PSYCHOLOGICAL EFFECTS OF THE FINANCIAL CRISIS

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Abstract: The economic, financial crisis affects anybody. This paper will focus on risk perception, and some personal and social factors during financial crisis. It will examine people’s behavior in the credit market, and how they make their decisions regarding loans. It will study the motives, attitude, choices, and rejection of people concerning credit under financial crisis.

Key words: financial crisis, risk, credit, psychology

JEL classification: D10, D81, E59, G01

1. Introduction

“Given the global financial crisis that grips most countries in the world, with the attendant job losses, job insecurities, financial worries, pension deficits and the like, the health and well-being of individuals and families are severely at risk.” (C. L. Cooper, 2009)

Psychological factors play a decisive role in the current financial crisis. These factors are considered behavior patterns of people who find themselves in uncertain situations. The financial crisis has its psychological antecedents and also its consequences. One of the major consequences of the financial crisis is that people usually loose their trust in financial institutions. The capacity of the economic actors to make rational judgments and decisions is overrated most of the time. People, households, use certain tactics for adaptation to financial crisis and economic recessions, such as: buying cheaper, higher quality products, less quantity and more durable. One important issue is that people should be prepared to be able to think clearly during a period of crisis. They should be able to reflect and to account for their spending. They need to be taught budgeting and mental accounting. People’s knowledge about finances and the financial world differs according to age, gender, level of education, and occupation. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 1-2)

In financial crisis the credit market and the risk perception plays a big role. People, I think, should be careful how they perceive risk, and how they make decisions in risky situations. They should evaluate carefully the conditions offered for receiving credit. Especially in period of financial crisis, when everything is much more insecure, people have to evaluate in general every situation more carefully, before they make any decision.

People are able to borrow money on the credit market, which they will pay off in the future. “Credit use is a process consisting of different stages of decision making, starting with purchasing a product for borrowed money and ending with paying back the borrowed money.” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 1)

“...psychological factors always play a role in financial markets. However, psychological factors are not necessarily “irrational”; rather, they represent regularities in how people process information and act upon it. The contribution of psychology is to find these regularities in people’s perceptions and decisions—that is, their heuristics and biases—that account for their economic behavior. The late Herbert Simon, a political scientist, professor of psychology at Carnegie-Mellon University, and the 1978 Nobel laureate in economics, argued that people are bounded rational (Simon, 1956, 1982, 1990). They use their resources in sensible ways to adjust to the prevailing situational demands. But some situations exceed people’s capacity to judge probabilities and make good decisions. Many contemporary scholars in behavioral finance (e.g., Shefrin, 2000; Shleifer, 2000; Taleb, 2004) believe that in financial markets people are frequently not capable of acting rationally. The late Amos Tversky and Daniel Kahneman, another Nobel laureate in economics, have done more than any other scholars in psychology to show this empirically (Kahneman, 2003a, 2003b; Laiibson & Zeckhauser, 1998).” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 2)

Since people’s actions, in general, and their decision making is correlated to psychological factors, the study of such factors is necessary to better understand their economic behavior. At the time of financial
crisis, the only way we can make constructive suggestions to improve people’s success with their business, is to assist them in gaining a better understanding of the risks they are taking. It is also necessary to make them aware of how to react and behave correctly to survive the economic crisis, with the least possible stress and failure.

2. Economic risk

“In financial markets, actors take risks and evaluate future consequences of the risks they take. […] People take economic risks with personal loans, credits, and mortgages; trade risky equities in the stock market; purchase inefficient or risky products; and accept insecure jobs.” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 3)

Risk has been an important research topic since the 1970s, and it is considered an essential factor in the decision making process. The way how the public perceives and reacts to risk depends on the individual lifestyles. The same risk is perceived differently by people according to their circumstances: such as: in what country they live, what social group they belong to, etc. (Sjoberg & Engelberg, 2005, p. 327-328, 333-334)

To better understand financial decision making, we can rely on “expected-utility” theories. In this context, risk is defined as the probability of a decision outcome. A risk event is defined as a low probability of a negative outcome. Risk taking is domain specific and is influenced by personal and situational factors.

“Risk taking, economic or otherwise, is mediated by risk perception, risk attitude […], and risk propensity—that is, the extent to which one is aware of a risk, whether it is judged to be positive (an opportunity to gain) or negative (a threat of losing), and the extent to which one intends to take the risk.” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 3)

“Individuals are invited to use their response to the familiar situation as a guide to action in the new one; certainly, it is legitimate to seek consistency in one’s actions. However, little follows directly from most comparisons. Risk decisions are not about risks alone. One can accept large risks if they bring large benefits and reject small risks if they bring no good.” (Fishhoff, 1995, p. 141)

Risk perception is important and essential to understand decision making. Risk perception is influenced, and affected by certain psychological factors, such as: fear, regret, optimism, or pessimism. People, when they make their choices, will not process all the relevant information. They will make their decisions using their own experience, the judgments of their past, or routines. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 3-4) This might be dangerous because every situation is different, and not being focused on the information that we need to make our best choice, we can easily make a wrong decision, by underestimating the actual risks, and without being aware of possible consequences.

“Risk-avoiding decision makers are more likely than are risk takers to attend to and weigh negative outcomes and thus overestimate the probability of losses relative to the probability of gains. They consequently require a higher probability of gains to tolerate the exposure to failure (Schneider & Lopes, 1986). In contrast, risk-seeking decision makers are more likely to attend to and weigh positive outcomes more highly and overestimate the probability of gains relative to the probability of losses (Brockhaus, 1980; Vlek & Stallen, 1980).” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 4) While some people will take risks, it sounds as a reasonable assumption that, people try to avoid risk situations and risk related decisions, especially in the economic or financial domain. These two types of behavior depend on the individual’s personality, social and financial situation, and experience in similar situations. We can say that people, in period of financial crisis, are avoiding risks more often than otherwise, but basically the risk takers remain risk takers, and the risk avoiders will avoid risks regardless.

As I mentioned before, people’s personality is a strong factor in financial risk taking. Sensation seeking and extraversion are also such factors. High sensation seekers take more and larger risks, than low sensation seekers. Another factor is the impulsivity of people: they don’t have patience to analyze the information, so they make quick decisions. Openness to experiences leads to a high risk taking, and people with bigger conscientiousness usually are low risk takers. An important trait to be considered is anxiety, which may cause risk avoiding. Confidence is yet another important factor. In financial crisis situations, people are less confident, more pessimistic about the future and their own financial well-being. Consequently, they avoid risks and try to make more secure decisions. During economic recessions, people save more, take less credit, and prefer to pay back their loans. Regarding financial behavior, optimistic people will take more risk than the pessimists. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 4-5)

“In expected-utility theory, a choice alternative is evaluated by considering all its exhaustive and mutually exclusive outcomes in the future (also discounting time), then computing the expectation by multiplying the evaluation of each outcome with its probability. The alternative with the highest expected
value is then chosen. The evaluations made in prospect theory are evaluations of the difference between an outcome and a reference point. For instance, if a stock share increases or decreases in price from the purchase price, the change is assumed to be evaluated as a gain or loss, respectively. In expected-utility theory, the current price is added to (or subtracted from) the total wealth. Unless the person is broke, the outcome is therefore always a gain. In experimental studies (e.g., Kahneman & Tversky, 1979), it has been shown that the evaluations of outcomes differ in a systematic way depending on whether they are coded as gains or losses. When coded as gains, less-risky outcomes are preferred to more-risky outcomes (risk aversion), whereas the reverse is true for losses (risk seeking).” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 8)

People usually choose only after having evaluated what outcome each choice would produce. They have to decide which of the outcomes is the closest to the expected one. Garling, Kirchler, Lewis and van Raaij show in their article that the final decision depends on the evaluation of the outcome, whether it is considered a gain or loss.

The risk attitude has an asymmetric behavior, meaning that if the probability of the outcome is large, then risk aversion is preferred for gains, and risk seeking for losses. If the probability of the outcome is small, then this behavior is reversed. “Garling and Romanus (1997) demonstrated an asymmetrical influence such that when future potential losses were evaluated, the prior outcome influenced the reference point by making the evaluation worse if the prior outcome was a loss and better if it was a gain. In contrast, evaluations of gains were not influenced by the prior outcome. […] Related to the coding of outcomes as gains or losses, Thaler (1980, 1985, 1999) and Tversky and Kahneman (1981) proposed that coding of outcomes is made in mental accounts. The existence of mental accounts violates the basic assumption that money is exchangeable. Tversky and Kahneman (1981) defined a mental account as “an outcome frame which specifies the set of elementary outcomes that are evaluated jointly and the manner in which they are combined, and a reference outcome that is considered neutral or normal”” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 9) People dislike losses more than they like gains. For example, people rather prefer a situation of an even chance of winning and losing a small sum of money, than an even chance of winning and losing a big sum of money. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 10)

3. Credit Market

Consumers use credit in situations when they need something and do not have the financial means to purchase the product at the time they need it. In this case the credit lending company is ready to offer that money, which must be repaid in an interval of time. People have two choices: to wait until they can afford it outright or use credit. The latter of the two choices carries the risk that the consumer will not be able to make monthly payments. There are a few factors of economic psychology that help to explain why people use credit.

“The first is materialism. In general, the link between wealth and happiness is less strong than you might think, but there are some people who strongly believe that owning more things will enhance their happiness. Such people tend to be less happy than others - they are always on the hunt for more possessions. […] The second is money. Often thought of as simply a convenient tool for facilitating transactions, it can be argued that, psychologically, money is like a drug, giving pleasure and being sought for its own sake as well as for what it can purchase. One aspect of its drug-like properties is the money illusion: people feel they are better off if the price of their house has doubled, even though, if all house prices have doubled, and they still need somewhere to live, their real wealth is unchanged at exactly one house. Finally, we have the most spectacular deviation from rationality: the massive myopia with which we approach choices between good things that will arrive at different points in the future. Humans are quite hopeless at such "inter-temporal choice", consistently choosing to take small benefits sooner rather than large benefits later.” (Lea Stephen, 2010, p.24-25)

Debt can be associated with high level of psychological distress. People or households with a big debt have lower level of psychological well-being than the people or households without debt. There are a few qualities that play an important role on the decisions people make on using credit. These qualities that play a big role on the ability of people to not use credit are: anticipation, self-control, and self-representation.

“Neoclassical economics tries to integrate credit use into standard economic theory (e.g., Brito & Hartley, 1995) by conceptualizing it as maximizing utility by consuming in advance (e.g. Modigliani, 1966, 1986). Neoclassical economics largely ignores the types of credit used, personal characteristics of credit takers, and situational circumstances (Frederick et al., 2002); this is in contrast to the economic-psychological research
In the case of using credit cards, people do not really think that it is necessary to first obtain information. They can underestimate the loan duration, especially for longer periods. Garling, Kirchler, Lewis, van Raaij, 2009, p. 24-25)

They use especially personal contacts as source of information. In most cases people are not collecting enough information because of the costs associated with the search time. They could be somewhat overconfident about their financial possibilities. They are concerned just about the monthly rate. Generally, they might wait for a while. After this first step people can still decide not to accept the loan money possible to wait and save up on their own, or accept the loan after a longer period of time. The individual may want to take a loan after researching about credit and credit alternatives. The third stage starts to come into focus when people need to start paying off the debt in installments. This period may differ from older experience of paying off and can be temporarily difficult. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 22-23)

People have different kind of motives to why they use credit. Sometimes people use credit even if they have the actual liquid money. This may be motivated by the desire to maximize one’s profit. Credit can be used to maintain one’s lifestyle. For example, low-income people need to borrow more money as a complement to their income to maintain their lifestyle, and higher-income groups need less to do this. Keynes had identified six motives for borrowing money, these where the enjoyment, extravagance, short-sightedness, miscalculation, ostentation and generosity (Garling, Kirchler, Lewis, van Raaij, 2009, p. 23). An important role is the social motives of borrowing money, like the social comparison results that people process and want what others have.

Optimistic people are more likely to borrow than pessimistic people. People with positive attitudes use credit much more often and run into debt than people who have negative attitudes about borrowing. An important fact is that people can keep track of their finances by mental accounting. This can be seen as a factor of self-control by constraining the budget for each account. “Although mental accounting may in most cases work as an efficient self-control technique, it may also result in inefficient behavior such as overconsumption, if budgets are set too high (Heath & Soll, 1996), or in self-deception through a decoupling mechanism (Prelec & Loewenstein, 1998).” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 24) The fact of the extreme availability of credit can more easily persuade people use them. If the credit card would not be in a person’s hand then maybe that individual would not use credit so easily.

In many cases people do not contemplate enough before taking up credit, and they decide on impulse, mostly when they use credit cards. The process of deciding to take up credit is complex and it involves risks. It is wise to search and collect information about credit alternatives to choose the best offer. In the case of using credit cards, people do not really think that it is necessary to first obtain information. They use especially personal contacts for their source of information. In most cases people are not collecting enough information because of the costs associated with the search time. They could be somewhat overconfident about their financial possibilities. They are concerned just about the monthly rate. Generally, they can underestimate the loan duration, especially for longer period. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 24-25)

“Decisions about taking the burden of a loan, about payback rates, and about the amount of benefit from a desired product that can be purchased with borrowed money are intertemporal choices; people need to consider, on the one hand, the rewards of immediately purchasing and using or consuming the product, and on the other hand, the burden of sequential installments to be paid in the future. At the time of credit take-up, intertemporal choices pertain to the benefit of immediate consumption or, if people are patient, postponement of purchase and consumption in the future. When they are impatient, they need to consider costs of immediate payment or credit use and costs of payments in the future. Research on intertemporal choice has repeatedly and consistently shown pervasive devaluation of the future. Future costs and the value of future benefits are smaller than present costs and the value of present benefits (Ainslie & Haslam, 1992; Frederick et al., 2002). In other words, buying and using or consuming a product immediately rather than at a later point in time, and paying later for it, is most rewarding. This should be especially true for more impatient or impulsive people with less self-control.” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 25) A person’s decision about taking the burden of a loan has to be well considered, they really need the benefit of immediate consumption, or it is better to postpone the consumption in the future, and be patient. In this case they can be saved by the unpleasantly monthly payment. That decision is influenced by the patient and
inpatient character of human beings. Garling, Kirchler, Lewis and van Raaij agree that buying and consuming immediately is much more pleasant than postponing this activity.

In the moment that people take up a credit, borrow money; they take the risk that they will not be able to pay the installments. When they are deciding that they need the credit or not, they have to consider that the repayment procedure carries a risk factor, and can have a negative outcome. In this case people might want to reduce or avoid this risk. “…risk-defusing operators (Huber, 2007; Huber & Huber, 2008), defined as actions intended to be performed in relation to a specific alternative and expected to decrease the associated risk of the negative outcome. People who want to buy an apartment or a car on credit but are uncertain whether they can meet the monthly installments may obtain consumer credit repayment insurance. Risk-defusing operators are quite common in everyday risky decision making. A risk-defusing operator provides the decision maker with at least some control over the risk, and controllable risks are experienced as less serious than uncontrollable risks.” (Garling, Kirchler, Lewis, van Raaij, 2009, p. 25-26) It is wise to obtain credit repayment insurance for any case, of course that depends on the size of credit, because in the case of a very small credit risk can be considered almost not existed.

Before taking a loan people consider their experience of the paying back of previous credits. On the other hand they imagine a level of burden they predict, and this predicted experience of the repaying in most cases differs from the actual experience during repayment the loan. Predicted experiences are more positive than the actual experiences of repayment. In this consumption-oriented society people may slide into problem debt, because they are tempted to borrow again and again. Credit encourages people to buy things they actually do not really need. Credit users usually, if they finished paying back the loan; they might reconsider their experience from the period they were actually paying the installments, and conclude that if all ended well than everything is well. In this case this situation may induce people to take up further credits. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 27-28)

People are affected by the financial crisis in several ways, they may lose their income; they can remain without a job. “The present crisis, rooted in the subprime mortgage market, is the result of a number of risky and irrational economic behavior pursued, in time, by financial institutions, public decision makers and individuals, all disregarding the economic consequences of risks’ spreading through the open markets. The accumulating tensions spread, by contagion, to the whole world, eventually affect the global economy and the living standards.” (Donath, Popescu, 2010, p. 682)

People are influenced by the mass media, and being confronted with these messages, they become pessimistic about the international and national economy and about their own financial situation. Mass media influence the consumer confidence in negative way mostly in international and national perspective. The consumer confidence regarding their personal financial situation is influenced more by their personal experiences such as income changes and job situations. A person’s confidence affects their spending and saving. Pessimistic people will spend less and on durables, and they will save more. This behavior will lead to fewer sales for companies and after to a further fall of the economy, and in that way people will become more pessimistic. This circle has to be interrupted by showing positive developments for restoring the consumer confidence. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 28-29) “John Maynard Keyenes pointed out the paradox of recession economics: in the long run, people need to save more and borrow less to prevent the crisis recurring. But in the short term, if we all do that, the recession will deepen into a depression.” (Lea Stephen, 2010, p.25)

The great majority of people are not really affected, not directly affected by the financial crisis. Some people lose their jobs, or lose their businesses, but the majorities are just marginally affected by the higher taxes, or higher prices on some products, but they are in a way immune to the whole financial crisis. But they can still become pessimistic by the influence of the mass media, and act like they are affected. This kind of affect is indirect, meaning that is mostly psychological, for example the fear from losing the regular income or everyday job. To move away from that pessimism and economic fall circle, people need to recover their confidence in their financial situation. It is important to build realistic confidence among those who can afford to act confidently in period of recession. (Lea Stephen, 2010) “There is no economy without psychology, so there can be no economic recovery without psychological recovery.” (Lea Stephen, 2010, p.25) It is important that people, especially in period of financial crisis, to keep their psychological well-being and this can be done if people remain confident, and positive. The economic policy needs to encourage people that they are in that group which can afford to act confidently. They have to be advised how and for what to spend their money. “Recovery will be faster if they spend money on products that have a high multiplier effect - in other words, they keep money in the economy where it will be spent again. That means...
spending it on services rather than goods, and spending it disproportionately with those of lower income.” (Lea Stephen, 2010, p.25)

4. Conclusions

Financial decision making is very important, especially in a financial crisis. People need to make the best decision for their financial well-being. This paper discussed the risk taking phenomena, and people’s decision about credit taking.

Risk taking is important regarding financial decision making. The components of risk taking are risk perception, risk attitude and risk propensity, and the influential factors of risk taking are socio-demographic, personality and situational factors. Consumers with high confidence in the future take more financial risks than consumers with a lower optimism and confidence.

Credit use is a process starting with the purchase of a product with borrowed money and ending with having paid back the borrowed money. The decision to take a credit to buy a product in this moment, and not later, is a complex process. This consist two interacting choices: first to choose an alternative product available, second to find a method of financing. The decision making process for credit taking may involve spontaneous, habitual decisions. Because credit users may not correctly see their experience of paying back their loan, they need to be informed and taught how to choose a credit, how to collect information, and how to make their best decision for their current and future financial well-being. Credit users should be advised to use risk-diffusing operators such as consumer credit repayment insurance. It is needed an education in financial management and the most effective way of coping would be the lifestyle changes. (Garling, Kirchler, Lewis, van Raaij, 2009, p. 28)

The influence of the mass media about financial and economic crisis may cause some feelings in people, like fear, anxiety, concern or negativity, pessimism regarding their financial situation. In this case individual confidence is lower. If they are not very confident, they will save more, and spend less. However, not everybody is directly affected by the financial crisis; moreover the majority is affected indirectly by stress. These people need to be encouraged to regain their confidence, and start using their capabilities of taking an active part of the economic world, and start consuming. They need to be advised on how to manage their financial situation, and how to spend their money. In this case the money will be reintroduced in the economy and it can be spent again and again, taking the economy out of the crisis.

My opinion is that people have to resist big waves of psychological influence especially in period of financial crisis, but if they are led to be able to evaluate their situations financially then they can live this period much easier and can help in the economic recovery.

5. References

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