

- [OPINION](#)
- AUGUST 1, 2011, 7:19 P.M. ET

## Excessive Optimism and Other Economic Biases

No president, chairman of the Council of Economic Advisers, Secretary of the Treasury, or chairman of the Federal Reserve has ever forecast a recession.

By [HENRY KAUFMAN](#)

We urgently need new ways of thinking about market behavior from our economic thinkers and political leaders. Regrettably, it remains very difficult for those who have dominated economic thought and political life in recent decades to think in fundamentally new ways.

My own profession, economics, has not distinguished itself in recent decades. Classic monetarists have lost their footing as the definition of money became elusive with the changing structure of the financial markets. Keynesians failed to achieve their objectives because fiscal policy responses lagged economic requirements. The biggest failure has been timely fiscal restraint to ward off economic and financial excesses.

Rational expectations is another economic theory popular in academia. It was recently described by Roman Frydman and Michael Goldberg in their book "Beyond Mechanical Markets" as starting with a premise that the world is "made up of fully specified mechanical rules that are supposed to capture individual decision-making and market outcomes at all times." Rational expectations has encouraged the mathematical modeling of economic and financial behavior and led the academic community to downplay the importance of structural changes in economic and financial behavior.

Academicians and private-sector economists alike are heavily influenced by behavioral biases. On the whole, these biases discourage analysts and market participants from accepting the likelihood of panics, crises and other financial mishaps. Consider, for example, the all-too-human propensity to minimize risk and avoid isolation. It is comforting to run with the crowd. Doing so minimizes the likelihood of getting singled out for being wrong.

When it comes to looking ahead, we inescapably look to the past for guidance. Yet it is important to keep in mind that history never exactly repeats itself, but rather (as Mark Twain reportedly said) it rhymes. The real challenge is to identify what is different in the current situation from the past. Mathematical equations based on historical data are unable to make such judgments.



Another important cognitive bias is that most of us find it very difficult to change our minds. An economist who has gained prominence through years of writing and developing an economic and financial theory is unlikely to change his conclusions in light of contrary evidence.

There is also a clear bias against negative predictions. As far as I know, no American president, chairman of the Council of Economic Advisers, U.S. Secretary of the Treasury or chairman of the Federal Reserve has ever forecast a business recession. For that matter, large business and financial institutions avoid talk of near-term difficulties.

The latest financial turmoil was no exception. Just months before the recent crisis reached its depths in 2008, many officials noted publicly that the problems in the housing market were well-contained.

There are many reasons for this bias, not least the fact that negative economic and financial projections make for bad politics. They can cut short the careers of political leaders, interfere with the aspirations of leaders in business and finance, and imperil the performance record of financial managers. And that's even when they are on the mark!

Economists and business analysts, especially those employed by "sell-side" institutions—i.e., organizations involved in such activities as trading and investment banking—are confronted with the difficult task of maintaining objectivity. Just the designation of "sell-side" suggests that their analysis should help to further a trade or the distribution of new securities.

To minimize the suggestion of bias, the research chief of financial institutions engaged in a wide range of activities should be a member of the senior management and not report, as is the practice today, to the head of an operating function such as trading, sales or investment banking.

For all the advanced econometric modeling and other new techniques at the disposal of today's economists, they are simply not observing a world as reliably predictable as experts in the physical sciences do, and cannot run the same kinds of controlled experiences. Theirs is a human science shaped by often unpredictable human actions.

Unfortunately, I still fail to see any new awareness or enlightenment in the economics and financial profession. Struggling to emerge in the aftermath of the recent upheavals, we continue to face major headwinds. Far too many

financial assets are still not shown on the books at realistic prices. Effective government oversight in both the United States and Europe remains uncertain.

One side of the economics profession urges continued substantial fiscal policy stimulation. That is supposed to increase renewed private sector spending and borrowing. But it will hardly bring household debt and total debt growth into a sustainable alignment.

Other economists urge tighter monetary policy and a slowing of fiscal policy expansion. That may well run the risk of stalling an already anemic economy.

The intractable problem is excessive debt. How do we effectively deal with it? Yesterday's answers no longer seem relevant. The new paradigms almost certainly will emerge—not from the minds of incumbents—but rather from the ranks of tomorrow's leaders.

Mr. Kaufman is president of Henry Kaufman & Company Inc. and author of "The Road to Financial Reformation: Warnings, Consequences, Reforms" (Wiley, 2009).