Book review


This book is an analysis of the recent extraordinary bullish performance of the US stock market. By historical standards the market appears to be grossly overvalued as of mid-2000. (The phrase “irrational exuberance” to describe the state of US market sentiment was coined by Federal Reserve Chairman Alan Greenspan.) Robert Shiller provides a detailed appraisal of the current valuation including comparisons with previous stock market booms, and subsequent busts, in the US and elsewhere.

For readers of the Journal of Economic Psychology the book is of great interest in drawing heavily on psychological explanations of the behaviour of stock market investors and of the social interactions among them. Shiller claims that these provide a better explanation of the observed performance of stock markets than the conventional “efficient market” model used by economists, and that attempts to use the latter to account for the recent events in the US and similar episodes are inherently flawed. (Perhaps the most interesting attempt to argue that there is nothing basically “irrational” about at least some famous historical examples of apparent overpricing is Peter Garber’s work on tulipmania and other early “bubbles”, now published in book form as Famous First Bubbles (MIT Press, 2000). Shiller has a somewhat half-hearted critique of Garber.)

What sets Shiller’s book apart from many superficially similar psychologically-based accounts of the stock market is that he is a leading expert on the serious economics of financial markets. He properly understands that: first, many of the easy dismissals of the economists’ model misinterpret the model and underplay its strengths; and, second, that taking popular models of behaviour as having real explanatory force does not mean that we have therefore to adopt a “pop” view of the market. Further, he has over the years assembled a large amount of original questionnaire data on the views and activities of investors on which to draw.
With Thaler and a few others, Shiller was one of the pioneers of “behavioural finance” as well as of more conventional statistical testing for “excess volatility” of share prices. (Excess volatility is observed if share prices fluctuate by more than would be predicted from the “fundamentals” of discounted expected dividends.) Clearly if excess volatility is observed, then this creates a space for more behavioural explanations of the activities of financial market participants to come into play quite apart from any inherent plausibility that such explanations may or may not have. The present book provides a highly accessible introduction to these arguments. (A more technical development of a similar argument is provided in Andre Shleifer’s recent Clarendon Lectures on Inefficient Markets (Oxford University Press, 2000) which usefully complement Shiller’s account.)

Shiller argues that the recent US bull market is a naturally occurring “Ponzi” process. In the strict sense, these schemes (named after a 1920s Boston fraudster) are pyramid selling scams that rely on inducing successive waves of investors to part with their cash on the basis of some plausible but obscure profit opportunity, and using the cash of later waves to pay off the earlier ones. Obviously, the waves have to be of ever increasing size to avoid the scheme’s collapse. A naturally occurring Ponzi process does not involve deliberate fraud but simply the circulation of information that encourages investors to continue to believe in the plausibility of ever-rising share prices. And, of course, as long as the bubble grows the doubters are discredited: the believers are justified by their financial success. As Paul Krugman put it in a New York Times review of Shiller (March 12, 2000): “in effect, you get a Ponzi scheme without a Ponzi, a scam without a scammer”.

Thus we need to identify, first, the arguments which are used to justify unusual profit opportunities and hence trigger the process; second, the feedback mechanisms that propagate and reinforce belief in these opportunities among investors; and, finally, the reasons why investors fail to anchor their beliefs to the true state of market fundamentals but instead use other subjective anchors. The substance of Shiller’s book is to develop, in turn, these features of market participant’s behaviour, outlining the relevant theory and the supporting evidence.

The most widely discussed trigger is, of course, the advent of internet technology, but there are others, such as the weakening of labour’s bargaining position. Often these are rolled up into a whole golden age package of accelerating productivity growth with low inflation. There are two large uncertainties here: whether the golden age is really upon us and whether it has the supposed benefits for long-run profitability that are often assumed.
Whatever, it has the required plausibility. Reinforcing feedback may occur because past gains generate expectations of further gains or because past successes generally increase confidence or for emotional reasons, such as the belief that investing past gains is not really risking one’s own financial resources. Anchors may be quantitative or moral: the former enables individuals to judge whether the level of the market is appropriate (which may well depend on what information happens to be readily available, such as the most recent level), and the latter provides reasons for investing rather than not, often through confidence-building storytelling. Shiller shows in detail how all these effects, and others, are at work, interactively, in forming the decisions of market participants.

The book concludes with some important policy observations. Contrary to some proposals, notably the well-known “Tobin tax”, that aim to stabilize markets by inhibiting transactions, Shiller (building on his earlier work) argues for expanding the menu of tradeable instruments so as to enable proper diversification of risks.

Though Shiller’s book is very much a tract for the times, it is also a sustained and serious attempt to show the coherence and relevance of behavioural insights into the workings of financial markets. Only recently heretical, this is fast becoming almost a new orthodoxy and is being built into professional advice as well as into academic discourse. But, of course, there is nothing new under the sun: much of this would have been familiar long ago to economists such as Keynes and Shackle.

Adrian Winnett
Centre for Economic Psychology
University of Bath
Bath BA2 7AY UK
E-mail address: a.b.winnett@bath.ac.uk