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Psychological Drivers of Financial Instability: A Review of the Literature

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ABSTRACT

Greed and fear are powerful psychological phenomena that play a huge role in financial decision-making and the behavior of economic institutions. This review closely examines how these drivers contributed to instability during the 2008 financial crisis, with greed pushing for short-term gains and fear fueling widespread panic. By analyzing 25 studies from Psychology and Economics, this review dives into how weak governance and poor regulations let these emotions get out of control, leading to risky decisions and market chaos. Greed can motivate ambition and growth, but without ethical oversight, it causes major trust issues and reckless behavior. On the other hand, fear often leads to hasty sell-offs that destabilize the market even more. The research shows that strong governance and balanced regulations are crucial to managing these forces, focusing on long-term stability instead of short-term wins. This review breaks down the relationship between greed, fear, and financial instability, while pointing out areas that need more research. Moving forward, better governance and smarter regulations are critical for handling these psychological drivers and protecting the stability of financial systems.

Introduction

Greed is defined as an unending desire to acquire more concerning wealth, possessions, or power (Zeelenberg, 2022). Economists have found that greed plays a significant role in the functioning of economic institutions (Kirchgässner, 2014; Juurikkala, 2008; Malhtora, 2012). These institutions, which include banks, investment funds, and government organizations, manage the economic distribution of money, goods, and services. The decisions within such institutions are driven by profit motives, risk assessments, legal compliance, and market conditions, but also by psychological phenomena like fear and greed. This literature review explores the psychological drivers of financial instability and how corporate governance and legal frameworks seek to manage it. By analyzing 25 studies in the fields of Psychology and Economics, this review provides insights into how greed shapes economic behavior and points to areas where further research is necessary.

The Role of Fear in Financial Decision-Making

Several studies have examined the psychological factors driving greed within economic institutions (Nikelly, 2006; Lambie, 2019). Bernanke et al. (2020) explain how fear significantly triggered panic during the 2008 financial crisis. Investors and creditors, in their rush to minimize exposure to mortgage-backed securities, caused market-wide instability, including loss of sales and margin calls. This reaction exposed the fragility of financial systems dependent on short-term borrowing and long-term lending. Bernanke et al. emphasize that fear and existing system-wide issues intensified the crisis and its economic impact.

Psychological research examines how emotions, particularly fear, influence financial decision-making, often leading to more cautious behaviors (Loewenstein, 2001; Lee & Andrade, 2011). In their study, Lee and Andrade (2011) showed that fear significantly impacts investors' tendency to sell assets prematurely in high-risk environments.

Their results reveal that fearful participants in a stock market simulation were more likely to take part in early sell-offs compared to those in a neutral emotional state. This behavior is explained as social projection, wherein fearful investors assume others share their fears, speeding up market sell-offs. The findings align with Bernanke et al.'s (2020) analysis of the 2008 financial crisis, where widespread fear led to rapid asset liquidations and market instability. These studies highlight the critical connection between psychological factors like fear and economic behaviors, highlighting how emotions can destabilize financial systems.

The Role of Greed in Decision-Making

Economists have found that greed can be associated with ambition and economic drive (Seuntjens, 2015; Seuntjens, 2015; Wang, 2011). In their empirical study of the effect of greed on job performance, Zhu et al. (2019) found that greed acted as a double-edged sword, enhancing both job task and contextual performance through employee motivation for increased social status but inhibiting both task and contextual performance through perceived distributive injustice (employees questioned whether tangible or intangible rewards and benefits were distributed relatively). Other researchers support the claim that greed can harm outcomes without regulation and ethical boundaries (Bagga, 2015; Balot, 2001). Kirchgässner et al. (2014) paper finds that greed is not inherently harmful but becomes dangerous when uncontrolled. Their research shows that unchecked greed leads to riskier behaviors, especially in the financial sector, where immediate profits overshadow long-term planning. In their analysis of the 2008 financial crisis, the researchers point to speculative investments, driven by short-term gains, as a critical factor contributing to the collapse of several major financial institutions.

This perspective aligns with the research conducted by Oskari Juurikkala of The Acton Institute (2008), who examines the ethical implications of greed in economic decision-making. Juurikkala asserts that when profit is prioritized without regard for ethics, financial institutions contribute to a loss of trust within the markets. This behavior, driven by greed, creates major risks that hurt the stability of institutions and markets alike.

The 2008 Financial Crisis

The economic literature often points to the 2008 financial crisis as a prime example of how unchecked greed can destabilize entire economies (Knowledge at (Wharton Staff, 2009; Arner, 2009; Trickey, 2017). MIT Sloan Economist Cate Reavis's (2008) study highlights how the structure of incentives for executives, particularly performance-based incentives like bonuses for short-term financial gains, played a critical role in promoting greed-driven behavior. These incentive plans encouraged executives to invest in risky ventures like mortgage-backed securities (MBS). Fueled by the desire for quick profits, these investments contributed significantly to major financial institutions' collapse and the subsequent global financial meltdown.

Additionally, the study also emphasizes that legal failures contributed to the crisis. The lack of sufficient oversight laws allowed these greed-driven activities to flourish, ultimately destabilizing the financial markets. The Acton Institute (2008) supports this view, arguing that the financial crisis was not only a result of policy shortcomings but also a moral failure. According to Juurikkala, greed led financial institutions to abandon ethics, focusing exclusively on maximizing profits at the expense of market stability.

Greed and Corporate Governance

Corporate governance is defined as the system of rules, practices, and processes that guide a company's direction and control (Chen, 2024). This plays a crucial role in managing the influence of greed within economic institutions (Erkens, 2012; Rehman & Hamdan, 2023). Harvard Economist Deepak Malhotra (2012) emphasizes how weak governance systems fail to mitigate the risks of greed-driven decision-making. Their research points out that performance-based compensation models, which reward short-term financial performance, incentivize executives to prioritize immediate profits without carefully considering long-term risks. As a result, these failures allow greed to dominate decision-making, ultimately destabilizing individual firms and the overall economy.

However, Malhotra's study also highlights companies that successfully align executive compensation with long-term value creation (Malhotra, 2022). These firms balance profit motives with ethical responsibility by focusing on sustainable growth over immediate financial returns. Kirchgässner et al. (2014) support this view, arguing that solid governance frameworks are essential for balancing the pursuit of profit with the need for ethical oversight.

Regulatory Responses to Greed in Economic Institutions

Many economists have found that regulation is critical in managing greed within financial institutions (Li, 2021; Hopt, 2021; Allen, 2018). In his case study of the 2008 financial crisis, Reavis (2008) discusses how the deregulation of the financial sector, notably repealing the Glass-Steagall Act in 1999, allowed commercial banks to engage in riskier investment activities. By blurring the lines between traditional banking and high-risk trading, deregulation enabled greed-driven behavior to destabilize the global financial system.

Reavis (2008) suggests that legal frameworks must be strong enough to curb the overreach of greed within financial institutions. Financial markets become vulnerable to speculative behavior that prioritizes short-term profits over long-term stability without proper oversight. The Acton Institute (2008) supports this view, calling for more robust legal measures to prevent future greed-driven crises. They argue that effective regulation alone is insufficient to manage greed and emphasize the need for moral accountability alongside legal frameworks.

Kirchgässner et al. (2014) advocate for a balanced approach to regulation. While acknowledging the need for oversight to prevent the negative effects of greed, they caution against overly restrictive policies that could slow down innovation and economic growth. Instead, they suggest that regulation should promote transparency and accountability rather than imposing blanket restrictions on financial activities.

Conclusion

The literature on greed in economic institutions reveals a complex interplay between profitability, ethics, and regulation. Research in Psychology and Economics finds that fear and greed contribute to decision-making that disregards long-term consequences, often leading to high-risk behaviors that threaten financial stability (Lo, 2002; Plassmann, 2024). Kirchgässner et al. (2014) provide a nuanced perspective, arguing that greed can drive economic growth when balanced with ethical oversight and robust governance structures. However, the destructive potential of unchecked greed, as demonstrated by studies from MIT Sloan Economist Cate Reavis (2008) and The Acton Institute (2008), is evident in the 2008 financial crisis. These studies emphasize the need for strong legal frameworks and ethical governance to mitigate the risks posed by greed. Moving forward, further research should explore how legal frameworks and governance structures can be strengthened better to manage the influence of greed within economic institutions while accounting for the psychological factors that drive these behaviors.

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I would like to thank ABC college for enim ad minima veniam, quis nostrum exercitationem ullam corporis suscipit laboriosam, nisi ut aliquid ex ea commodi consequatur? Quis autem vel eum iure reprehenderit qui in ea voluptate velit esse quam nihil molestiae consequatur, vel illum qui dolorem eum fugiat quo voluptas nulla pariatur.

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