market can lead to speculative bubbles which occur when the market price of a share departs from its intrinsic value. Excessive optimism can cause prices to exceed intrinsic value while excessive pessimism may cause prices to fall below it. These behaviours are well known in financial theories; however the reasons for their occurrences are less clear. Various traditional theories have failed to provide a complete picture of the whole situation. This points out the importance of a psychoanalytical perspective to explain and determine the reasons for the irrational behaviours leading to bubble and bursts in the market.

2.2 Biggest Fool Theory

Keynes's (1936) 'biggest fool' theory explains that investors "*priced shares not on what they thought their fundamental value was, but rather on what they thought everyone else thought their value was, or what everybody else would predict the average assessment of value to be*". Refer to the following figure:

Figure1: Keynes' Biggest Fool Theory



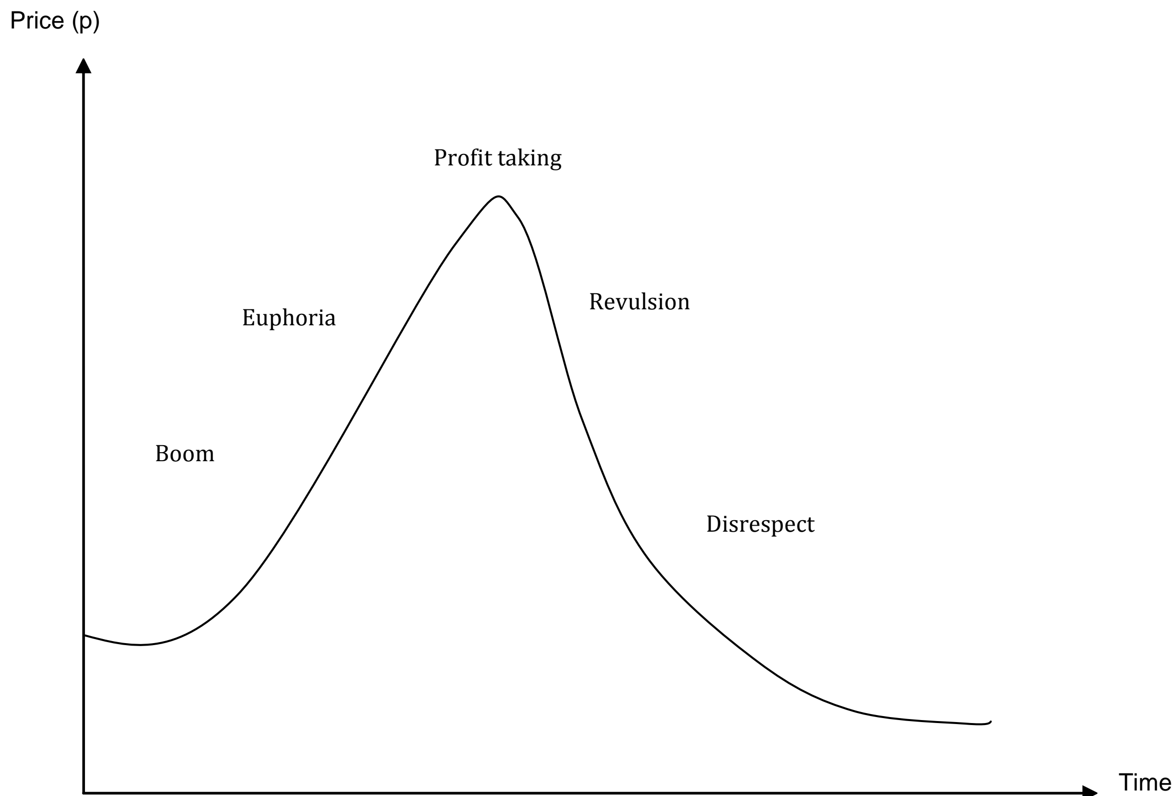
Source: Keynes (1936)

It illustrates that if an investor predicts that the share price of an asset would increase pushing other investors to buy it, then he/she would buying it. The reason provided is the pressure by other investors would result into a craze for the demand of the asset. As the demand increases, the price also rises. This false perception would persist, leading to the overvaluation of the asset. Subsequently, a point would be reached (biggest fool) where the share price would no longer reflect the reality. This realisation would reverse the process in which investors start believing that share prices will drop further and decide to sell. The main criticism against the theory is that it does not involve an in-depth analysis of the decision-making and risk assessment process of investors for the different stages which make it less realistic.

2.3 Financial Instability Hypothesis

Minsky's (1989) financial instability hypothesis (FIH *hereafter*) explains the behaviours of investors during financial instabilities as follows:

Figure 2: Financial Instability Hypothesis



Source: Minsky (1989)

Figure 2 shows that the boom period is where investors tend to overestimate expected returns and then move to the euphoria level known as the bandwagon effect where investors are collectively very optimistic about the market. Profit-taking stage is the peak of the bubble and it is where investors realise that their estimates are far from reality

leading to panic. This contributes to a herding behaviour (revulsion) of investors to sell the shares and where they start discrediting the whole boom period. This theory also provides an indication about the risk attitudes and the changes in the expectations of investors. Even though this model analyse the behaviours of investors within the boom and bust periods, it still does not fully explain the reasons for the attitudes toward risk taking and overestimation of assets.

2.4 Paranoid-schizoid and Depressive positions

The two states of mind involved in dealing with anxiety are “paranoid-schizoid” (PS) and “depressive” (D). These are crucial in understanding the reactions of investors when there is an element of euphoria in the financial market. Opportunities are expected to contribute to the excitement whereas those investments that feel bad emanate anxiety, leading to a biological protective mechanism for people to run away from (Tuckett and Taffler, 2008). As such, human evolution has equipped Man with the psychological ability to split excitement and anxiety, risk and reward. For instance, scientific research showed that secretions of dopamine in the brain blind the decision-making and risk assessment abilities. Conversely, other chemicals in the brain make people run away or panic, affecting their decision-making capabilities.

Paranoid-schizoid position (Klein, 1946) is where experiences are split between wholly good experiences with “good” objects and wholly bad experiences with “bad” objects. The ego protects itself from the bad ones through a mechanism that splits the ego itself. Therefore, the PS position is characterised by splitting, projection, identification, denial, and idealization. Klein (1946) argued that the ego’s primary function like the later more fully developed ego **is to manage anxiety**.

On the other hand, a more evolved state is the depressive position which involves not splitting the object but looking at it as a whole so there is a bi-polar element of love and hate. In this state, the person would take in and tolerate more pain rather than projecting it on others. The achievement of a stable good internal object represents a developmental move from the paranoid-schizoid to depressive position.

These two states provide a deeper understanding of the behaviours of investors in periods of great uncertainty. Traditional theories are not equipped to explain the reasons why investors react irrationally in periods of bubbles and crashes. The following reviews the main problems that led to the property bubbles and crashes in the financial markets.

3. Methodology: Theory Development and Application

This paper juxtaposes the theories of psychoanalysis to the financial phenomena of financial bubbles and crashes. The 2006-2009 credit crunch is used to explain the irrational behaviours of investors during the property bubble and the crash of the US and UK markets. The underling concepts and theories of paranoid-schizoid and

depressive positions are used to explain and understand the decision-making and risk assessment mechanisms of investors.

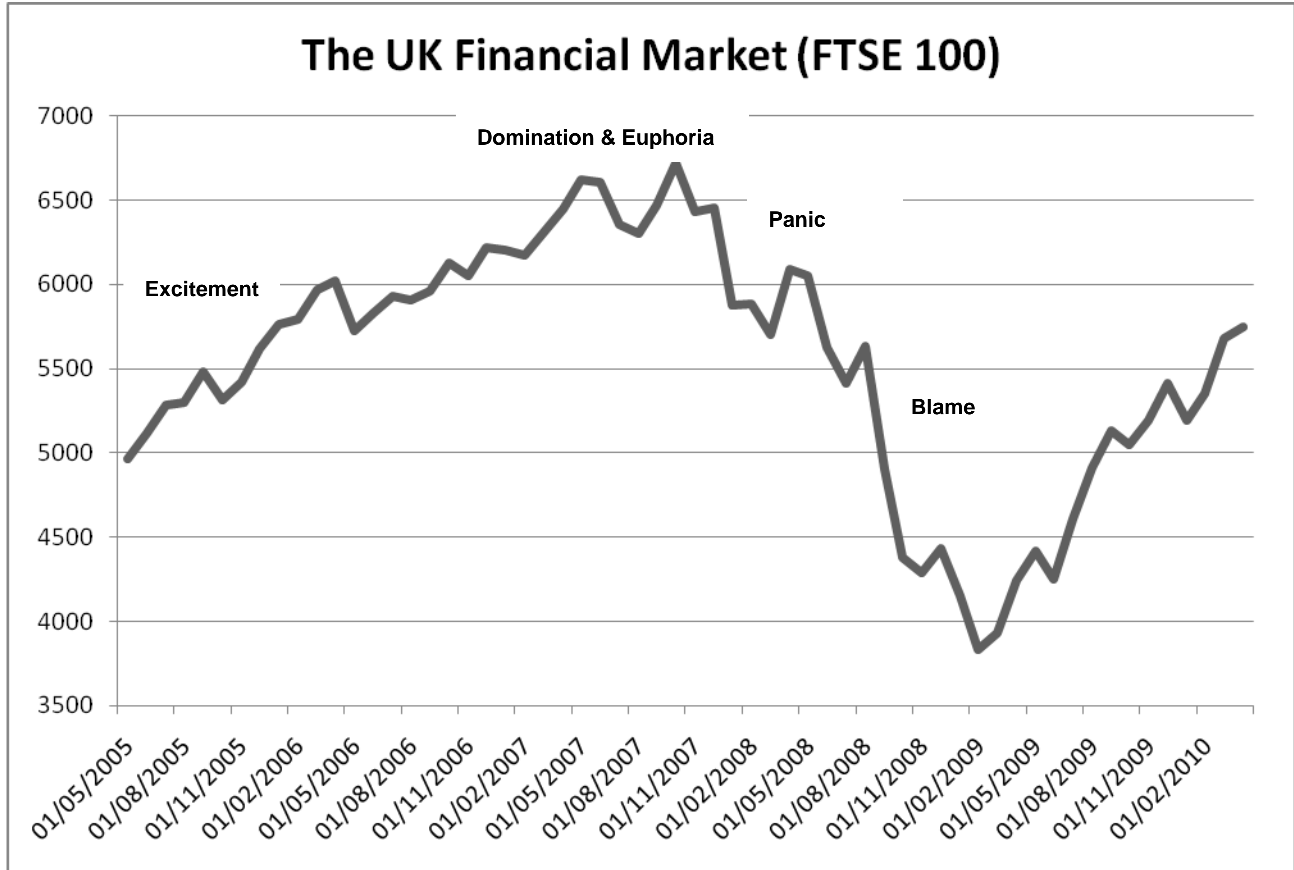
FTSE 100 is used to represents the UK market to illustrate the different main stages and behaviour attitudes of investors. These are the “Excitement, Dominance and Euphoria, Panic and Blame” which provide an indication of the decision-making patterns of investors, risk assessment attitudes and their relationship to the real world.

4.0 Findings

Analysis of the property bubble and burst showed clearly that there are different stages of the phenomenon which can be associated with psychoanalytic emotional patterns. Terms such as: “*manias...insane land speculation ... blind passion ... financial orgies ... frenzies ... feverish speculation…”* (Kindleberger, 2002) have been coined to explain the irrational behaviours of investors in period of instabilities during the financial history. These descriptions of an investor are not associated to the description of a rational person acting in a rational market. These statements are all related to the emotions that can describe investors as they are no longer risk-averse and taking decision which violate Bayes’ theorem.

This study shows that in a period of bubble; behaviours of investors change at different stages of a continuing process. At the beginning of the bubble, Investors are still rational and risk averse. Then with new financial opportunities easily made available push them to accept higher risk. Eventually, they lose contact with the reality and their risk assessment process is completely distorted. The different groups of investors will have different degrees of rationality depending on the stage that they are at. However, eventually all will fall into the trap of irrationality as the market will fail and the reaction of the practitioners will no longer be reflect the reality. They will underweight certain pieces of information and overweight others. The following analyses the UK market during the property bubble and burst:

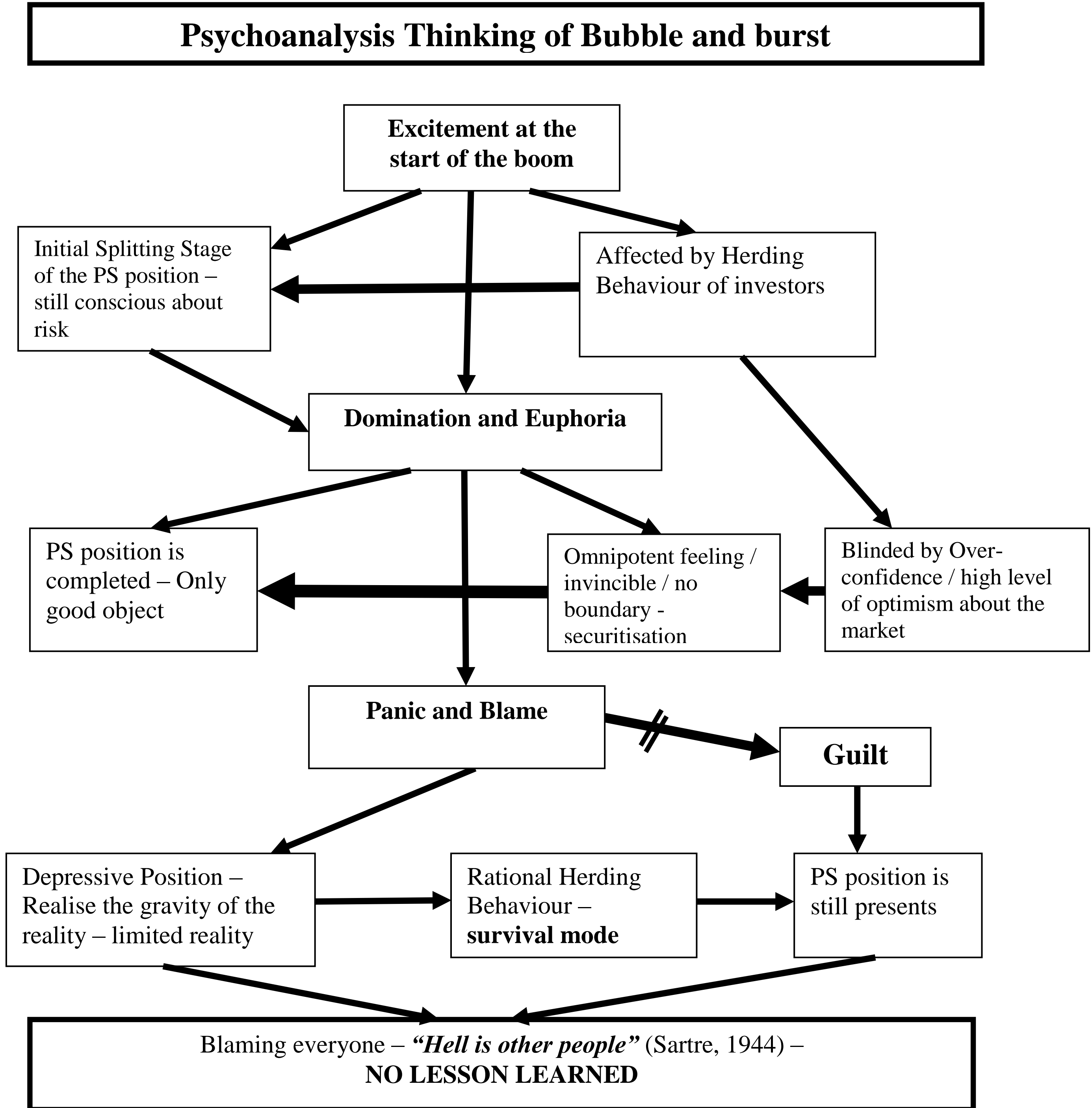
Figure 3: FTSE 100 (2005 – 2010)



Source: Thomson DataStream

Figure 3 clearly illustrates the different phases and how they are affecting the market. FTSE 100 is used to represent the UK financial market. During the excitement phase, the market is growing at a rapid rate, reaching its peak at domination and euphoria then, with realisation of the overreaction in the market, panic and blame follows. These are further schematically analysed with a psychoanalysis perspective in figure 4.

Figure 4: Psychoanalytic perspective of the bubble and burst



All the different components are scrutinised in-depth to understand the irrational and partly rational behaviours of investors. These are crucial as it lays the basis for an investigation on how investors' decision-making process departs from the traditional financial theories explained above.

4.1 Excitement

In the initial PS state, investors started separating their responsiveness of risk from the expectation of reward. Their judgements to take the appropriate decision are blurred and where they should refuse one investment they might accept it, without completely realising the risk of their actions. With the excitement of opportunities that might lead to higher reward, the investors are disassociated from the riskiness of the investment. Good and bad feeling starts to be detached from one another. Investors begin to undertake higher risk blinded by the level of excitement and confidence level in the market. This is due to the overvaluation of property prices and also of the growing confidence in the financial prospect of the market. Looking at the start of the property bubble (2005-2007), it can be observed that the market participants are in a PS state of mind reflecting this sense of the financial reality.

Analysing the U.S. housing market, the main conditions that have led to an **'excitement'** in the housing market are the low interest rates, favourable demographics and restrictions on development. However, the most important factor which has contributed immensely to the home-buying mania is the bad tax policy particularly the Taxpayer Relief Act of 1997. The policy exempted the first $500,000 in profit on the sale of the home from capital gains taxes. The tax-free profit led to the inflation in the home process at a nearly 7% annual rate in 2005. Hence, due to these conditions the real estate market experienced an alarmingly rapid growth. The increased ease and availability of credit to subprime borrowers even with bad credit rating contributed to the excitement in the market. This showed that lenders took more risk as they were lured to the expectations of the market.

However, the most important reason to these irrational behaviours is because lenders had their eyes glued to the expectations of financial gains rather than concentrating on rational decisions-making and risk assessment. Riskiness of mortgage borrowers were not seriously analysed as lenders and other agents were contaminated with the disease of greediness (Shefrin, 2002). This is where the decision-making abilities of individuals are negatively affected and they are no longer completely objective about their risk assessment abilities.

Therefore, it is obvious that the market participants have started to split-off the good object (expectation for higher rewards) and bad object (riskiness of assets). They are no longer risk averse and are increasingly attracted towards the property boom. This led to the next phase of the bubble which is the 'domination and euphoria'.

4.2 Domination and Euphoria

The notion of '*Phantastic object'* is highly associated with this phase as it provides a very good indication to how investors viewed the reality. Klein (1946) explains that the *phantastic object* represents the state of investors indicating their omnipotent denial of the existence of the bad object where the PS position is fully completed. That is, they annihilated the painful situation or consciousness of reality. Therefore, the word

"phantasy" is used to mark a contrast to 'reality'. According to Freud (1911), this kind of attitude tends toward a depreciation of psychical reality and of the significance of mental processes as such. Moreover, Freud (1911) further argues that the inner world of the mind has a continuous living reality of its own, with its own dynamic laws and characteristics, different from those of the external world. This is a mental process whereby the person aims at diminishing instinctual tension, anxiety and guilt and only targets toward wish-fulfilment.

'*Phantastic object'* was first utilised in the financial context by Tuckett and Taffler (2008) explaining that financial practitioners were disconnected from their anxiety and fear for the risk associated with investment. Investors started hallucinating on the prospects of financial gains and dissociated all aspects of anxiety about the future financial position of the market. *Phantasy* expresses the alternate reality in which the investors are now living in where he/she thinks that his/her deepest desires will be fulfilled. This can be juxtaposed to explain the behaviour of investors whereby in period of euphoria, they feel as if they are **omnipotent** and that they blindly think that their desires will fully be accomplished. This is quite strong whereby investors are no more risk averse, as they do not have an objective account about the level of risk they are taking. They feel that the market will grow indefinitely.

The period of financial euphoria led to the financial crisis in 2008. During this period, the ways that investors' decision-making process can be described are: illusion, insanity, madness, unreality, make believe and euphoria. Both financial experts and individuals did not have an objective quantitative risk assessment process in place to determine that the acceleration of the market was too quick. In the period of euphoria, investors' liquidity preferences rose exponentially with the explosion in the level of expectation for asset, causing them to be overvalued.

One important aspect of the "*Phantastic Object"* related to the property euphoria relates to the extraordinary journey of the **securitisation mechanism**. The securitisation boom and bust was truly unrealistic in nature. The process involved packaging of mortgages, credit cards receivables amongst other debts sold to the capital markets investors. In 2006, there were around two third of all mortgages and half of all consumer credit in America that was channelled through this process. Therefore, by distributing loans, banks were able to cut their capital needs and thus allowing them to lend more. This process allowed insurers, hedge funds and others to gain access to a broader range of credit risks. Additionally, home loans were securitised into different types of mortgage-backed securities (MBS). This allowed the separation of loan origination and funding as well as the transfer of risk. Securitisation facilitated the separation of credit risk and market risk. It transformed relatively illiquid loans into highly liquid securities. This negated the notion of risk of the securities from the reality. Hence, the securitisation mechanism can easily transfer the burdens of risk to other parties blurring the risk assessment of investors.

Moreover, the overreaction hypothesis (De Bondt and Thaler, 1985) is another factor that can clearly explain the euphoria in the market. According to the hypothesis, in the

period of euphoria investors violates Bayes theorem whereby they overweight recent information on the optimism of the market and underweight the fact that the market is booming with higher degree of speculation which will eventually burst. This shows that the PS state is in-line with the overreaction hypothesis whereby investors, both lenders and borrowers were not taking decision objectively but were blinded by the expectation of profits. Consequently, as goes the law of Newton, everything that goes up quickly, eventually fall harder to the floor.

4.3 Panic and Blame

The panic and blame stages are regarded as the rational herding behaviour of investors. No psychoanalytic thinking is needed to explain that after the realisation of the reality, investors were in a state of panic faced with a sudden threat to the value of their investments. However, psychoanalysis is needed to scrutinise why the investors' decision-making process is still being affected by the decisions taken in the past, even though the past circumstances might no longer be relevant. This is known as path dependence. This contrasts with the bubble or excitement phase where investors were in a PS state of mind splitting the reality and considering only the good object. However, during the bust they suffer the consequences of their actions. Their repressed feelings which they have been negating come to haunt them. They knew that the foundation of their investments was very risky, but they were idealising the growth of the market which clouded their decision-making abilities. Now, investors are conscious about the way that they managed their anxiety/risk from the previous activities. They are now forced to face the high level of risks accumulated over the boom period. However, the panic phase describes the survival mode of investors where they try to run away from their responsibilities rather than confronting them.

The panic phase eventually gives way to the final phase of blame. This may be interpreted as the Depressive position where investors accept the limited reality of the financial market. However, the PS state of mind still prevails as they are not fully ready to face the consequences of their acts. They still split-off the objects and blame others for the consequences of the decision taken in the past. Investors start by denying any responsibility or part played for the financial burst and then to avoid the extent of the reality they look for scapegoats. Consequently, from a more psychoanalytical perspective it is very interesting to investigate how the financial burst induces investors to have feelings of denial, anger and then blame as opposed to guilt. Investors in this phase have become extremely risk averse which due to the path dependence and their risk assessment mechanism has not reversed back to its original place. They are now very pessimistic about the future of the market which in the context of the US and even the UK has pushed the economies into a recession. Therefore, are investors still not accepting the reality? Do they accept their mistakes? Can they learn from their mistake to avoid this behaviour in the future? All these questions are debatable as investors are still splitting the reality and looking at the elements that they want to see rather than accepting the full truth of the situation.

5. Conclusion and Recommendations

Investors are still reluctant to accept their responsibilities in this historic financial mess. Denial and blaming others are preventing them to assess the roles that they played in this crisis and to learn objectively from their mistakes. Psychoanalytic thinking which looks at the “depressive” (D) and “paranoid-schizoid” (PS) states of mind has clearly painted a true picture of the behaviours, decision-making patterns and risk assessment mechanism of investors. Different stages were identified and they clearly showed how investors split-off the “*phantastic objects”.* They disassociated themselves from the reality and were only concentrated with the excitement of the growth in the market. This led to euphoria in the market where the investors were completely blinded and overestimated the assets. This reflected on their attitudes toward how the ego manages anxiety. Finally, the financial crash led investors to adopt a rational way to deal with the situation and thus start panicking. However, the path dependence attitude provides a psychoanalytic basis for more analysis. The aftermath of the panic led investors to start blaming others for the situation rather than recognising the fact that they played a role in this issue. Therefore, without the feeling of guilt and fully acceptance of the situation, lessons cannot be learned which might not be helpful for the future of the financial markets. The next step of this paper will be to further analyse the phenomenon of **path dependence** affecting the decision-making abilities and future risk assessment mechanism of investors.

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