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THE IMAGINARY OF FINANCE

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Abstract

During the last century economic development has become one of the most important human endeavours while the study of economics gained a special status among social sciences. Although classics like Adam Smith argued the importance of passions in economic contexts, over time economists chose to model economics after natural sciences. We believe that economic phenomena are in fact projections of the complexity of human social interactions. By rejecting the human aspect which governs all transactions a significant part of economic behaviour was ignored by the economists. The alternative is to employ perspectives and research knowledge gained from other disciplines such as psychology, sociology, communication studies and medicine study it. It is important to point out that some of the most significant contributions to the understanding of economic behaviour belong to authors such as Herbert Simon (Bounded Rationality), George Katona (Consumer Confidence Index), Serge Moscovici (Social Representations) or Amos Tversky and Daniel Kahneman (Prospect Theory) to name but a few. Their work showed that judgement is altered by perception; people are subject to various (cognitive) biases; social and affective influences. This is in clear opposition to neoclassical economical thinking, based on the assumption of humans as rational analytic agents who make optimum (financial) choices.

We argue that research in such fields as economic psychology (and behavioural finance) and the effects of media communication can be integrated in a theory that can shed light on the behaviour in the real economy as well as in financial markets. From our point o view neglecting the human element while focusing on the prospective (overly rational) nature of these phenomena is a grave error. The crisis amply demonstrated that theory should have been closer to actual economic life of people and that pivotal psychological mechanisms were misunderstood and the fact that it became systemic adds further credence to this belief. All in all behaviour in the markets is not fundamentally different than in general. As a consequence of rejecting people`s humanity as the source of the phenomena, economics has become abstract.

Beside its intrinsic monetary value money has a symbolic one as well as because it is based on the existence of social consensus without which it would not be accepted as a medium of exchange and accumulation of wealth. Weather it is paper banknotes, metal coins,

or electronic cards (accounts), money draws upon people's beliefs and trust. Without trust the system would ultimately collapse. In fact, the fiat currency system means that the value of money is implicitly supported by the trust of those involved in the exchange, without which it would be worthless.

Decisions are impacted by social representations – set of values, beliefs and practices internalised and used by groups, as Moscovici (1961) argued. Our approach to understanding the interaction between the individual and the collective is based on the knowledge from research in the field of media communication. We argue that the economic imaginary is a result of reflexive exchange of information between individuals and groups.

The central concept, the *imaginary of finance*, was developed as an interdisciplinary theoretic frame around which the thesis is built. To our knowledge we are the first to use this concept, which is situated between psychological processes, behaviour and communication. This thesis examines the relevance of psychological research on economic thought as it aims to outline a theoretical framework centred on the concept of a *financial imaginary*. By considering the impact of perceptions and emotions on economic judgement and behaviour we argue for the pivotal role of the imaginary (individual and group) in finance. The present paper puts reviews the literature on human decisions in economic contexts. While we rely on evidence from economic psychology, and behavioural economics, we also draw upon previous research on media effects in financial markets. We lay special emphasis on the importance of trust as a pillar of any transactions. We argue that an integrative theoretical framework can yield a deeper understanding of financial decision making and, indirectly, of the present crisis. After the Crash of 2008 and, the subsequent financial and economic crisis, it was widely argued that economic theory has failed. Although there is no consensus on the causes and the extent of the failure, it has been argued that the failure is profound, going back to the foundations of economic theory. In spite of economic theory's assumption that market participants act in a rational manner, there is considerable evidence that challenges this claim on which neoclassical economics is founded.

Traditional economic theory posits that people make decisions by maximizing a utility function in which all of the relevant constraints and preferences are included and weighed appropriately. The fundamental assumptions neoclassical economics is built upon are that people have rational preferences among outcomes and act independently on the basis of full information. Thus, it is assumed that prices, outputs, and income are the result of a process of rational allocation of assets. These principles gained wide acceptance in financial economics in the 1960`s, when Eugene Fama introduced the Efficient Market Hypothesis (EMH). In short, EMH argues that information propagated by means of mass communication allows for the rational evaluation of investment opportunities. The neoclassical approach faced mounting criticism from academics and practitioners alike, as neoclassical models had little in common with actual economic or financial behaviour exhibited in real life. Its normative bias comes as a direct consequence of economics being shaped as a natural science. explains: economics is a social science and there is a fundamental difference between the natural and social sciences. Social phenomena have thinking participants who base their decisions on imperfect knowledge. That is what economic theory has tried to ignore.

We explicitly challenge the traditional economical approach as we believe that the causality implied by the neoclassical principles has little bearing on actual human behaviour in real markets. We argue that the nature of economic and financial interactions is more reflexive, and heavily influenced by individual and collective psychological phenomena. Furthermore, the claim that new information has a direct impact on decisions and behaviour, without considering any sort of psychological mediation is an essential oversight. The few studies that analysed the implications of media consumption on participant's behaviour in the markets brought evidence that raises serious questions on EMH`s assumptions.

In our previous research we analysed how communication interacts with the decision making and behaviour of an elite audience of professional investors. We concluded that contrary to the direct effects assumed by finance theory and the EMH, media has an indirect effect, `setting the mood` or amplifying the dynamic already in play. The results also indicated that investors often behave irrationally, are subject to biases, and do not fully integrate the available information in their evaluation and decision making. These findings are consistent with other media effects studies.

The emergence of economic psychology is related to the works of Gabriel Tarde (1902), Maurice Allais and, George Katona. The turning point was Herbert Simon's introduction of Bounded Rationality to explain how people irrationally seek satisfaction, instead of maximizing utility, as conventional economics presumed. Later, psychologists began to compare cognitive models of decision-making under risk and uncertainty to economic models of rational behaviour showing that heuristic short-cuts created probability judgments which deviated from statistical principles (Tversky & Kahneman, 1974). Their continued researches lead to the development of the axiomatic Prospect Theory (1979). By framing outcomes as gains or losses, Tversky and Kahneman highlighted asymmetric risk attitudes – risk aversion on gains and risk seeking on losses – also pointing out that the value function of losses is much higher than that of gains (Tversky & Kahneman, 1979). Also notable were the development of mental accounting, the process whereby people code, categorize and evaluate economic outcomes (Thaler, 1980) and the Behavioural Life-Cycle hypothesis which argues that people mentally frame assets as belonging separate accounts (Shefrin & Thaler, 1988).

People are confronted with economic risk through debt, investments, purchases (consumption), and jobs. Thus, risk is an intrinsic component of economic behaviour. Socio-demographic factors such as sex, age and personality also play a major role in risk attitudes and associated behaviour. Studies consistently indicate people have positively-biased outlook. Individuals spend, consume, and invest more when they have positive expectations; and they spend less on consumption, and stop investing during periods of uncertainty. An equally important effect is the perceived value of the exchange medium – the `money illusion`. People tend to disregard the difference between the nominal value and the purchasing power and do not take inflation into account. In financial markets, people are not able to act consistently in a rational manner, which leads to increased volatility in the markets, speculative bubbles, and ultimately crashes.

The financial market crash of 2008 and the subsequent crisis that is still unfolding globally has brought conclusive evidence that neoliberal ideals of free-markets were just ideals. Markets have been proven to be unable to regulate themselves voluntarily. Furthermore, it was argued that additional strict regulative measurements would be needed in order to reinstall trust in the economy and in financial markets. The crisis eroded trust and between economic and political stakeholders, but also participants from the real economy stopped trusting the financial institutions, and changed their lending and borrowing decisions accordingly, their behaviour caused considerable problems in the credit markets. In turn, citizens blamed the moral hazard and misconduct of financial institutions, losing trust in the government's ability to regulate international financial markets.

We reviewed both the traditional approach towards economics and the economical psychology approach. The former is normative, dominates mainstream economics, and offers a logical theoretical framework. However, its assumptions have been challenged by empirical research, and actual behaviour observed in markets. The latter is more descriptive, has been validated by experiments, and it is in line with actual behaviour. Its main shortcoming is that it has no cohesive theoretical framework.

We propose the concept of the *financial imaginary*, by merging theories from different backgrounds (psychology, communication) relating to mental representations, affective influences, and framing. Trust plays a vital role in our integrated concept as it mediates all transactions. This approach, we feel, is preferable because it can accommodate a theoretical framework which is interdisciplinary and inclusive, as well as the challenges posed by the practical aspects of finance.

We argued that economic behaviour is self reinforcing by means of a feedback mechanism which does not regulate itself smoothly. Rather it tends to follow the boom-bust cycle observed repeatedly in the course of history. Researchers have noted that humans pass from optimism to pessimism and back again in a cycle of mood that might be linked to the feedback effect in financial markets, whereby the price trends tend to be reinforced and amplified by the prevailing mood among the investors. This also holds true in economic cycles, as expansion is followed by recession. It is our view that economic trends are generated by the participants themselves through spending, consumption and investment. The causal implication is that participant imaginary (perceptions, mood, biases) induce positive or negative feedback loops (tendencies), to which people react in turn in the reflexive function. This view supports our hypothesis of a *financial imaginary* – a reflection of reality, without being necessarily real. This is why finance can be so deceptive, and confusing to most participants, as was seen from the onset of the crisis.

Although there is a substantial literature on the confines of human rationality, psychological effects in economic behaviour, the role of trust in the economy, and overwhelming evidence of the importance of mental representations (imaginary) in financial markets, academics have failed to provide an integrated theoretical framework. On the other hand, the traditional paradigm in economics, which has been largely proved inadequate, still resides at the very centre of economic thought today. It is taught in universities around the world shaping generation after generation of economists, professionals in administration and the financial sector. For this reason we agree with the claim that the current crisis is, at least in part, the end result of this gap.

We set out to argue that finance is imaginary, but as the purpose of this study theoretical, we limited ourselves to introducing the concept of a *financial imaginary*. A further development would be to include the emotion component into this concept. We would like to analyse and interpret the possible direct and causal effect of emotions (either positive or negative) on decisions/behaviour in a financial context. We already know that emotions regulate mood, and mood affects behaviour through perceptions. We are taking into consideration conducting experimental trials where we induce positive or negative moods and affective responses by means of either electro stimulation, or more probably using images.

Keywords: *economy, imaginary, perceptions, decisions, rationality, trust*.