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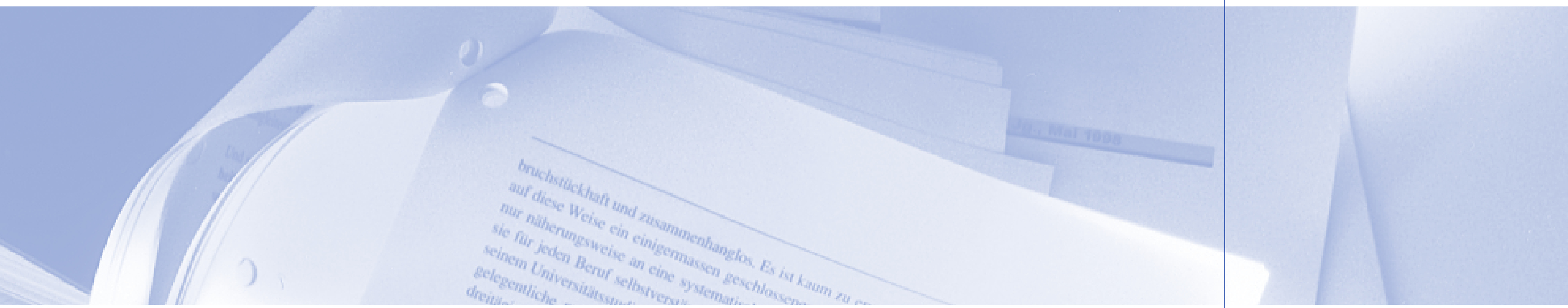

The Triumph of Mass Manufactured Will – Circumstances and Rules

- The origins and development of mania and delusions
- Improving our knowledge in order to improve our understanding

Keywords:
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Foreword

In the November edition of m.o.m.®, I can offer readers a discussion on a particularly important subject. This is an insight into the fascinating world of mass manufactured will and the psychology of crowds, written by Dr. Linda Pelzmann, Professor of Economic Psychology at the University of Klagenfurt, Austria.

Professor Pelzmann wrote an article for m.o.m.® in January 2001, in which she discussed the topic of critical incidents as a means for personnel evaluation and selection. The article received a great deal of attention both from m.o.m.® readers and the media.

The subject of this edition is in keeping with the times in a number of ways. *Firstly,* it is in my opinion the only way of gaining any sort of understanding of the mania and madness prevalent on financial markets in the last few years. Any number of explanations has been produced by the media. They are apologetic in tone and begin something like *«Everyone was doing it …»* or *«No one could have known that …»,* but this doesn't allow us to learn anything from the experience.

Secondly, only half of the madness is behind us, the positive half. The other one, the destructive half, is still to come, and this will also be governed by the laws of crowd psychology. Although the exaggerations were positive in nature before, in the future they will be negative. If one is familiar with the laws which govern these processes, they can be used to avoid damage and to safeguard opportunities.

Thirdly, this subject is also important for entrepreneurs and managers who are not involved in the euphoria of the stock market and the New Economy, because markets, marketing and consumption are very often behavior driven by mass manufactured will and crowd psychology.

St. Gallen, November 2002

Yours sincerely,

F. Malik

Prof. Dr. F. Malik

«Total Quality Management is important, but Total Management Quality is ten times as important.»

Linda Pelzmann

Mass Manufactured Will: Circumstances and Rules

1. Collective seduction

It may be that one day people will no longer allow themselves to be led, but it will always be possible to mislead them, says Fredmund Malik. This article deals with misleading people by applying the madness of crowds. This exploits the fact that *in the undertow of other-directedness* the individual does not pay attention to the facts but instead to what other people are doing. This type of emulation is leveraged by euphoria, greed, uncertainty and lack of orientation. On this basis, many people are happy to go along with the purchase recommendations suggested to them. *«Credulous idiots following crafty insiders»,* says **Charles Kindleberger,** professor at the Massachusetts Institute of Technology. For more than half a century, he has been researching the virus which repeatedly infects economic systems: *speculation with borrowed funds.*

The cumulative collective financial and economic seduction reached its peak in the **New Era** of the 1920s and the **New Economy** of the 1990s. These were mass movements which exploited all the psychological levers for generating crowd excitement and co-movement. This initiated positive return auto-correlations, which at first led to the astronomic rise and then to the crash.

When the New Economy bubble reached its peak, Professor Malik asked me, «What crowd dynamics are driving the agglomeration of individual will towards irrational exuberance and mass hysteria? How are they able to fashion and even to create the will of the people? Can you as a psychologist explain what is happening?» Since September 1999 I had been working in the Mass Manufactured Will Project at Harvard University, but during the boom nobody, with the exception of Malik, really wanted to find out why these illusions were marching in step across the world and why they were fuelling each other. It is only now, after the crash, that people are starting to listen.

Oil discovered in hell

In order to illustrate the dynamics of crowd psychology, I would like to tell a story which the investor **Warren Buffett** (Cunningham 1997) heard from his respected mentor Ben Graham.

An oil prospector, moving to his heavenly reward, was met by St. Peter with bad news. «You're qualified for residence», said St. Peter, «but, as you can see, the compound reserved for oil men is packed. There's no way to squeeze you in.» After thinking for a moment, the prospector asked if he might say just four words to the present occupants. That seemed harmless to St. Peter, so the prospector cupped his hands and yelled, «Oil discovered in hell.» Immediately the gate to the compound opened and all of the oil men marched out to head for the nether regions. Impressed, St. Peter invited the prospector to move in and make himself comfortable. The prospector paused. «No,» he said, «I think I'll go along with the rest of the boys. There might be some truth in the rumor after all.»

When this dynamic is in action, analysts and economists refer to this type of behavior as being **irrational** and **unpredictable,** but this is not the case. This crowd behavior has a **rationality** of its own and is **predictable.** I will demonstrate the circumstances in which it operates and the rules of conduct which govern it.

In the introduction I should actually have attacked the army of economists and financial experts who are so attached to the *Efficient Markets Hypothesis (EMH)* and the *dogma of rational behavior* that they do not want to admit the existence of the waves of mass manufactured will. However, I do not need to do this because I can simply refer to the excellent analyses produced by Charles Kindleberger (MIT), Fredmund Malik (MZSG) and Andrei Shleifer (Harvard University). This means that I can turn my attention straightaway to the crowd phenomenon which brings about the reversal of genuine individual will. The attraction exerted by other people means that the will and the behavior of the investor are no longer controlled by fundamentals, but by *other-directedness.* With the help of a field experiment, I have investigated this dynamic and discovered that the process involved has a clear structure and is predictable.

Irrationality, negligence, waste and disinformation are no longer the result of a failure on the part of the individual. They are pre-programmed to occur when speculative fever reaches a critical mass. Anyone who resists the process will be ignored, isolated or trampled under foot.

What we are confronted with in the analysis of crowd behavior is largely not a genuine but a manufactured will. Mass manufactured will thrives in an economic and political environment which promotes and finances greed, euphoria and ignorance instead of belief in economic rationality. This reinforces the tendency of the system to become increasingly vulnerable to **psychological chain reactions,** which rapidly spread across different sectors and countries. Once the process has reached a critical mass, it runs its course until it has used up all the available financial and economic energy.

2. Circumstances

2.1 Transforming the coordinates of economic rationality

The freedom of the individual to want, to decide and to act is regarded as a fundamental feature of our economy. Economic theory rests on the idea of a free and definite will that is the prime mover of action. *The Efficient Markets Hypothesis* stands or falls by the independent and genuine decision-making of the individual.

However, when economists maintain that this highly developed order in market relationships applies at all times and in all places, they are mistaken. For there are other circumstances in which people do what other people are doing, without thinking or deciding for themselves. People only need to **panic** or, even better, to be filled with **enthusiasm,** and they will prove that this is true. In *«no-data situations»,* where there is no information available and people cannot fall back on experience, they also become other-directed.

The fact that markets are generally efficient, because market participants use the available information to make independent decisions, does not prevent manic phases occurring in which people, on occasion as victims of irrational exuberance, greed, over-optimism and over-trading, revert to primitive behavior. A characteristic feature of this type of relapse is that **people become other-directed.** The pull, or attraction, which is exerted by other people on an individual grows with the size of the manipulable crowd. The extent to which panic and euphoria will spread is a quantitative question. The contagion often develops in geometrical progression.

People tend to adapt their behavior to the structure of the information available in the environment where they form expectations. They act ecologically rationally to the degree they are using the structure of the information provided by this environment. One factor of this type in people's environments is other people. *«The others»* are a significant source of information and means of orientating oneself. In conditions such as uncertainty, insecurity, anxiety but also euphoria, it is *«the others»* who provide the individual with his coordinates.

The confrontation with an unknown environment, in which people do not know their way around, leads circumstances to evolve in which people create new rules of conduct. People respond with a new pattern of actions which give their group an advantage in the competitive situation. The new rules of conduct do not develop as consciously acknowledged conditions for a conscious purpose. They occur because the groups which put them into practice have more success than other groups and as a result, these rules displace other sets of rules. As Friedrich von Hayek (1973, p.18.) puts it: «These rules of conduct have thus not developed as the recognized conditions for the achievement of a known purpose, but have evolved because the groups who practiced them were more successful and displaced others.»

2.2 Displacement of profit opportunities

The American economist **Hyman Minsky** (1982) developed a «model of instability» of the credit system in which the events which finally lead to a crisis start with a displacement.

The endogenous shock can take the form of the outbreak of war, the end of a war, the adoption of an innovation or the spread of a new technology. Whatever the source of the displacement, if the event itself is big enough, it causes a displacement of profits. For some market participants the chances of making big profits dry up, while new business opportunities open up for others.

The result is that many people want to make the most of this new opportunity and raise credit for financing purposes. The triumph of success, the euphoria, spreads and so does the credit, a boom starts. In Minsky's model, the boom is fed by the expansion of credit and debt. Euphoria, the spread of credit and growing debt make a very unstable and highly explosive mixture. Minsky uses the term «displacement» to describe a tectonic shift in the economic process which is fed by two different sources. Firstly, a **structural break** takes place and, secondly, market participants **misinterpret** this change, generally by seeing it in far too **optimistic** terms. This misinterpretation prepares the ground for the instability of further developments. **Euphoria is the raw material for rising prices, overestimates of profit opportunities and overextended credit lines.**

2.3 Euphoria: the fuel of the New Economy

The reaction generated by the dynamics of mass manufactured will always starts with an **exciting piece of news.** Sometimes the news is initially good, and sometimes it is alarming. Sometimes the excitement simply backfires and sometimes it turns into a triumph for some market participants. Where there are profits to be made, other people want to join in. The more market participants observe the success of the others, the more of them become involved in speculation. As they say in America, *«Monkey see, monkey do»*.

Euphoria was the most important raw material for the unrestrained growth of the New Economy. Irrational expectations for the future, rapid growth without a single cent actually being earned, balance sheets in which problems were glossed over and debts were booked on the assets side, all these unrestrained behaviors fuelled one another through positive feedback. Following the emergence of new circumstances based on developments in IT, people created a «culture» by reacting to these new circumstances which in the short term turned out to be more assertive and 'stronger' than other cultures. Participants in the New Economy market orientated themselves in relation to other market participants and no longer took genuine facts into account.

Market participants solved the problem of achieving success in a world which was only partly familiar to them by following rules of conduct which had served others well.

«Learning from experience» is not primarily a process of drawing logical conclusions but rather of following, spreading, transferring and developing practices which have evolved. It is often not even because they have brought identifiable benefits for the individual in question, but more because they have improved the chances of the group. Practices and behaviors which have evolved because the groups who practiced them were more successful and displaced others have had an impact in a cumulative process on the decision-making situation and as a result have changed it.

Euphoria, which may sometimes even have a foundation in reality, creates a biotope for unrestrained growth. The resulting circumstances have a cumulative force: the behaviors of the participants move further and further away from reality as a result of the positive feedback of euphoria. In this way, unrestrained forces determine what is rational in economic terms. The decision situation is transformed by crowd behavior; it leads to a new decision situation somewhat different from that the other would have produced; and in this new situation a further crowd action produces its results and leads to yet another situation. Over extended time, small differences in rationality combine to produce very different results and this compounding of differences leads to vastly different bodies of crowd behavior. The mass of the market participants reacts to the changed situation by changing their behavior. The change in behavior produces a new situation and the new situation results in a slightly modified behavior pattern and so on and so on.

This process has a cumulative force which changes the environment and determines what is rational in economic terms in this environment. It has an impact on the circumstances and **changes the coordinates of economic behavior.** It influences the rules of conduct which govern behavior patterns and changes the rules. From stage to stage the priorities change, until – when a critical mass of market players is reached – **reactions** rather than **decisions** take priority. The shift from decisions to reactions changes the **logic of the situation.** What is rational in economic terms in this situation is no longer determined by feedback from facts, basic data and fundamental value. Instead it is determined by feedback from the reactions of other market players. **Reality has ceased to operate.**

3. Catalyst

A field experiment in which I followed the liberalization of the Austrian telecoms market demonstrates the circumstances, the rules of conduct and the dynamics of mass manufactured will (MMW). In comparison with the stock market boom, this MMW is harmless and not particularly spectacular. Nevertheless, it includes all the significant factors which are involved in the development of mass manufactured will: displacement, excitement, a lack of experience, other-directedness, a catalyst, communication, synchronization, risk evaluation and positive return autocorrelation. This data shows that MMW no longer belongs in the dark realm of *unpredictable, irrational exuberance.* This type of behavior can now be predicted. We can analyze and understand it, and also forecast the course of events using the following model.

Displacement through liberalization: In 1998, the Austrian telecoms market was opened up to competition, initially for business customers and later for private customers as well. Until then the only telecoms service provider was the Österreichische Post (Austrian Post Office). From 1998 onwards, eleven other service providers gradually entered the market.

Excitement and lack of experience: In the autumn of 1998, a colleague from the University of Graz rang me up to find out whether the University of Klagenfurt had also changed its telephone company. He explained that the University of Graz was no longer a customer of the Österreichische Post-Telekom (Austrian Post Office), but had moved to a competitor, UTA. A rumor was going around that the move could reduce the university's telephone costs by a third and that this had been confirmed by the first telephone bill received after the changeover. Everyone can see it with their own eyes, he said, because since the move an access number appears on the display when you dial an external number.

Catalyst: As the University of Klagenfurt had not changed to another telecoms company, I could compare two random samples and systematically monitor whether the change instigated by the President of the University in Graz would act as a catalyst which would prompt university employees to change the service provider for their home phone line. The question was: Will this process happen more quickly and involve a larger number of employees than at the University of Klagenfurt? What are the differences in the behavior of the two random samples? All the «rational» economic conditions were the same in both locations. There was the same flood of advertising material accompanying the liberalization of the market, there were the same opportunities for saving money, etc. If there were significant differences in the behavior of the two random samples of 100 employees, this could be attributed to the impact of the catalyst.

Communication: How did the communication between sender and recipient work? The President of the University, who acted as the catalyst, did not talk to the university employees who changed over. The signal was the access number on the display. This number indicated the «status», which acted as an appeal to the recipient. The signal to make the change was propagated further via the private telephone lines of the people who had changed over. Without intending to, UTA and Tele 2 had included an effective signal in the form of the unpopular access number, which accelerated the «ripening» process and the increase in the number of people changing over.

Synchronization: After the University of Graz moved over to UTA in the summer of 1998, the employees at the university only very slowly became «ripe» for change. The «early birds» began changing over at the end of 1998 and the beginning of 1999. Apart from these initial exceptions, there were two main waves of contracts with Telekom Austria being terminated: November-December 1999 to March 2000 and November-December 2000. Thus the first wave did not start until a year after the catalyst had made the changeover. And it was not until another year had passed that the second wave was in full swing. From the summer of 2001 onwards, Telekom Austria gradually began to match its prices to those of its competitors. The result of the falling prices was a weakening of the incentive to change.

The first weak wave of changes in Klagenfurt did not start until the autumn of 2000, two years after the liberalization of the market! The second stronger wave took place in the summer and autumn of 2001. The comparison of the two random samples shows that customers became «ripe» for change to another telecoms company significantly earlier and in significantly larger numbers as a result of the catalyst. The catalyst accelerated the rate of change by a year and increased the proportion of people changing from one third to two thirds.

Other-directedness: In Graz, the people who changed over mentioned on average three «others» who had changed over before them. They also mentioned on average one «other» who had changed over after them. However, none of them expressed this in terms of being prompted to change «by» the others. In our culture, changing because others have changed, that is reacting to others instead of acting as an independent individual, is seen as inferior. Hardly anyone would attribute this sort of behavior to themselves. For this reason we broke the questions down into several stages: *«Do you know someone who has changed?» «When did they change?» «When did you change?»*. The data showed that people orientate themselves in relation to other people, even if they do not admit it.

Risk evaluation: What sort of information did they obtain from other people? Firstly, they found out whether other people had had problems and, secondly, whether the promised benefit actually occurred, that is whether it was worth making the change. The experience of other people was used to identify the absence of mistakes and risks.

The data show that market participants who enter new territory and have no experience of the benefits and dangers involved orientate themselves in relation to other people. This does not mean that they react «blindly» by running to wherever the other people are, as is suggested by the terms «herd behavior» and «herding». It would be far too risky to test out the consequences oneself. It is «safer» to let others acquire the experience and observe the consequences.

The test subjects evaluated the risks undergone by others who changed over before them. They observed what was happening in order to find out whether these people had problems and whether they really made the promised cost savings. After observing that the other people did not suffer from any negative consequences or experience any problems or mistakes, more and more of the Graz employees became «ripe» for change.

Positive feedback and increasing returns autocorrelation. The crowd response only started once it was clear that the risks involved were negligible. After people were sure that they could change without undergoing any risks, they no longer felt the need to check what had happened. People's doubts, controls, constraints and blockings were annulled and the way was clear for a psychological chain reaction to take place.

4. Rules of conduct

When crowd response takes place, this means that other-directedness replaces genuine individual decision-making based on fundamentals. Their place is taken by the response to other market players. Six rules drive this crowd behavior: the response rule (1), the other-directedness rule (2), the risk-evaluation rule (3), the communication rule (4), the synchronization rule (5) and the positive feedback and increasing returns autocorrelation rule (6):

(1) Genuine individual decision-making is replaced by response.

(2) Other-directedness substitutes for directedness towards fundamental data. It is not the facts themselves which drive people, it is the opinions about those facts.

(3) People do not find out about the risks and dangers themselves, but by evaluating the consequences of others' actions.

(4) Communication: The announcement of the sender's status has the effect of an appeal to the recipient.

(5) Synchronization takes place as a result of sentiment and suggestion. When a person is lacking in orientation, they accept the explanation of the environment which they are given. The

coordination and «safeguarding» of their actions by means of sentiment and suggestion is more effective than using other means.

(6) The law of positive feedback applies. Momentum exhibits positive returns autocorrelation: Money follows money. Prices go up and up just because noise traders are chasing the trend.

5. Mass manufactured will

If people do not know their way around, the number of them who will orientate themselves in relation to facts decreases. In the same way, the number who will orientate themselves according to the behavior of others increases. Market players who react to others displace those who make their own decisions. If other people emerge from a particular situation having failed, or having been damaged, betrayed or made bankrupt, then those who come after them will avoid running the same risk. However, if they emerge unscathed and successful, all the others will rush to follow them. Observing the consequences of other people's actions produces information which allows people to avoid exposing themselves to risk. Dangers are not inferred from fundamentals, but it is the wounds, injuries and losses of other market participants which indicate the risk.

For millions of years, animals have been using members of their own species for risk evaluation. Rats wait to find out **whether other** rats **survive** eating a particular type of food before they eat it themselves. If they find an unfamiliar foodstuff, they let the young rats eat it first. The young rats are curious, and if they do not survive, the old rats will produce a new litter. The old rats will only eat if they smell the scent of the unfamiliar food on the breath of other rats. The condition of the surviving rats indicates whether there is a danger.

This is a safe survival strategy for rats, but not for investors. There are powerful forces at work in the financial markets which have nothing else to do than to attach the scent of winners to unfamiliar «food» to stimulate an appetite. The triumph of the bulls is deafening, but the bears do not make a sound.

Suggestion is ever present in the business world in the form of purchase recommendations which compete with one another for influence and effectiveness. The manipulation industry uses ingenious suggestion techniques based on sophisticated experiments and is prepared to go to great expense and trouble to put over its insistent messages via the mass media. However, even the most ingenious messages can only achieve their full effect if the target group has an increased level of receptiveness, if there is an absence of danger signals and if there are promises of profits which the target group also believes in. Nothing fulfils these conditions as effectively as general euphoria, excitement and a state of over-optimism.

Excitement and euphoria are the surest means of making people blind and deaf to possible risks. Under the influence of enthusiasm, control and inhibition are thrown to the winds. Enthusiasm transmits the positive hopes and suppresses alarm cues and doubts. Euphoria does not only make people careless and reckless; euphoric arousal also removes inhibitions. Emotional excitement inhibits rational performance. The hypothalamus blocks the cortex. One model of these processes is provided by the so-called **cognitive appraisal theory of emotion.** Emotions are regarded as the product of an initially evoking stimulus and a cognitive appraisal or interpretation of the situation as beneficial or harmful for the individual. The key notion here is the cognitive appraisal. The appraisal of sensory stimuli is followed by an emotional statement. Only after this are the reactions stored in the hypothalamus triggered and finally the response to the activity is transmitted, which is subject to another appraisal. The process has a snowball effect. To a certain extent one's emotions are fuelled by the addition of the evaluation of one's own euphoria to the initial «cool» evaluation of the situation. This fuelling process is particularly effective for cumulative euphoria.

The American psychologists **Stanley Schachter** and **Jerome Singer** (1962) demonstrated how arousal, excitement and suggestion can be manipulated. They discovered that people who had no adequate explanation for their arousal were euphoric when another person behaved in a euphoric way; and they also became outraged when another person expressed their outrage. Only **people who were uninformed could be infected** in this way. The informed test participants, on the other hand, regarded their euphoric outbursts of emotion with mistrust. Since this experiment we know that three components are needed to make people susceptible to **suggestion:** firstly, either anxious or euphoric **arousal,** secondly **ignorance,** a lack of knowledge, and thirdly an environment which suggests **explanations.**

Enthusiasm transmits behavioral models and suppresses warnings. This means that people's sense of reality is disabled. Experience and realistic conceptions of feasibility become ineffective. Market participants who interpret facts and fundamentals correctly are displaced by market players who succumb to interpretation, suggestion and manipulation by highly-paid analysts – actually, they are the propagators – and media companies. The rest of the work is done by auto-suggestion and positive feedback, which are indispensable constituents of the manipulation of crowds.

In the telecoms field experiment, there were no paid propagators in action. The people who changed over passed on their access number, and therefore the signal, unintentionally to the others. Nevertheless, positive feedback and increasing returns autocorrelation took effect, particularly amongst the children of the people taking part in the test. A teenager who wanted to make cheap phone calls followed what his friends were doing. If they were customers of Max-Mobil (an Austrian mobile phone company), he also became a customer of Max-Mobil and his other friends also had to become Max-Mobil customers.

Positive feedback and increasing returns autocorrelation have been known for a long time. The American psychologist F. H. Allport (1933) showed that many social phenomena which are dependent on the extent of participation are subject to this law and can be described by a characteristic distribution, the so-called J-shaped curve. Allport attributed the appearance of J-shaped curves to conformity pressure. In our case, I would refer to «co-movement and synchronization», because the process is a mechanical one which is not intended or planned by the participants.

In the New Economy, many items such as computers or telecommunications equipment work in networks that require compatibility. This phenomenon has had the well-known snowball effect. The larger the number of customers who already use a specific computer system, the greater the benefit for all new customers, because their systems are compatible with many other users. When one brand gains a significant market share, people have a strong incentive to buy more of the same product so as to be able to exchange information with those using it already. It is a case of determining the probability of current events by referring to the past. Any company which already has a large market share has a better chance of making it even larger. Any company which is losing market share will find that the same dynamic which was responsible for its rapid growth will also accelerate its decline.

6. Propagation

«There is nothing so disturbing to one's well-being and judgement as to see a friend get rich.» **Charles Kindleberger** always quotes this sentence when he speaks about financial markets. Everyone feels the pressure to emulate people who have just been successful. This pressure is strengthened by speculative financial markets which have a whole range of effective levers for firing up enthusiasm and disabling braking systems.

When companies and private individuals see other people making money through speculative trading, they want to do it, too. When the number of companies and individuals who are taking part in this type of «investment» grows and whole sectors of the population become involved which would normally keep well away from this type of risk, the markets become disconnected from fundamental economic data, and mania or a speculative bubble start to develop.

The word «mania» puts more emphasis on the psychological and behavioral aspects of the phenomenon, and stresses the irrationality; the term «speculative bubble» foreshadows the bursting and focuses on the imminent crash.

A bubble is a cumulative movement in the price of an asset whose price is high mainly because speculators believe it will rise still further, causing a heavy deviation from 'fundamentals'. Small price variations around fundamental values are called 'noise'. From a certain stage onwards the speculation tends to become disconnected from fundamental values and to start chasing after illusions. More and more people want to become rich without really understanding the processes involved. It is therefore preordained that there will be a spread not only of rash and euphoric behavior but also of fraud and the selling of rubbish. Economic pathology occurs. In the fevers of destabilizing speculation, markets move more closely in step with one another. Boom and panic in one country seem to induce boom and panic in others, often through psychological channels. Boom and panic travel through conduits of crowd psychology. The driving force behind crowding and behavioral contagion is emulation.

'With the exception of the instinct of self-preservation, the propensity for emulation is probably the strongest and most alert and persistent of the economic motives proper.'
Thorstein Veblen (1857–1929)

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A short summary of the author's career

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Managerial Effectiveness Programm

Seminar-Nr. 310061	1. Teil	19.–21. März 2003	Interlaken
	2. Teil	6.– 8. Mai 2003	Interlaken

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