Free market madness and human nature

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Abstract

Purpose – This paper aims to discuss the crises of free market capitalism in terms of its understanding of human nature. It reveals how recent market madness can be attributed to certain elements of human nature.

Design/methodology/approach – The paper uses a conceptual and philosophical approach to analyze crises of free market capitalism. It links both success and failure of capitalism to its understanding of human nature. It compares and contrasts economic assumptions of human nature in conventional and Islamic economics. It attempts to explain the 2008 financial crisis through a comprehensive theory of human nature.

Findings – It sheds some light on the irrational aspect of human nature as the driving factor behind the 2008 financial crisis. It elaborates on the importance of knowing self for knowing human decisions in free market economy. It concludes with the need for a comprehensive theory of human nature to predict and prevent irrational and irresponsible behaviors of populist politicians, greedy capitalists and conspicuous consumers. The paper also reflects on the 2013 Nobel Prize in economics as a victory for the study of human nature.

Originality/value – The paper offers a new perspective to understand crises of free market capitalism.

Keywords Moral economy, Financial crisis, Animal spirit, Capitalism, Free market, Human nature

Paper type Research paper

Introduction

The free market system has been on the rise since first elegantly articulated by Adam Smith in his masterpiece, *The Wealth of Nations*, 1776[1][2]. Particularly, with the fall of The Union of Soviet Socialist Republics and East European regimes, the free market system proved its superiority to its main rival. Even the Maoist regime in China envied and, ultimately, embraced the free market principles. Therefore, it was not a surprise to hear from Fukuyama (1992) declaring the end of history as a triumph of capitalism, and liberal democracy flourished within the free market system. According to Fukuyama, mankind's historical search had been concluded with the finding of the optimum system. Ironically, two decades after the declaration of the victory for free market capitalism, *The Economist* ran a cover story, "Capitalism is at Bay", in October 2008, asking for help to save capitalism. In its editorial, the voice of capitalism, for over 165 years, uttered concern that "economic liberty is under attack and capitalism, the system which embodies it, is at bay". It was crying for help: "Capitalism is at bay, but those who believe in it must fight for it. For all its flaws, it is the best economic system man has invented yet" (*The Economist*, 2008).

Indeed, the 2008 financial crisis was threatening both the capitalist system and the well-being of humanity. It touched almost every nation around the world. People had watched with awe and shock and asked the following questions: is this going to be the end

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for capitalism? Or is it just another great depression? Was Karl Marx right in his view of capitalism? Is capitalism preparing its own end? Why does capitalism face such crises? More importantly, why did economists fail to predict, let alone prevent, the crisis? I will try to answer those questions in this paper. After summarizing the recent "free market madness", as suggested by Peter Ubel[3] and new Nobel Laureate Shiller (2008), I will first shed some light on the irrational aspect of human nature as a driving factor behind the 2008 financial crisis. Then, I will deliberate on the strong tie between human nature and nature of free market economy. Within this context, I will discuss the success and failure of capitalism in terms of its assumptions about human nature. I will also highlight the importance of knowing self for knowing human decisions in free market economy. I will conclude with the need for a comprehensive theory of human nature to properly deal with the irrational aspects of human nature which ignites financial and economic crises (Aydin, 2012).

The road to the "free market madness"

Despite their complex forecasting instruments, economists almost completely failed to foresee the crisis and the madness of free market actors. In Krugman's (2009) terms, this was because of "the profession's blindness" to certain elements of human nature.

> They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets – especially financial markets […].

Indeed, overconfident economists were instrumental in inflating the bubble. They were busy with building more complex models to help greedy capitalists in achieving profit maximization through toxic assets. They were firm believers of the free market system. Many economists were not able to see the coming financial tsunami. Indeed, some like Eugene Fama[4], the intellectual father of the efficient market theory, vehemently rejected the idea of housing bubble just a year before the crisis. In an interview, he stated that "the word "bubble" drives me nuts", and he added that:

> Housing markets are less liquid, but people are very careful when they buy houses. It's typically the biggest investment they're going to make, so they look around very carefully and they compare prices. The bidding process is very detailed (Clement, 2007).

While Fama was rejecting bubble in the housing market, Robert Shiller, who was a pioneer in behavioral finance, was not only identifying the bubble but also predicting its burst. Indeed, he was famously known as "Mr Bubble" among his colleagues. Shiller disagrees with Fama that capital markets work efficiently. In an interview, after being awarded Nobel Prize with Fama, he spells out his difference as follows:

> The capital asset pricing model is a view of how to form an optimal portfolio. That is an interesting model. People who do portfolios ought to study mean variance model as a first approximation to what they should be doing in terms of portfolio management. But they took a next step, which is saying that everybody already does that. That's where I start to part company. They assume people are already doing that. That can't be right, because nobody understood it when the model was first developed. There's an element of absurdity that they refuse to acknowledge. They fell in love with the model too much (Arvin, 2013).

In his book, *Irrational Exuberance* published in 2000, Shiller rightly foresaw asset price bubbles in making. He presented non-economic and irrational factors that create price bubbles. He was proven to be right when the bubble burst in 2008. Populist politicians, greedy capitalist entrepreneurs and conspicuous consumers prepared the perfect storm conditions for the 2008 financial crisis. Many causes can be mentioned for this crisis. As forcefully argued by Shiller, the root cause of the housing bubble might be the animal spirit with a greedy and selfish nature. Populist politicians driven by the greed for votes deregulated the financial market in the 1990s to maximize their votes. Capitalist creditors driven by the greed for profit issued mortgages to risky consumers and later repacked and sold them in derivative market. Conspicuous consumers driven by the greed for higher utility engaged in lavish consumption through bank credits without thinking about their ability to pay off their bubbling debts. The free market madness was at its peak, particularly at the housing market.

The Federal Reserve Bank became the guarantor for two giant mortgage companies, Fannie Mae and Freddie Mac. Furthermore, it made cheap credits available to consumers through its low interest rate policy. Relying on the support from the Federal Reserve Bank and loose regulations, greedy entrepreneurs opened credits to risky consumers to maximize their profits in the short term. In one way, they were acting quite rationally under loose regulations by inventing new instruments to make money out of money. They came up with innovative derivative assets to realize their dream. In the subprime market, mortgage originators passed their entire risks to the ultimate creditors around the world. Therefore, they had less incentive to be cautious in their lending decisions. The hidden hand of free market was promoting, rather than preventing, the bubble in the housing market. Creditors invented various kinds of derivatives to accomplish risk-free lending. The mortgages issued through the guarantor of Fannie Mae and Freddie Mac alone reached over $6 trillion (Desmond, 2009). Mortgage originators did not worry about the repayment risk because they had the ability to disguise bad assets and sell them off to investors around the world under the blessing of credit rating agencies. They were not even bothered to verify the borrower's income with internal revenue service (IRS). They turned mortgage market into a money-making gamble. They gave bonuses to their employees for issuing mortgages to almost anyone. Employees followed through because this was the way for them to maximize their income through additional premium from new mortgages. The derivative market skyrocketed within two decades: "From 1987 to 2007, the face value of over-the-counter derivatives rose from $866 billion to $455 trillion" (Foster and Magdoff, 2009). In short, the role of greedy creditors in the 2008 financial crisis is quite obvious. However, it is important to remember that they did what they were supposed to do. As capitalists, they are in the business to maximize their profits. They would do everything to realize their goals if not constrained by moral or legal obligations.

If creditors are shielded from risk sharing because of the lack of sufficient discipline in the financial market, they will engage in excessive lending to maximize their profit, at least for a short term. Particularly, this will be the case if it is possible for them to transfer their risks by repackaging and selling their liabilities to someone else. Likewise, they assume government protection because they think they are "too big to fail". Indeed, there is evidence showing that banks with such a safety net are taking greater risks than what they otherwise would (Mishkin and Symposium, 1997). This kind of safety will result in a "moral hazard" problem because it will give incentives to big creditors to participate in highly risky lending, as they would expect a government bailout. However, if creditors are not immune from the risks, they would be more cautious in their lending decisions.

Populist politicians and greedy creditors are not the only ones to be blamed for the 2008 financial crisis. Conspicuous consumers who engaged in lavish consumption to realize their "American dream" should be blamed too. Even consumers with very low credit ratings were given opportunities to realize their dreams of big and better homes. Home prices and home ownership had boomed from the late 1990s up to 2007. "The chains of events […] overly aggressive mortgage lenders, complaint appraisers, and complacent borrowers proliferated to feed the housing boom" (Shiller, 2008). Of course, if asked, these borrowers would claim complete innocence. They would argue that they acted as expected to maximize their utility. Perhaps, Greenspan would blame their greedy animal spirits for their irresponsible acts. In reality, they acted upon their self-interest to take advantage of a historical opportunity of having more fun with more credits. Many purchased houses without little or no down payment. If they already had one, they upgraded or refinanced to cash out money for more consumption and fun. They were racing to consume more. The jump in demand for housing pushed up prices. In just a few years, home values more than doubled in many parts of the USA. With increasing home values, people felt a hike in their wealth. They began to spend even more because of the "wealth effect".

Economists have to take a fair share too for the crisis. Indeed, most economists turned out to be wrong. The creative manipulations and speculations under the disguise of a free market resulted in a big crash. In Peter Ubel's terms, what was happening could be defined as "Free Market Madness". The madness lasted for several years in which everyone was quite happy. However, the happy period did not last long because excessive consumption was based on the bubble in asset prices and not on the growth of the real economy. It was not sustainable. It had to fail.

The increasing cost of wars and high oil prices resulted in a slowdown in the US economy and burst the housing market balloon. The economy got worse every day. Unemployment reached a record level. Many homeowners, particularly those who received mortgages based on adjustable interest rate, failed to pay back their loans. The "American dream" for many consumers and capitalists turned into an "American nightmare". The homeowners who did not make any down payment when they purchased their house did not have anything to lose other than their keys which they returned to their banks. Foreclosure rates hit a new record every month, and property values dropped considerably. Banks which were mostly responsible for creating the housing bubble suddenly found themselves under the remnants of a housing market tower. They became the victim of their short-term desires for profit. They built the housing price tower on unstable grounds. Therefore, with the collapse of the tower, their valuable assets (mortgage notes) suddenly turned to useless papers. Century-old companies like Lehman Brothers and Merrill Lynch fell one by one. The storm in the credit market quickly turned to a tsunami at a global level. Everyone began to doubt about the fate of capitalism.

Unlike some critics of capitalism, I did not think that the 2008 financial crisis would be the end of it. If we compare the capitalist system to a human body, money is like blood and banks are like blood vessels. The 2008 crisis was not a complete paralysis; rather, it was a loss of blood. Of course, any losses would slowdown the growth of the body. However, it is not going to kill the body if new blood is supplied. Likewise, the 2008 crisis slowed the economic growth around the world; however, it did not kill the system because key players had supplied blood to the system and taken measures to prevent the bleeding.

The financial crisis in the USA had global ramifications because of globalization of the economy and the way US mortgage assets were funded. Relying on the assurance from the Federal Reserve, US banks repackaged most of their mortgage assets and sold them to investors around the world. With the collapse of the US market, these international investors lost trillions of dollars. For instance, according to the head of the General Union of Arab Chambers of Commerce, Industry and Agriculture, Arab Investors alone lost $2.4 trillion because of the crisis (Gulfnews, 2009).

Indeed, developing countries have paid an even higher price for the crisis. In other words, the financial tsunami has affected them disproportionately. Although the US Government was able to find trillions of dollars at low interest rate to finance its unprecedented spending packages, developing countries could not even get credits in the international financial market to fund their basic projects. Those who had money were afraid to lend to developing countries during the crisis and preferred to give it to a developed country like the USA because they wanted to make sure they will get their money back. Even though the USA ignited the global tsunami, it began recovering earlier than other countries. Indeed, according to *The Institute of International Finance*, although developing countries received almost $1 trillion credit in 2007, they were able to get only $466 billion in 2008. The amount was estimated to be around $296 billion in 2009 (IFF, the Institute of International Finance, 2010).

In short, unlike the argument made by some discontents of capitalism, the 2008 "credit tsunami" has not become the end of capitalism. It has made the whole world pay for the mistakes of greedy capitalist entrepreneurs and consumers. As Foster and Magdoff (2009) state:

> […] the tragedy of the USA economy is not one of excess consumption but of the ruthless pursuit of wealth by a few at the cost of population as a whole.

Following Keynesian policies, developed countries are finally overcoming this crisis, although it took much longer than a recovery from an ordinary recession. They have regulated financial markets to a certain degree to prevent a similar "madness", at least in the short run. They are doing so to protect players in a free market from their irrational decisions. However, they are likely to experience many more crises if they do not make fundamental revision in the system based on comprehensive understanding of human nature.

Human nature versus the nature of free market economy

The 2013 Nobel Prize in economics is a victory for study of human nature. It is praise for heterodox economics. It is an acknowledgment of the strong tie between human nature and the nature of market economy. Even though three winners often disagree about how the real world works, they agree that the understanding of human behaviors under financial stress is the key to know the financial market. They pay great attention to human nature. Indeed, as Hume (2000) writes in the introduction to *A Treatise of Human Nature*:

> […] all the sciences have a relation, more or less, to human nature […]. Even Mathematics, Natural Philosophy and Natural Religion are in some measure dependent on the science of Man because they lie under the cognizance of men and are judged by their powers and faculties.

Indeed, human nature plays a central role in most scientific fields, particularly in social science. The 2013 Nobel Prize is a confirmation that understanding human nature is a key to understand financial and economic decisions in free market economy as well.

Despite the agreement on the importance of human nature, there has been major disagreement on the nature of human nature. For many centuries, the major theories of human nature have come from Judeo-Christian tradition which argues that humans are made in the image of God with certain spiritual faculties in addition to mind. From this perspective, even though humans have a tendency to commit sins, they are capable of repenting for their sins, respond to the God's message, choose good and love God and His creations (Miller and Delaney, 2005). The secular theories of human nature are quite different. For instance, John Locke uses the metaphor of "tabula rassa", describing the human nature as a "scraped tablet" which can be shaped by individuals and society. While some thinkers like Rousseau claim that humans are inherently good (Noble Savage) and learn how to be bad in social life, others like Hobbes argue that humans are inherently brutal, nasty and should be civilized through establishing a civil society.

Both secular and religious theories of human nature aim to understand the common universal elements shared by humanity. It does not matter whether human nature is shaped by God, nature or nurtured by society. It is the fact that we all have similar biological needs like food, water, oxygen, etc. Although the types of food may vary from culture to culture, the need for food is common across all cultures. Similarly, we all experience sensual, emotional, intellectual and spiritual needs because of the universality of our nature. Although methods to satisfy these needs vary among cultures, existence of the needs is shared by all human beings. For instance, every human being has the capacity to love and the desire to be loved. It is only the objects of love and values surrounding the concept that differ across cultures. The understanding of the common elements of human nature is the foundation of any theory, model or system related to human behaviors.

Like any other economic system, the capitalist free market system relies on a certain understanding of human nature. Indeed, this understanding is a key to explain both the success and failure of capitalism. In my view, as the success of capitalism comes from its partial understanding of human nature, its failure comes from its partial misunderstanding or exploitation of human nature (Aydin, 2012). On the one hand, the system has been very successful in production and consumption by igniting certain elements of human nature. On the other hand, the system has failed to provide sustainable growth and subjective well-being because of ignoring or denying other elements of human nature (Aydin, 2010a, 2010b). As the secret of success for capitalism in production and consumption is hidden in its understanding of human nature, the secret of failure for socialism in the same arena is because of its misunderstanding of human nature. Capitalism, at least partially, understands and relies on three elements of human nature: ego, animal spirit and mind. Capitalism uses the market mechanism because of its compatibility with understanding human nature. Socialism denies the fact that human behaviors are driven by ego and animal spirits. Therefore, it wrongly expects people to act for the common interests. It assumes that cooperation, not competition, will create a better result for everybody. However, it fails to give an incentive better than self-interest to push people for cooperation and collaboration. Meanwhile, socialism relies on the minds of a few selected instead of the collective minds of the market.

Free market and capitalism

Capitalism and the market system are not the same thing. It is true that they are like twins. It might be hard to imagine capitalism without the market system with the exception of "state capitalism". However, it is possible to have a market system without capitalism. For instance, China's current economic system is defined as "market socialism", meaning that the socialist government uses a market mechanism for its socialist economic policies. The history of the market system goes far beyond that of capitalism. However, capitalism is credited with the free or competitive market system. Capitalism is much more than a free market system. It is an ideology that makes money (capital), the central purpose of life for individuals. In Marx's and Lederer (1958) terms:

> Money degrades all the gods of man – and turns them into commodities. Money is the universal self-established value of all things. It has, therefore, robbed the whole world – both the world of men and nature – of its specific value. Money is the estranged essence of man's work and man's existence, and this alien essence dominates him, and he worships it.

In this sense, the main goal of a capitalist is to accumulate/gain money. Such a person considers money as a God who could open any door. In Marxist terms, capitalism is an ideology, which has turned money into the God of the world. It is a secular ideology, which promises to build a paradise in this life, not in the next life as promised by many religions. Capitalism relies on the magical power of the free market mechanism to fulfill its promise of paradise.

According to Polanyi (1971, 1957), the free market system dehumanizes human beings by turning them and their natural environment into "fictitious commodities". The system alienates and separates human beings from both their surroundings and from their own powers that they exercise in their life activities. This commodification process turns human beings in society homo-economics. In other words, the free market system destroys the non-economic and social nature of man and turns him to an individual who acts on the basis of only two motives, the fear of starvation and the hope of profit.

Self-interest and the free market

Self-interest is the "invisible hand" behind the free market which is shaped by supply and demand. Indeed, Adam Smith first conceptualized the free market system based on his understanding of self-interest as a key component of human nature:

> Every man is, no doubt, by nature first and principally recommended to his own care; and as he is fitter to take care of himself than of any other person, it is fit and right that it should be so. Every man, therefore, is much more deeply interested in whatever immediately concerns himself, than in what concerns any other man (Smith, 1976a, pp. 82-83).

Smith argues that people involve in market exchange not because of caring for others but because of their own interests. In his terms, "it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest" (Smith, 1976a, pp. 26-27). Therefore, Smith concludes that to enhance wealth, every man should be "free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of [...] other(s)" (Smith, 1976b, p. 687). Even though the idea of free market based on self-interest is well-known among economists, the source of self-interest is somehow a mystery. It has become an article of faith among free market economists rather than a subject for inquiry.

As argued by Aydin (2012, 2011a, 2011b), the concept of self-interest is based on the two elements of human nature: animal soul and ego. "Self" is equivalent to "ego", while "interest" is equivalent to "animal soul". In other words, the driving force behind free market or supply and demand is ego and animal soul. The self does not refer to human self in a holistic manner which is supposed to include other elements of human nature. Likewise, self-interest might not be the interest of heart, mind and conscience. Smith assumes that we have a single, unified self. Therefore, he argues that if we let individuals to act in a manner to maximize their self-interest, everyone would be better off. Furthermore, he assumes that any desire that comes from animal soul and ego is worthy to be satisfied.

One can argue that the capitalist system relies on the self-interest-driven free market system to serve human ego and animal soul at the expense of other elements of human nature. The system has been very successful because people who are motivated to pursue their self-interest come up with a very good efficient production system through division of labor. As people consume more and more, they keep asking for even more because of the greedy nature of their animal soul (Akerlof and Shiller, 2009; Ariely, 2008). Meanwhile, the system gives incentives to consumers to make more money to meet more needs and desires.

On the other hand, socialism assumes that humans are essentially social beings; therefore, it gives priority to social interests over self-interests. It invites individuals to make sacrifices for the common good. However, it does not provide great moral values needed for such sacrifice. Rather, it destroys sacrificing values which are promoted by religions. In this regard, socialism failed because of its denial of self-interested human nature, whereas capitalism has succeeded because of its understanding of "self-interested" human nature. That is the reason why China has experienced phenomenal economic growth after learning from her mistake and using the market mechanism driven by self-interest.

Rationality and the free market

Free market capitalism assumes that individuals make rational decisions to maximize their interests. Prudent consumers would use their income in the best manner to maximize their utility. If they face different options, they would compare them based on utility per unit and choose the optimum combination to achieve maximum utility. Likewise, producers would choose the best option to maximize their profit. The revealed preferences in the market are assumed to be the product of rational decision by consumers and producers. Since the time of Adam Smith, David Ricardo and Alfred Marshall, the capitalist system has assumed that competition in the marketplace among economic participants is governed by their rational self-interest. Therefore, they are against government intervention with a few exceptions.

The rational choice theory suggests that our preferences are the outcome of our rational deliberations for maximizing our expected utility. It assumes that we weigh the expected benefits and costs of the choices we have and choose the one that brings the highest net expected benefit (utility). Subjective expected utility takes this assumption further and argues that consumer behaviors are a function of expected outcomes and their assigned values. The rational choice theory is widely used across many social science fields, including economics, in which cost–benefit analysis and utility maximization are nothing more than a quantitative form of the Rational Choice Model (Becker, 1978; Elster, 1986).

The mainstream economic theory of consumer preferences assumes that consumers rationally maximize their utility in the market, based on the available income, price of goods and their tastes (McConnell and Brue, 2008). The theory suggests that consumers are rational in their decisions. This is the same assumption embedded in the Rational Choice Model. The Rational Choice Model is also used to explain consumer preferences for non-marketed goods, such as time, gifts, appreciation, charity, etc.

Beginning with the works of Nobel Laureate Simon (1982), debates erupted among economists about whether people are actually rational in their decisions. Ultimately, they would move from perfect rationality to "bounded rationality" under certain circumstances. Bounded rationality means that people are not perfectly rational. Their rationality is limited by the information they have, the cognitive limitations of their minds and the time they have to make decisions. Even though eventually most economists acknowledge that we are not always rational, they have resisted incorporating this change into economic modeling and expectations. With the works of some psychologists such as Dan Ariely, it seems like we are moving further away from the rationality theory. Ariely (2008) argues that we are not only irrational but that we are "predictably irrational".

Knowing self for knowing the market

As explained above, "self-interest", "rationality" and "utility maximization" are key concepts in explaining the merits of a free market economy. It is assumed that individuals know who they are and what is in their best interests. Thus, if we let them make their own decisions, they will act to maximize their utility. As suggested by recent studies, there is a fundamental flaw in such assumptions because it is not easy to know one's "self". Indeed, Greenspan (2008a, p. 16), in his recent book, confessed that "We rarely look closely at that principal operating unit of economic activity: the human being. What are we? What is fixed in our nature and not subject to change?" However, he acknowledged the fact that even "economists cannot avoid being students of human nature" (Greenspan, 2008a, p. 17).

In my opinion, most crises in capitalist nations are driven by the misunderstanding of human nature. If we could come up with a comprehensive human nature theory, we could better predict, even prevent, all kinds of crises that originate from human nature. Inspired largely by the writings of some Muslim scholars, such as Al-Ghazali, Rumi and Nursi, and Western scholars, such as Plato, Carl Jung, Haidt, Kaser and Schelling, I recently developed a new theory of human nature: "A Grand Theory of Human Nature (GTHN)", using the palace and resident metaphors that follow (Aydin, 2012). If we compare the human body to a luxury recreational vehicle, the following elements of human nature would be the companions on this vehicle: *King*, *Judge*, *Elephant*, *Advisor*, *Showman* and *Driver*. The *King* is the spiritual heart that is the source of love and inspirational knowledge. The *Judge* is the conscience that is the source of positive feelings after performing "good things" and negative feelings experienced after doing "bad things". The *Advisor* is the mind. The *Elephant* is the animal spirit, which is the source of animalistic desires. The *Showman* is the self-centric ego that pursues power and possession to show its importance to others. The *Driver* is the observing self that drives that the vehicle under the influence of the residents.

The King: the spiritual heart

Metaphorically speaking, the spiritual heart of an individual is like the King in a human vehicle (Aydin, 2012). He has the capacity for love, compassion and inspiration. He also has certain needs and desires for the fulfillment of his potential, and he takes actions to acquire what he needs and desires. First, the King has an almost infinite capacity to love. He needs/desires beauty, perfection and benefits in his lover(s). The King uses his capital of love to make attachments in his search for lover(s). From his perspective, life is a journey of making attachments with material and/or immaterial things such as money, property, lovers, friends, nature and God. Second, the King has the capacity for compassion, which is the source of empathy for the well-being of other individuals. He receives pleasure from exercising this compassion and feels pain when he is not able to exercise compassion. Third, the King has the capacity for inspiration. Concentration and contemplation of objects of amazement or novelty inspire the King to gain knowledge. GTHN suggests that individuals should take care of the needs and desires of the inner King first.

The Judge: the human conscience

Conscience, which is defined as the ability to distinguish right from wrong, is like an inner judge in the human vehicle (Aydin, 2012). The Judge makes judgments about an individual's decisions in life. If we treat someone unfairly, the inner judge causes us to be aware of this injustice and feels guilty for being unfair to others. Central to the Judge is the notion of equity or fairness. The Judge is affected by perceived unfairness in his community or broader society. He desires "fairness" in relationships and seeks equitable social arrangements in which the individual trusts and is trusted by other members of society. Feelings of inner peace exist when community norms and social policy reflect values consistent with those of the Judge.

The Advisor: mind

Mind which consists of intellect, logic and memory serves as an Advisor to the King, the ruler of the human vehicle (Aydin, 2012). The Advisor has the capacity to learn, reason and contemplate the inner and outer universes. He performs the role of making rational decisions for the King and other residents such as the Elephant and Judge. However, he has no power to endorse his decision and may be silenced if the Elephant is too strong.

The Elephant: animal spirit

The Elephant is an animal spirit in the human vehicle (Aydin, 2012). In the traditional Islamic literature, it is known as Nafs. Al-Ghazzali calls it horse. He argues that if we spend all our time looking after it and feeding it, we would never get anywhere. Instead, we should train and give it just enough attention, so that it can carry us where we want to go (Ghazali and Winter, 1997). I prefer to call it the Elephant because of its similarities to what is described by Jonathan Haidth in his book titled *The Happiness Hypothesis*. Haidth suggests that we have a divided self, which consists of a rider and an Elephant. The rider is the reasoning part of the mind, and the Elephant is the part seeking pleasure (Haidt, 2005, pp. 21-22). The Elephant has the capacity for sensual experience through using the five senses. He needs and/or desires many things such as food, drink, sleep, sex, etc. His fulfillment is determined by the acts of eating, drinking, sleeping, sexual activity and so on. Indeed, he is addicted to pleasure (Nursi, 1996c, 1996b, 1996a). He pursues instant gratification and selects present pleasure over any greater reward that could be achieved through deferment. Blind to the future, he wants to gain pleasure and avoid pain now with no ability to conduct long-term cost and benefit analysis. He is never satisfied with what he has and always asks for more. One of the key purposes of religion is to provide restraint and control of the elephant, guide and train him.

The Showman: the self-centric ego

The self-centric ego is like a showman in the human vehicle (Aydin, 2012). He enjoys working for the Elephant because of recognition he receives from the latter's activities. He is motivated by acts that acquire recognition, identity, fame, etc. and frequently compares his own possessions with those of others. However, if the Showman gains too much power in the vehicle, he will act like a dictator trying to control other people and nature. Indeed, he might even claim to be a sort of God. Relying on his assumed power, he will attempt to oppress others for his interests. In modern consumer society, individuals are competing with each other in serving to the Showman through conspicuous consumption. As Cushman (1990) said that the "empty self" of a consumer is constantly in need of "filling up" through material consumption. Companies are quite successful in providing positional goods and services to conspicuous consumers. They do not sell "just" products; they sell brands, prestige, visions, dreams, associations, status, etc. (Klein, 2001).

The Driver: the observing/deciding self

The observing/deciding self is like a driver in the human vehicle (Aydin, 2012). He is the source of self-awareness and serves as a conduit for relationships with other human beings and the external environment. He is the reference point to know everything including other beings and God (Nursi, 1996c; Al-Ghazali, 2007). He is in charge of the vehicle. He is aware of his possessions and protects them from intruders. As seen in the diagram below, the Driver pursues self-esteem, awareness and identity formation.

The 2008 financial crisis explained by human nature

The driving force of free market madness

Shiller and Akerlof (2001 Nobel Laureate in Economics) outline their distinctive views of the free market system in a book titled *Animal Spirits*. They argue that economists failed to predict economic and financial crises because of the lack of comprehensive understanding of human nature and its inclusion in economics assumptions and models. They call for revising macroeconomic models to take animal spirits into consideration. They explained the 2008 housing bubble through greedy animal spirits:

> People began to buy housing as if this were their last chance ever to buy a house (because they thought prices would continue to escalate beyond their means), and speculators began to make investments in housing, as if other people were going to think that they should buy now, at almost any price, because they would not be able to afford to buy a house later (Akerlof and Shiller, 2009, p. 169).

Akerlof and Shiller also argue that ignoring "animal spirits" in economic analysis prevents us from understanding how the economy really works. This makes it difficult to understand the loss of "trust and confidence", the importance of fairness, the role of "corruption and the sale of bad products in booms" and the role of stories that affect people's decisions (Akerlof and Shiller, 2009, p. 167).

For that matter, the success of Robert Shiller in predicting the 2008 housing bubble can be attributed to his understanding of human nature because of his great interest in psychology. Indeed, we can explain both success and failure of free market capitalism through its understanding of human nature. Free market capitalism recognizes three elements of human nature: mind, ego and animal soul. Its ultimate goal is to serve to self-interest, meaning in reality the interests of ego and animal soul. The success of free market capitalism comes from the so-called rational decisions made by capitalist entrepreneurs who try to maximize their profits and consumers who try to maximize their pleasures (utilities) in the market system. Capitalist ideology gives the following message to people: the ultimate goal in life is to have fun and power. Consumers need to work hard to become rich to have fun and gain admirable images. Capitalist entrepreneurs try to maximize their profits by creating demand for their goods and services and by minimizing the cost of their production. By using all kinds of advertisements, they ignite animal spirits and egos, thus creating demand for their products. On the other hand, by rewarding workers, they increase labor productivity and minimize the cost of production.

The producers' goal of profit maximization overlaps with the consumers' goal of pleasure (utility) maximization. While one side tries to maximize profit, the other side tries to maximize pleasure. People work very hard five days a week to buy goods and services and entertain themselves over the weekend. Supply from producers and demand from consumers work like an "invisible hand" that shape market activities and, in theory, make people happier. As this mechanism is supposed to produce the best possible outcomes, government intervention is not desirable because it will create distortions. Although free market capitalism has worked smoothly for the most part since Adam Smith, it has also witnessed many economic crises. In my view, economic and financial crises of capitalism are driven by the excessively ignited desires of animal souls and ego.

Understanding human behaviors in market by understanding human nature

Understanding key elements of human nature helps to understand and possibly avoid economic and financial crises, like the recent one. Indeed, the 2008 financial crisis can be better explained through its relation to human nature. Even Greenspan (2008c), one of the many people blamed for the 2008 crisis, defends himself by saying that we should blame human nature for the crisis:

> The economic edifice – market capitalism – that has fostered this expansion is now being pilloried for the pause and partial retrenchment. The cause of our economic despair, however, is human nature's propensity to sway from fear to euphoria and back, a condition that no economic paradigm has proved capable of suppressing without severe hardship.

He argues that it is impossible to prevent such crises because it is hard to predict and prevent certain human behaviors coming from their ambiguous nature.

Greenspan (2008b) acknowledged that the main driving force behind the 2008 financial crisis was sheer greed. Perhaps, it was the greed of both consumers and creditors. In my view, the bankers knew they were being hasty; they knew that the rosy days will not last forever. However, they proceeded to make more money for their shareholders and attained higher bonuses. Greenspan later argued that it was a simple mistake of not taking greedy human nature into consideration. He made the following apologetic statement to the House Committee on Oversight and Government Reform:

> I made a mistake, in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms (Kravitz, 2008).

I agree with Greenspan that the 2008 financial crisis, and perhaps all economic crises, was driven by human nature. However, I disagree with him that human nature is not predictable. I think the capitalist theory of human nature has some serious flaws. If we could come up with a comprehensive human nature theory, we could better predict, even prevent, all kinds of crises that originate from human nature. Indeed, there were some economists who did foresee a major economic crisis. For instance, Robert Shiller, also known as Mr Bubble, accurately predicted the "dot-coms bubble" and "housing bubble". In his book, *Irrational Exuberance*, he argues that irrational exuberance is the cause of bubbles in stock markets and housing markets (Shiller, 2005). In an interview, Shiller acknowledged that with the encouragement of his wife, who is a clinical psychologist, he came to the understanding that "psychology is at the heart of economics" (Leonhardt, 2009).

In the middle of the Great Depression, John Maynard Keynes published his famous book, *The General Theory of Employment, Interest and Money*. He offered a lasting prescription for any economic recession. Even though many economists have adopted his views of government intervention as an effective means to deal with economic recession, they have somehow dismissed his fundamental message on how the economy functions. In his book, Keynes (1936, pp. 161-162) argued that economic crises are generally caused by animal spirits:

> Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits - a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.

In short, the 2008 financial crisis was mainly due to the irrational decisions made by consumers, bankers and politicians. What caused them to make such mistakes was their nature. We failed to predict the crisis because of ignoring the importance of human nature in our economic models. Knowing human nature will help us to make workable assumptions about human behaviors, thus making it possible to conduct more robust macro- and microeconomic analysis. Otherwise, our economic models and predictions based on wrong assumptions are doomed to fail. The comprehensive theory of human nature presented above is an attempt to overcome this shortcoming (Aydin, 2012). The theory does not assume that people are irrational in general. It simply recognizes that people are imperfect decision makers because of influences from the Elephant (animal soul) and the Showman (ego). Even though they make rational decisions most of the time, they predictably make irrational decisions under certain circumstances in which the Elephant and/or the Showman are in control. Indeed, we frequently face choices between immediate and delayed gratifications. The awareness of the Elephant and the Showman within human nature will help us increase our rational decisions in life.

Conclusion

Free market economy has proven to be very successful in the efficient use of scarce resources to meet the needs and desires of human beings. However, as seen in the 2008 financial crisis, the unchecked behaviors of market players result in the free market madness. The paper argues that free market madness is an unavoidable outcome of the fundamental flaws of the capitalist economic system which mainly relies on three elements of human nature: ego (self), animal spirit (interest) and mind (rationality). The success of capitalism comes from the so-called rational decisions made by capitalist entrepreneurs who try to maximize their profits and consumers who try to maximize their pleasures (utilities) in the market system. However, as seen in over 100 crises throughout the history of capitalism, people are not perfectly rational as assumed by classical economics; in fact, they are predictably irrational. From a comprehensive understanding of human nature, irrational behavior due to the influence of the animal spirit and the ego. Capitalism boosts ego and exploits the animal soul to increase supply and demand in the market without providing certain moral and legal restraints on ego and animal souls to avoid speculation and exploitation.

The 2008 financial crisis was mainly driven by the irrational and irresponsible behaviors of politicians, creditors and consumers. The paper argues that the madness of free market is due to the lack of comprehensive understanding of human nature to predict and prevent such irrational behaviors. It calls for moral and legal restraints to control consumers from lavish and unsustainable consumption and capitalists from accumulating wealth without contributing to production.

In short, we will see many more crises if the flawed assumptions of capitalism are not revised based on a comprehensive understanding of human nature. As the main problem of capitalism lies in its (mis)understanding of human nature, we should start with ourselves first. Indeed, economics as a field suffered a major blow with the 2008 financial crisis because of the failure of its elegant models which rely on some inaccurate assumptions about human nature. To reclaim its reputation, economists have to see the major flaws in the free market capitalism because of its misunderstanding of human nature. Then, they have to revise certain assumptions and models to better predict irrational behaviors of consumers and producers. As Krugman (2009) says, economists "have to face up to the inconvenient reality that financial markets fall far short of perfection that they are subject to extraordinary delusions and the madness of crowds". Once we make some radical changes in our assumptions about human nature, this will have a cyclical impact in all areas of scientific studies. It will provide a necessary framework to solve major crises that are financial-, environmental-, moral- and happiness-related. Thus, it will help us come up with a humane market, a humane government and a human-friendly technology. Hopefully, the 2013 Nobel Prize in Economics will shift the tide toward a heterodox approach.

Notes

1. This research paper was supported by King Saud University, Deanship of Scientific Research, College of Business Administration Research Center.
2. Some of the ideas discussed in the paper were presented in the following conferences: "Global Financial/Happiness Crisis and End of Capitalism" at the Relational Goods and Happiness Conference, held in Venice, Italy, on June 11-13, 2009; "Free Market Madness and Human Nature", the Ninth Harvard University Forum on Islamic Finance on March 26-27, 2010. "Islamic Economics as a New Economic Paradigm", the paper was presented at the 8th International Conference on Islamic Economics and Finance, Doha, Qatar, December 19-21, 2011.
3. Ubel's (2009) book, *Free Market Madness: Why Human Nature is at Odds with Economics– and Why it Matters*, was published by Harvard Business Press in January 2009. Ubel argues in this book that the economic crisis is due to the irrational aspect of human nature which caused free market madness.
4. Ironically, he shared the 2013 Nobel Prize with Robert Shiller, despite their contradicting positions on the 2008 financial crisis and rationality of market actors.

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