Fear trumps greed as Wall Street worries paralyze world economy

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Greed and fear are the emotions that rule Wall Street. Fear has been winning.

Investors are in the grip of a panic that psychologists and historians say isn't necessarily rational and may intensify. They aren't buying stocks, and more importantly, suddenly afraid they won't be repaid, they aren't making loans by buying bonds. Banks have also tightened credit.

"People are driven by images of the best and worst that can happen," says George Loewenstein, a professor of psychology and economics at Carnegie Mellon University in Pittsburgh. "The image of the worst is much more vivid in their minds right now."

The fear that has frozen credit markets means Eileen Logan can't sell her Chicago-area condominium. In Los Angeles, Ron Schwartz can't replace his wife's old car. In Seattle, Lisa LeVere is buying only the bare necessities. Consumer spending is two-thirds of gross domestic product. If Americans close their wallets, recession - or worse - is all but certain.

To limit the damage, the Federal Reserve lowered its benchmark interest rate today, in concert with central banks in Europe, England, Canada, Sweden, Switzerland, and China. Stocks in the U.S. and Europe fell anyway. Fear that an economic contraction will mangle corporate earnings has driven the Dow Jones Industrial Average down 30 percent so far this year. The S&P 500 index is off 33 percent.

'Spontaneous urge'

The widespread fear of losses has taken John Maynard Keynes's so-called animal spirits, "a spontaneous urge to action rather than inaction," out of the markets.

"Everyone is worried about getting paid," says William Silber, a New York University economist and author of "When Washington Shut Down Wall Street: The Great Financial Crisis of 1914." While that's a rational feeling for an individual, panics happen when everyone tries to act on their fears at once. "No one wants to be the last one in line," Silber says.

Normally, a little fear is a good thing, economists say. For decades after the 1930s, memories of the Great Depression tempered optimism and kept asset bubbles from growing too large.

Today's fears, however, have reached an intensity that magnifies every additional piece of information and creates a vicious circle, according to Hersh Shefrin, professor of behavioral finance at Santa Clara University in California.

Wall Street's so-called fear index, the VIX, measures the cost of using options as insurance against stock-market losses. It reached an intraday record of 59.06 today.

Questionable prospects

The failure of Bear Stearns in March led investors to question the prospects for Lehman Brothers and other investment banks. Concern about the financial holdings of Fannie Mae and Freddie Mac led to a government takeover of the mortgage lenders in September.

That led to fear about the viability of insurance giant American International Group, which in essence had written insurance policies on investors' holdings. Then the U.S. House of Representatives initially rejected Treasury Secretary Henry Paulson's $700 billion plan to rescue troubled financial institutions.

"When we are panicked we misread signals, we misread mild threats as catastrophic threats and we become unduly conservative," says Shefrin, author of a 2000 paper "Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing."

Fell off a cliff

That's one reason why, even as the Fed made $1 trillion available to banks, lending fell off a cliff. Borrowing by U.S. consumers unexpectedly declined by $7.9 billion in August, the first drop in more than a decade.

"There's a lot of fear out there and there's a lot of worry," says C.R. "Rusty" Cloutier, president and chief executive officer of MidSouth Bancorp Inc. in Lafayette, Louisiana. "There's no question we're being more careful" in making loans.

The cost of issuing commercial paper, or short-term business loans, reached the highest level in eight months this week, squeezing companies, banks and public institutions that rely on the market to raise cash for expenses such as payroll. Combined with the pullback in bank lending, the commercial- paper freeze threatens to choke the economy.

That forced the Fed Tuesday to announce for the first time it would make loans to private companies, accepting commercial paper as collateral. Even this won't bring a quick end to the crisis, says 94-year-old Seth Glickenhaus, who was a messenger at Salomon Brothers when the stock market crashed on Black Tuesday in 1929. Today he manages $1.8 billion as chief investment officer of Glickenhaus & Co. in New York.

'Constructive things'

"There is a business cycle," he says. "The mere fact the government does constructive things doesn't make it go away."

Charles Geisst, a finance professor at Manhattan College in Riverdale, New York, sees a parallel to 1932, with credit markets bad and the stock market falling just ahead of the presidential election that put Franklin D. Roosevelt in the White House.

"But I'm not sure anyone is FDR this time," says Geisst, author of Wall Street: a History, who puts the possibility of another Great Depression at 50 percent. "I don't think either candidate has a clue what they're dealing with here. This is more than a political problem that's going to blow over."

Crippling uncertainty

When experts and authority figures are uncertain, it's especially crippling, says Paul Slovic, a professor of psychology at the University of Oregon in Eugene and founder of Decision Research, which investigates decision making and risk. "It makes people feel vulnerable and leads to greater anxiety," he says.

Within days of his inauguration, Roosevelt declared a bank holiday and held the first of his "fireside chat" radio addresses to try to reassure Americans. In the days after Lehman and AIG melted down last month, President Bush was nearly silent, uttering a total of 160 words about the worst financial crisis since Roosevelt's time.

Another large component of fear is ambiguity, psychologists say. Investors simply don't know what is going on, making them even more anxious. Faced with an unfamiliar situation, humans, like other animals, retreat into "fight or flight" mode, Shefrin says.

That's what investment adviser Stefan Greenberg is hearing from clients who wonder if their money-manager firms are still solvent and whether they should sell their holdings, moving 100 percent into cash.

"We hear a lot of emotion, we hear a lot of fear" says Greenberg, a managing director at Lenox Advisors in New York, which counsels high net-worth individuals. Greenberg is urging clients not to liquidate their portfolios.

"Of course there's panic," he says. "The next few months will take a strong stomach