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A psychosocial explanation of economic cycles☆

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ABSTRACT

How human expectations and behaviors impact the economy has been of interest to economists since at least Adam Smith. However, recent advances in psychological and social psychological research have led to an improved level of knowledge about human adaptation processes, as well as about optimistic and pessimistic expectations and their consequences on human behavior. These developments allow us to understand these adaptive expectations and behaviors in a more integrated fashion. Based on these improvements, I develop a model of human adaptation under different external circumstances and apply it to explain the ups and downs of economic cycles. A central conclusion from the model is that optimistic expectations of economic agents might not always have a positive impact over the economy. I conclude by drawing theoretical implications, as well as potential consequences for financial and economic policy-making.

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1. Introduction

In a recent address on the topic of "the economics of happiness", the chairman of the US Federal Reserve,[1] Ben Bernanke, cited Adam Smith's (1759, p. 119) observation that "[T]he mind of every man, in a longer or shorter time, returns to its natural and usual state of tranquility. In prosperity, after a certain time, it falls back to that state; in adversity, after a certain time, it rises up to it". Bernanke was citing Smith to stress the importance of understanding the psychosocial processes of human adaptation to different social and economic environments, particularly those in which the material economy does not seem to perform so well.

Transmitted from Smith, right down to our days, this message is still to be assimilated by economics in order to better understand how humans handle the challenges and threats they find in their context. It is true that eminent economists, such as Schumpeter and his socio-economic perspective, have enlarged the lens of analysis of economic behavior (Swedberg, 1995). However, given the advances in psychological research that have occurred over the last decades, new and more comprehensive models need to be developed.

Some economic approaches have highlighted striking similarities between biological and technological/cultural evolutionary features, claiming that social systems consist of collective human behavior with origins in the human biological system (Devezas and Corredine, 2001). These authors stress that regularities in human behavior manifest themselves as socioeconomic rhythms and that the cyclical nature of social phenomena is ingrained in the human biological structure. In the same line, we must acknowledge that leading authors in the field of economic psychology, notably Katona (1968), long ago launched the seeds of an adaptive theory of consumer behavior.

These pioneering works were followed by a surge in psychological research and understanding of core explanatory concepts, such as expectations, optimism, pessimism, and perceived control over events. I believe the time has come to put all this new knowledge into an informative model of how people adapt to changing economic conditions and how their consequent behavior, in turn, influences the development of the economy.

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[1] Commencement Address entitled "The Economics of Happiness", University of South Carolina, Columbia, South Carolina, May 8, 2010.

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As such, the goal of this paper is to present an integrated and up-to-date model of human adaptation to an economic changing environment. To achieve this goal, I first discuss the major increments in psychological knowledge on key constructs to understand human adaptation, such as appraisal and coping (Lazarus, 1991). In addition, I also aim to outline implications for economic theory regarding how and why people react to different economic conditions, particularly across different economic and business cycles.

I foresee at least two advantages to be gained from a better understanding of the psychosocial processes that underlie human adaptation and behavior in response to different economic contexts. First, traditional economic theories about economic cycles can be enriched with a behavioral perspective of why and how people engage in overoptimistic or pessimistic expectations and why they change their behavior accordingly. This, of course, follows the resurging importance of a behavioral economic perspective that we have seen over the last decades (Akerlof and Shiller, 2009; Kahneman and Tversky, 1979; Thaler, 1980). Second, by understanding the human adaptive psychosocial processes underlying these expectations, economists can best inform policy-makers in terms of their own goals. For instance, policy-makers usually rely on the assumption that to beget more active consumers (i.e., stimulating consumption) authorities should implement policies to nurture positive optimistic expectations, such as lowering a central bank's interest rate (De Grauwe, 2008). But as I shall demonstrate, in some circumstances optimistic expectations might, in fact, lead to less problem-solving behavior and to higher passivity on the part of consumers (Aspinwall et al., 2005).

Understanding the mechanisms that regulate these adaptive behaviors under different circumstances (e.g., upswing or downswing) can thus help us to better intervene in the economy at a macroeconomic level. Psychologically informed explanations of economic cycles and financial crisis have already been advanced in the literature (e.g., Schwartz, 2010), including topics such as mental biases, envy, and illusions. In this case, however, I base my research on the specific literature of human adaptation processes and I hope to contribute toward enlarging our knowledge of how psycho-socio-economic mechanisms can inform us about these phenomena and how we can influence them accordingly.

In the remainder of this paper, I review the major traditional explanations for economic cycles that have been proposed and then discuss the state-of-the-art on human adaptation theories in psychological and psychosocial research, ending that section by presenting an integrated model of human adaptation. I then discuss a psychosocial explanation of economic cycles in the light of the proposed model and finish the paper by drawing conclusions and implications for economic theory and policy-making.

2. Current explanations for economic cycles

The existence of recurring patterns of economic activity has long intrigued economic scholars (Kleinknecht, 1986; Kondratiev, 1935).[2] Schumpeter (1939) was perhaps the most notable of the first economists fascinated in teasing out the causes of these patterns and he showed particular interest in integrating different long-tale types of waves, namely Kondratievs (structural economic development changes occurring in a range of about 48–60 years), Kuznets (based on migration and investment in construction occurring in cycles of about 15–25 years), Juglars (investment in machines occurring in cycles of about 7–11 years), and Kitchins (inventory investment cycles occurring in turns of about 3–5 years) (De Groot and Franses, 2008).

The cyclical behavior of economic variables such as GDP growth, employment, or interest rates is such that it resembles the features of a fractal with the different types of cycles nested within each other. As some have noted, the relationships between these cycles is so tight that one can even establish the direct functions of 1 Kondratiev-type of wave happening for each 3 Kuznets, each Kuznets happening for each 2 Juglars, and each Juglar happening for each 2 Kitchins (or 1 Konratiev = 3 Kuznets = 6 Juglars = 12 Kitchins) (Van Duijn, 1983).

In the same vein, Schumpeter also viewed business cycles as pulsations of the rate of economic evolution (Kuznets, 1940). His most salient explanation for the different pulsation rates of the economy was the innovation process (Rosenberg and Frischtak, 1983; Swedberg, 1995; Schumpeter, 1939), which according to him, helped to explain the long cycles through the understanding of how innovation brings both cyclical instability and economic growth.

The core explanation of Schumpeter for the existence of economic ups and downs lies in the discontinuity of the distribution of entrepreneurial ability. As Kuznets (1940, p. 259) asserted, "This ability to dare, to initiate, to overcome obstacles to innovations is, like many other abilities, distributed along a curve which suggests that there are few individuals endowed with such ability to any great degree", and it is the activity of these entrepreneurs that destabilizes and promotes instability in the economic system.

Considering that the innovation process and the entrepreneur's action is behind the occurrence of economic and business cycles means that human behavior is at the roots of economic behavior. As Kuznets (1940, p. 266) puts it, "for whatever quantities reflect cyclical changes, these changes result from discrete acts by individuals (. . .) in the social system". If true, understanding the psychological mechanisms behind the different behaviors that humans actually show while they try to adapt to different economic stages is a crucial element of the explanation for economic upswings and downswings. However, despite the importance to better understand these human adaptation processes to an economic changing environment, there is scant literature on this topic.

A close research area to which one can refer are the pioneering studies of Katona (1968), which launched the basis of a line of research evidencing the influence of the "consumer sentiment" on consumer expenditure and buying patterns. Katona's proposals and assumptions are considered the first main explicit adaptive theory of consumer behavior using socio-psychological principles. Although he did not directly address the issue of economic cycles, these were always related to his work because, as he asserted, the major psychological variables used in his research, such as expectations and attitudes, "are believed to be related to fluctuations in the business cycle" (Katona, 1957, p. 120).

In any case, Katona (1968) foresaw the critical variables that seem to be necessary in explaining economic variation derived from consumer behavior. First, he stressed that human responses are a function both of changes in the environment and the person ($R = f[E,P]$), which led him to acknowledge that motives, attitudes, and expectations are intervening variables that mediate between stimuli and responses, and are acquired through past experience. Second, he verified that human wants are not static and that optimistic/pessimistic expectations play a critical role in explaining consumer behavior.

He specifically found that expenditures and consumption are not a mere function of the ability to buy (i.e., income) but also of the

[2] "Economic Cycle" and "Business Cycle" are disputed empirical phenomena. However, given the core of this theoretical paper, we will assume their factual existence and will not make that discussion here. For further knowledge about this topic, readers are referred to e.g., Hartley et al. (1998) and Grandmont (1985). I thank an anonymous reviewer for noticing the need to make this explicit.

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