Swept Up by Insanity of Markets
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By Joe Nocera

“I can calculate the motions of heavenly bodies, but not the madness of people.” — Isaac Newton, 1721, after the South Sea bubble burst.

Sometimes I think we must be living in a movie, some kind of nightmarish, upside-down version of “Back to the Future.” It can’t possibly be that in the sophisticated, computerized 21st century, we find ourselves experiencing the same kind of financial panic — the same kind of financial insanity, really — that has dogged mankind at least since the Dutch tulip mania of the 1630s. Can it?

We look at those other eras — Dutch tulips and the South Sea bubble, the panics of 1825 and 1907, the crash of 1929 — and they seem so predictable in retrospect. They were marked by years of speculative excess, by financial innovation that got out of control and by mammoth asset bubbles that seem incredibly obvious in hindsight. There had to be a crash. It was all so unsustainable! Isaac Newton is said to have lost his life’s savings during the South Sea bubble. We think to ourselves, “A smart guy like that should have known better.”

And yet here we are. Iceland is bankrupt. European banks are teetering. Barely a week after the federal government passed a $700 billion rescue plan that revolved around the sale of toxic assets from financial institutions to the government, the Treasury Department announced it would focus its attention on a new plan to inject capital directly into the banks that most needed it. That is now supposed to be the thing that rescues the banking system.

Every financial instrument relied on by investors — with the possible exception of Treasury bills — remains under severe pressure. Credit markets have been frozen all week, with giant multinational banks afraid to lend money to other giant multinational banks. The Japanese stock market dropped 24 percent this week. Panic was everywhere.

In the United States, the Dow Jones average dropped 370 points on Monday. On Tuesday, it dropped 508 points. Wednesday: 189 points. Thursday: 679 points, including a sickening plunge of more than 450 points in the last hour of trading. And it didn’t relent on Friday; although the Dow wound up “only” down 128 points, it came after an early 700-point swoon, followed by a brutal whipsaw of a day. It was the worst week in history for the Dow.

Someday, when the history books are written, the inevitability of this crash — following as it did speculative excess, Frankenstein-like financial engineering and a huge asset bubble — will seem every bit as obvious to future generations as the South Sea crash seems to us.

So why didn’t we know any better? Why do we, as a species, continually have these bouts of financial insanity? This week, with the markets collapsing, that was what I most wanted to understand.

“What does humanity ever learn about romance?” said James Grant, editor of Grant’s Interest Rate Observer and the author of the forthcoming book “Mr. Market Miscalculates.” Science, said Mr. Grant, is a discipline that builds cumulatively. Previous knowledge isn’t forgotten or cast aside — it is built upon. But finance isn’t like that.

“People keep on stepping on the same rakes because money, like romance, is only partly an intellectual experience,” Mr. Grant continued. “Money, like sex, brings out some thought — but also much heavy breathing and little stored knowledge. In finance, the process is cyclical. Some people learn from their ancestors, but mostly they repeat the same mistakes. Thus it has always been and thus it will always be.”

Mr. Grant’s point, echoed by almost everyone I spoke to, is that it is not just the analytical part of our brain that deals with money, it is also the instinctive, emotional part — what we like to think of as our gut.

Paul Slovic of the University of Oregon, an expert in the psychology of risk, pointed out that when times are good — when markets are rising, for instance, and bankers are making millions trading their mortgage-backed securities — “the sense of risk is depressed. You don’t look as hard for warning signs.” Robert Shiller, the Yale economist, said, “One thing we know about human behavior is that our memory is influenced by recent events.”
Thus, when we are living through a housing bubble, it is hard not to be caught up, emotionally, in the idea that prices can only go up — even though our analytical brain knows that acting on such impulses defies logic. But in the moment, a kind of unshakable euphoria takes over, and we just can’t imagine its ever ending. Similarly, when times are bad, fear and loathing capture our imagination, and we find it equally impossible to see a glimmer of hope. We take actions to protect ourselves — like banks refusing to lend to other banks — even though these individual actions result in a kind of cumulative madness. That is where we are now.

William Goetzmann, an economist at Yale who has studied financial panics, told me that after the South Sea bubble burst, people went back to writings and illustrations that were done nearly a century earlier in the wake of tulip mania, trying to understand how they could have made the same mistake.

We’re now wondering the same thing. But while history may help us understand why financial panics take place, it doesn’t do anything to prevent them. The impulses that make us want to forgo the slow and steady for instant riches, that cause us to go along with the crowd instead of bucking it, that allow us to think that this time it’s different, instead of understanding that it never is — these are such basic aspects of human nature that they cannot be changed through study alone.

They can be changed only by cold, painful experience. That is what our parents went through during the Depression; they were so scarred by that experience that most of their generation were debt-averse forever after. That is where we are now, too.

Mr. Shiller, a leader in the field of behavioral economics, believes that bubbles and crashes are a kind of social epidemic. “Ideas become contagion,” he said. When housing prices were rising quickly in the early part of this century, he said, “people misinterpreted the meaning of the price increase. The theory that housing prices could only go up began to sound plausible. It became a thought virus. And people believed it was true rather than realizing it was a thought epidemic.”

Crashes tend to feed on a similar dynamic, except in reverse. Mr. Shiller did a study of the days leading up to Black Monday in 1987 — days that also had sharp market drops — asking people what they were reading and talking about. Invariably, they were reading and talking about the big price drops, which led them to pull money from the market, which led to yet more price drops. “Exactly the same thing is happening now,” he said.

“At times of crisis, people have an instinctive need to get into a huddle and talk about it with other people,” he added. “On the one hand, this creates a sense of community. On the other hand, it amplifies the speed with which news is related.”

As I was speaking to Mr. Shiller, I suddenly realized I had spent the week in a huddle of my own making. I’m not someone who usually has CNBC on all day — but I did this week. I needed to hear every rumor and track the market’s every move. I called hedge fund managers to hear how they were doing. I saw Jim Chanos, the well-known short-seller, and empathized as he complained about the foolishness of the ban on short-selling. I had dinner in a restaurant and fell into a long discussion about the credit crisis with two complete strangers. So many of my conversations this week began with a kind of resigned acknowledgment of the predicament we’re all in.

Late on Thursday, right after that awful 679-point drop in the Dow, I got an e-mail message from someone I didn’t know, a trader and blogger named Karl Denninger. “We have an extremely serious credit market dislocation about to occur — like maybe tomorrow,” he wrote. He asked me to call him.

So I did. “There is a flight of money from the U.S.,” he said breathlessly. “We need $2 billion a day in foreign capital to operate our government, and that has mostly come from China and the oil-producing countries. Now that money is leaving. We are going to have a complete lockup of the credit markets within 48 to 72 hours. Everybody is trying to push this off to the election. But we’re not going to make it to the election.”

On Friday, Mr. Shiller told me of a conversation he had with an economist friend of his. The man had spent his entire career advocating the efficient market hypothesis, which posits that all known information about a stock is already priced into it. But with the market in collapse, the economist sold all his stocks. “I feel like a Christian Scientist who has come down with appendicitis,” he told Mr. Shiller.

All around me, I hear the sounds of panic. Some things, it turns out, never change.