

FINANCIAL CAREER FEATURE



## Behavioral Economics

[By Akbar Ali]

One of the things sure to get business owners' attention is the reason why consumers buy what they buy. To be sure, not everything can be quantified and explained through a series of tidy numbers and graphs. What, for example, fully accounts for the popularity of a phenomenon like the *Harry Potter* books? Is it marketing? Timing? Quality? Or all of the above?

At the end of the day, most would be wise to simply chalk up the unparalleled success of *Harry Potter* to its having arrived at the right time in the world's fantasy-starved bookstores in the late 1990s. But not everything can be so easily explained away as serendipity. The field of behavioral economics looks into the reasoning behind purchasing, applying scientific understandings of cognitive behavior and emotional biases to the full range of financial decisions the average person is forced to make on a daily basis.

Behavioral economics deals specifically with the rationality applied by "economic agents," a term which can be defined in a number of different ways. Those who accept the idea of human beings as economic agents or *homo economicus* ("economic man") adhere to the idea that human beings are essentially self-interested but rational creatures whose primary aim is the acquisition of goods, avoidance of physical labor, and the ability to make these aims a reality through the application of economic judgments.

The study of human reasoning and its influence on the economy is an ancient

idea. Only in recent centuries, however, has the link emerged as an object of scrutiny studied by philosophers, economists, and psychologists. There is a great deal of debate as to whether the study of human economic reasoning is even a valid field of psychology, as many practitioners and academics shy away from defining it as such. Classical economists, who trace the beginnings of their line of work to the publication of Adam Smith's *The Wealth of Nations* in 1776, have expanded their work in the field through a series of neo-classical economists including Francis Edgeworth, Vilfredo Pareto, Irving Fisher, and John Maynard Keynes.

Experts in the field study behavioral finance and economics according to three primary criteria:

1. **Heuristics:** informal methodologies used by consumers in making economic decisions
2. **Framing:** the manner in which rational choices are presented
3. **Market inefficiencies:** explanations of market trends and outcomes

which defy rules, patterns, or expectations.

All of these were on display in the 2007 holiday shopping season, which witnessed the convergence of a poor economic outlook with a lackluster sales season. Much of the nation spent 2007 reeling from record gas prices, a seemingly bottomless and flailing housing market, and a rollercoaster ride on Wall Street, forcing many to cut back on spending and focus instead on securing their immediate financial futures.

The downturn in economic trends clearly signaled a fight to survive for many whose standard of living has been threatened not only by a tighter job market and limited energy supplies, but by the overall leveling of the field of international economics: the idea that the United States may be losing its grip as the world's economic superpower is no longer a distant thought in economists' minds. Rather, it is an ever-encroaching reality which has forced American consumers to rethink their priorities.

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