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## The Death of 'Rational Man'

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By David Ignatius  
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What allowed some people to see the financial crash coming while so many others missed its gathering force? I put that question recently to Nouriel Roubini, who has come to be known as "Dr. Doom" because of his insistent warnings starting in 2006 that we were heading into a global firestorm.

Roubini gave two kinds of answers. The first involves standard number-crunching of the sort that economists routinely do -- and that Roubini just did better and sooner. It's his second answer that's more interesting, because it goes to the heart of what we should take away from this crisis: Roubini decided to discard the assumption of market rationality that underlies most economics and to embrace the psychological insights of what's known as "behavioral economics."

First, the standard analytical explanation: Roubini said that he studied a chart in economist Robert J. Shiller's book "Irrational Exuberance." It showed that U.S. housing prices, adjusted for inflation, had remained essentially flat for a century, until the mid-1990s, when they began to shoot up. What's more, Roubini saw that the most recent housing correction in the late 1980s had a severe effect on the financial system -- leading ultimately to the collapse of the savings and loan industry.

So Roubini knew two things: Housing prices wouldn't keep going up forever, and when they went down, they would take a big piece of the financial system with them. From then on, it was a matter of watching the data.

But everyone else had those same numbers. Why did Roubini act? The answer is that he decided to trust his gut, which told him there was trouble ahead, rather than Wall Street's "wisdom of the crowd," which -- as reflected in stock prices -- said everything was rosy. He concluded that the markets were not pricing in the degree of risk that was actually present in housing.

"The rational man theory of economics has not worked," Roubini said last month at a session of the World Economic Forum at Davos. That's why he and other prominent economists are paying more attention to behavioral economics, which starts from the premise that economic decisions, like other aspects of human behavior, are influenced by irrational psychological factors.

The most compelling rebuttal of the rational model, paradoxically, was delivered by the ultimate rationalist, Alan Greenspan. "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders," the former Fed chairman told Congress last October.

That's why Greenspan didn't see it coming, argues Daniel Kahneman, a Princeton professor who is often described as the father of behavioral economics. His rational-actor model wouldn't let him.

Let me put in a plug here for the godfather of behavioral economics, John Maynard Keynes. His 1936 "General Theory" is often interpreted simplistically as a call for fixing recessions by boosting demand with

government spending. But at a deeper level, Keynes was analyzing the role of psychological factors, such as greed and fear, in economic decisions. He understood that markets freeze when people panic and start hoarding cash. ("Extreme liquidity preference," he called it.) Conversely, economies start to roar when investors feel a surge of what Keynes called "animal spirits."

One of the most powerful ideas I heard at Davos was the idea of "pre-mortem" analysis, which was first proposed by psychologist Gary Klein and has been taken up by Kahneman.

A pre-mortem analysis can provide a real "stress test" to conventional thinking. Let's say that a company or government agency has decided on a plan of action. But before implementing it, the boss asks people to assume that five years from now, the plan has *failed* -- and then to write a brief explanation of why it didn't work. This approach stands a chance of bringing to the surface problems that the decision makers had overlooked -- the "black swans," to use former trader Nassim Nicholas Taleb's phrase, that people assumed wouldn't happen in the near future because they hadn't occurred in the recent past.

One more take-away from this year's Davos forum was a Japanese proverb cited by one speaker: "An inch ahead is darkness." Recognizing the inherent unpredictability of economic life -- the darkness that's just ahead -- should make us wary. But it can also make us smart.

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