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Cognition, market sentiment and financial instability

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Abstract

The purpose of this paper is to explore the role for psychology within an open-system structural theory of financial instability, and to consider the implications for policy. While behavioural finance has drawn on ideas from psychology in order to explain evidence of behaviour that deviates from the rationality axioms, it is argued that the way in which psychology is framed by this approach is unduly limiting. Minsky's structural theory of financial instability, with its Keynesian (and ultimately Humean) roots, incorporates psychology into the theoretical foundations. In particular, cognition and sentiment are shown to be interconnected rather than separable. It is concluded that the policy implications for addressing the current crisis, while apparently similar between these different approaches, are in fact very different. The underlying theory involves different methodology, and indeed different framing, from behavioural finance. The way in which the crisis is understood is therefore important for policy.

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