“history first occurs as tragedy, then repeats itself as farce.”

- economics: constructs of rationality, optimization and equilibrium, and statistical testing of hypothesis

- The Central Problem of Depression was solved
- Assumptions of Rational behaviour applied to Financial markets
- Past Justification of Regulation based on Market Failures
  - Information failures
  - Adverse selection in credit markets
  - Opportunistic behaviour
  - Moral hazard
- Decision making was by Rational Agents
Rethinking rationality in Financial Markets

• The efficient markets hypothesis
• first, decision-making cannot be systematically biased
• biases are not correlated across the participants
• systematically correlated biases will be eliminated by rational arbitrage.
• No place for Bubbles
• financial asset markets always fully reflect all available and relevant information,
• adjustment to new information is virtually instantaneous
• participants are at least as good at price forecasting as is any model that a financial market scholar can come up with
• Empirical Evidence: misalignment between asset prices and economic fundamentals for long periods
• noisy-trader framework
• not consistent with EMH.
• theory has *normative* intents rather than a positive description of reality.
rethinking on the foundation of investor behaviour: Alternative Paradgims

- *instrumental rational choice theory*,
- *Other Dimensions*: observance of social norms,
- motivation for normative conformity,
- Prestige, irrespective of the direct profit
- heuristics, frequently relying on mental short-cuts and rules of thumb.
- over-optimistic;
- have limited willpower and limited self-control;
- and that people are ‘boundedly’ rational, in the sense that they have limited information-processing powers.
• decisions are myopic and seldom have long run consequences been worked out in arriving at them.
• three heuristics when making judgements under uncertainty (Tversky and Kahneman 1974):
  • Representativeness
  • Availability
  • Anchoring and adjustment
choices among risky prospects exhibit several pervasive effects that are inconsistent with the basic tenets of expected utility theory.

- underweight outcomes that are merely probable
  - **Certainty effect**
- **isolation effect**, leads to inconsistent preferences
- Overconfidence During upswings
- Panic during down swings
- Herd behaviour
- Irrational Exuberance
• limitation of the assumption of arbitrage (Royal Dutch Shell case)
• perverse incentives created by the Originate to Distribute model.
• over relied on Credit rating agencies
• “influenced by availability and representativeness heuristics, investors replaced rigorous credit controls and valuation mechanisms with over reliance on credit ratings.”
Macro foundations: KYNES AND MINSKY

- solved the problem of the business cycle spurred by the prosperity in the mid-1960s.
- endogeneity of cyclical instability and of the transitory nature of the institutional underpinnings of financial markets.
- investment decisions based upon the expected returns based on the Marginal efficiency of investment and the long run rate of interest.
• Thus expectations played an important, if not a central, role in this framework.
• Major features of the Keynes-Minsky approach:
  • future uncertainty, the formulation of expectations, the importance of confidence, and volatility.
  • financial market will inevitably be affected by waves of optimism and pessimism
  \rightarrow MEI calculations \rightarrow Volatility
• The Retreat from Keynes to a more mainstream approach: Monetarism

• Excessive government intervention is harmful: Inflation with unemployment

• what drives the waves of overconfidence and panic that cause and perpetuate crises.

• MINSKY: Hedge finance is expected to dominate in a healthy economy in equilibrium. However, this stable liability structure degenerates into an unstable speculative and Ponzi system.

• periods of prolonged prosperity due to the availability of cheap credit → Overconfidence → ponzi financing → off load assets → asset price meltdowns.
• rational self-interest or cognitive limitations?
• regulation of Banks and financial markets was not based upon regulating the *behaviour* of investors and borrowers
• *informational* imperfections of financial markets.
• Crises embedded not in the nature of Market imperfections per se,
• behaviour of economic agents
TOWARDS A NEW ORTHODOXY?

- flaws and frictions to with individual behaviour
- more pragmatic approach to regulation?
- behavioral shortcomings that hinder the optimal market clearing conditions proposed in efficient market hypothesis.
• current financial regulations tend to encourage Minsky type pro-cyclical risk taking behavior
• Herd behaviour → correlated behaviour → Systemic risk
• micro-prudential concern is about individual risk
• macro-prudential with common, herd behaviour, and with shifts in generalized attitudes to risk
• In the end its about individuals, their Motives and Attitudes.
• Regulation must not be aimed at both the micro-foundations of such behaviour as well as at the macro level.
• Financial Systems are at cross roads because the very profession of economics is at a cross road.
• Much would depend upon the path economic theory takes from here.
• “flaws and frictions economics will move from the periphery of economic analysis to its center.”