Financial, economic actions during crisis may be rational, if not ethical

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Wild stock market gyrations and runs on toilet paper as well as other home goods might seem like acts spurred by financial and economic fear and panic. But Paolo Pasquariello sees such reactions as rational—if not always ethical—in a time of a global pandemic, which affords economists and policymakers the opportunity to develop problem-solving approaches. Pasquariello, a finance professor at the Ross School of Business, shares his experiences and lessons learned from past crises.

How do you view the roles of fear and panic in the economy as we deal with coronavirus?

I remember the date of July 2, 1997, because that was the date when the Asian financial crisis officially began. Now, nobody remembers that crisis these days in light of everything that is going on, but that was actually the very first crisis of the global economy. That was the day that the Thai baht, the currency of Thailand, became much weaker relative to the dollar. That was the ignition of that particular episode of turmoil. I was sitting on a trading floor and the emerging currency trading floor desk was many feet away from me. I remember seeing from a distance some noise and people getting agitated. Within an hour, the entire floor, thousands of people, were screaming at each other, screaming at their phones, screaming at their screens.

I remember being scared to some extent but also curious why this was happening in front of my eyes. Why were people so agitated, so panicky? Why did something that began in such a far away part of the world, like Thailand, with no implications whatsoever for the U.S. or European economies, within an hour was enveloping pretty much the entire trading floor of that particular investment bank? It is on this day that I decided I wanted to understand more about this phenomenon.

I'm going to push a little bit back on the use of the words "fear and panic." These are words we routinely use with each other because we all understand them. I think they presume that the behavior of people is driven by irrationality. When you say someone is fearful, it means that their behavior is driven by their emotions. When you say somebody is panicking, you are inferring that people are not being rational. They wouldn't be making those decisions if they could think straight.

The goal of my research over the last 20 years was to analyze these episodes to try to understand whether these crises can be explained by fear and panic or by rational behavior. I tend to lean on rational behavior. It's an approach we typically use in economics to explain the phenomenon we observe. Second, because if I can explain people's behavior with rationality, I can try to fix the problem. I can try to prevent the behavior from happening again in the future. If behavior is driven by fear and panic it's going to happen over and over again and there is nothing I can do about it.

So you don't see the run on toilet paper caused by fear or panic?

Something that seems irrational and even immoral can be explained by rationality. I like to think about what's happening with toilet paper in the context of bank runs. Banks suffer from the same risk that stores have been experiencing these days with toilet paper. Why do banks run out of money? Banks use our deposits to lend money to companies or to consumers for mortgages for instance. We deposit our money with the presumption that we can get it back at any time. We give the bank a short-term loan. The loans made by the bank are long-term. This means that at any point in time banks keep in their drawers only a fraction of all the money that people like you and me have deposited. If all of us today decide to go to all the banks and ask for all of our money back, the money is not there. The money is simply not there and the banking system will collapse. Banks are intrinsically fragile for that reason and they are exposed to bank runs.

If I see you running down the street and I wave at you and say, "Where are you going?" And you say, "I have no time to talk to you. I am running to the bank to get my money out." What is my rational response—to wave goodbye at you and go home and think that you are crazy and I am sane, or to run faster than you so I can get to the bank before you and I can get the money out before you get it? Because there isn't enough money for both of us.

Toilet paper is experiencing the same type of run. Supermarkets do not keep enough toilet paper for 300 million people. First of all, 300 million people are not going to demand all the toilet paper they need at the same time. Secondly, it takes up a lot of space. And it takes space away from things that are perishable. And the profit margins on toilet paper aren't very large. So they just keep enough on the shelves for a few days.

During a period of crisis when people think that we might have to be at home for days or weeks at a time without being able to go out, well, you need toilet paper so you start going to the store to buy it. If I hear from my friends that they are buying it, I have to buy it myself because the store will run out. I have seen in the media and on social media people complaining that others are behaving unethically. Ethics and morality have nothing to do with it. If you know that people are going to the store to get toilet paper, you have to go to the store to get toilet paper.

With bank runs, we know how to fix that: We have deposit insurance. Every government insures the deposits that you have in the bank up to a certain amount. There is no toilet paper insurance. If I don't make it to the store, the government is not going to send it to me. Perhaps a solution is that stores in light of the latest epidemic should keep a strategic reserve for these items. Perhaps you need leadership that gives enough confidence to people that the supply chain is not going to be disrupted so that toilet paper is going to be continuously supplied to stores.

We hear talk of rational markets, or at least markets that correct and respond to disasters and calamities. In the case of COVID-19, we've seen multiple halts to

stock trading, and repeated, record plunges on Wall Street. Is there a difference here because the circumstances of a pandemic are different than we typically see?

While we hope that most people behave rationally in normal times and in times of distress, we also acknowledge that markets occasionally fail. We call them frictions, impediments that do not allow markets to function as they typically do. In response to these frictions, financial markets might behave in ways that to an outside observer might look crazy or difficult to explain. So there are several frictions that over the last several decades, many of us financial economists have been thinking about as explaining the type of events that we've been overving over the past several days.

The biggest friction I can think of is the absence of liquidity. Think of liquidity as blood is to your body. In the absence of blood, your body can't work. Liquidity is what keeps the market functioning: the ability of companies to borrow money, lenders to transfer their available funds to safe borrowers, entrepreneurs and innovators to take risks and governments to fund their budget deficits, which are becoming increasingly larger as they respond to the economic consequences of the crisis.

Liquidity is drying up right now because during times of distress, rationally, people look for safety. Safety right now is found in such things as cash and treasury securities. Because people and corporations are hoarding cash and treasury securities and buying gold, these assets are becoming scarce. If a company, even a very reliable, trustworthy, successful company, needs to borrow right now to fund its short-term operations it won't be able to. People start getting concerned, they sell the stock of the company and the stock drops. Soon, we are looking at the decline in stock prices of 8%, at which point circuit breakers kick in, allowing people to take a breather look at fundamentals and resume trading later.

I see definite similarities with the financial crisis of 2007-08, in the sense that the sudden collapse of (U.S. investment bank) Lehman Brothers created a funding and liquidity crisis. Basically the blood dried out of the U.S. economic body. I see this happening again for completely different reasons.

What else is important to understand about the implications of actions, fearful or not, in the economy and financial markets? What lessons have we learned so far to manage or mitigate their effects?

Of course, during the spread of the coronavirus crisis, all want to be good and ethical people. On the other hand, I'm not sure using the lever of morality or ethics is appropriate when evaluating the functions of an entire financial system. For example, this is something we've been experiencing in Europe for the past several years, as countries like Greece, Portugal and, to a lesser extent, Spain, Ireland and Italy suffered various forms of financial distress. The response of some policymakers has been that we need to help these countries be solvent. The other argument is the moral argument: If you cannot afford to pay your debts, you are a bad person. It's rooted in cultural, not just economic grounds.

In economics, we relate to something we call "moral hazard." That is when I feel that you make a mistake and the mistake will be fixed, you will continue to make mistakes. An example of the moral argument might be that I need Greece to default because if they do, they will never default again. That argument, fortunately, has been defeated in Europe. It also ignores the fact that defaulting on your debt is a legal option, not a crime.

I'm very wary of people applying notions of ethics and morality to what's going on right now. I really hope that going forward, policymakers and politicians will try to steer people to doing the right thing by virtue of incentives rather than by appealing to our morality. My morality and yours might be different. In economics, we've been thinking about how to incentivize people to do the right thing. Can we give an incentive for you to do the thing that collectively is going to benefit the entire system?

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