Deer in the Headlights, Financially Speaking

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BY any measure, the global economy is facing unusually high levels of uncertainty and volatility. But human nature may be impeding our ability to turn the economy around.

Fear and anxiety don’t bring out the best in anyone. When normally loving spouses are lost in traffic and late for a flight, their conversation is rarely suitable for young ears, even when the children are in the back seat.

Along with making people irritable, uncertainty can create paralysis. Some animals freeze when they are frightened. Acting like a deer in the headlights can be a good strategy if you are trying not to be seen, but it can get you run over.

In humans, this behavior is illustrated by an experiment conducted by the Princeton psychologist Eldar Shafir. The subjects, who were graduate students, were told about an attractive deal for a spring-break vacation. They could get an especially good price if they bought their tickets now, rather than waiting a week. But, as part of the deal, the students wouldn’t hear the results of an important exam until the discount expired. That uncertainty caused many students to freeze: Although a majority said they intended to take the trip whether or not they passed the exam — either to celebrate their success or recover from failure — they didn’t want to buy the tickets until they found out the results.
I worry that many Americans are now acting like Professor Shafir’s subjects. They know that there are investments they should be making, investments that are currently “on sale,” but they are waiting to see how things shape up before they act.

Congress certainly suffers from this problem. The country has a long list of roads and bridges that are either dangerous or obsolete. We can begin the inevitable process of rebuilding this infrastructure now, when construction costs are low and borrowing costs are essentially zero, or we can wait.

But why wait? Postponing will only make the projects cost more when we finally get around to starting them, and, in the meantime, we risk disaster if one of those bridges fails. Do we think we will no longer need bridges? If Greece defaults, American cars will not suddenly become amphibious.

Congress is not the only place where we can see paralysis. Corporations are hoarding cash at record rates. The Federal Reserve recently reported that nonfinancial companies in the United States were holding more than $2 trillion in cash and other liquid assets — money that is earning next to nothing. A considerable amount of that cash has been accumulated in the last two years — and the totals exclude the substantial sums the companies hold abroad in foreign subsidiaries. Of course, it can be sensible for businesses to have a source of emergency cash, but many appear to be stockpiling so much that it’s hard to imagine what emergency they fear. To cite just one example, Google is holding more than $39 billion in cash.

Google is far from alone. A recent survey of chief financial officers by Duke University reports that 55 percent of them say they won’t begin to deploy cash holdings in the next year. Many say they are waiting for economic uncertainty to decline.

Yet is such caution rational? As a shareholder, I would worry about a company that says it can’t find investments that can reasonably be expected to earn well above the tiny return of its cash.

Investment does not necessarily have to involve increasing capacity. Are there no plants or equipment that need upgrading? No promising research-and-development opportunities to be explored? Not even any parking lots that need to be repaved and painted?

I also do not buy the idea that companies need all this cash for acquisitions. If they really want to buy another business, they can issue stock to do so.

Loosening the purse strings just a little could have big effects on the economy. Suppose that American companies reduced their domestic cash holdings by just 10 percent and invested that $200 billion in productive investments. Using standard assumptions, these investments would spur growth in gross domestic product next year by about 1.3 percent and reduce unemployment by almost 0.7 percent. These investments would also increase tax revenue and generate long-term profits.

Some people contend that uncertainty about government regulation is making businesses cautious, but no solid evidence supports this claim. Corporations always complain about
regulators, but the fact is that corporate profits are strong in many sectors. Those piles of cash didn’t come out of thin air.

SOME households are also displaying fearful investment behavior. I’m not referring to those that are struggling with debt and unemployment, but to the segments of our society whose finances have rebounded nicely. These folks are investing in United States Treasuries and money market accounts in record numbers.

If you are among these more fortunate households, you may also be passing up attractive investment opportunities that will earn much more than the 0.01 percent you’re getting from your money market account.

One such opportunity lies in making improvements to your home — assuming, of course, that you aren’t underwater on your mortgage. As a starting point, analyze ways to make your home more energy-efficient. Investing in insulation, windows, heating and air-conditioning and even solar collectors often provides excellent and highly predictable rates of return. Not only will you eventually make money, but you can pat yourself on the back with both hands since you’ll be helping to restart the economy while helping the environment.

Some homeowners are already embracing this idea: one of the economy’s few encouraging signs is that residential remodeling permits were recently up 24 percent over the previous year.

Sure, there is much to worry about these days. But freezing in place is seldom the right strategy. Personally, I am planning to hire someone to repaint my apartment. What about you? Maybe some new gutters?

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