Stories can have a profound effect on our behaviour.Shutterstock

In his recent presidential address to the American Economic Association , Nobel Laureate Bob Shiller drew attention to the importance of narratives in economics and, particularly, in financial markets. This corroborates some recent research by the author and colleagues at the University of Queensland into the psychology of economic behaviour.

When we tell ourselves stories, we link up a number of different events into a coherent whole. In financial markets and across the economy as a whole, these stories not only affect expectations but *are* expectations. And expectations shape behaviour.

Our research shows that the more simple a story, the more it extends and agrees with preconceptions, the more *persuasive* it is. A good story becomes embedded in investors' minds; the story *becomes* the expectation.

If a narrative embedded in the mind of an investor tells a positive story about, for instance, profitability, they will act on it. A positive story results in good news in the financial markets.

The "Trump bump"

An example of what might occur when a powerful narrative spreads across financial markets is playing out right now.

The latest figures from the Australian Bureau of Statistics (ABS) reveal a huge spike in commercial loans last November. Seasonally adjusted, there was a 14.8% increase in commercial finance from the month before.

The strange thing is, this surge occurred at the same time NAB's Monthly Business Survey sho

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businesses were “increasingly concerned about the underlying momentum in the economy as evidence mounts that the non-mining economy is losing steam”.

Businesses expecting a sluggish future don’t suddenly go out and borrow 14.8% more money. But we can see in this graph that for much of the year business finance had been flat or declining. Until it wasn’t.

Now these are aggregate data; they tell us the change in the amount of lending to business done by the financial sector as a whole. Even then, this spike is unusually massive, and therefore in and of itself in want of an explanation.

John Maynard Keynes wrote that surges in finance are supported by two factors: relatively cheap credit and expectations of future returns.

Without strong expectations of future returns, no amount of cheap credit can induce businesses to borrow and invest. This is the famous “liquidity trap”.

Our research shows that a compelling story – one that extends and agrees with preconceptions – would have been sufficient to overcome the liquidity trap. A mathematical principle called the “Chinese Whispers” theorem indicates that for us to see remarkable and sudden changes in economic systems we must be observing the effects of a powerful narrative supporting positive expectations (i.e. future profitability).

Meanwhile, a concept popularly known as “Made To Stick” indicates that a simple story, connecting emotionally charged ideas together while extending and agreeing with preconceptions, is sufficient to become embedded in minds and inform expectations. In our research we demonstrate that this idea is the logical conclusion of a half-century of psychological research on cognitive dissonance, personality and “salience” in perception, as well as some simple mathematics.

You can see this play out in the headlines about the " Trump bump ".

Very soon after the Brexit vote and consistently afterwards, Theresa May indicated an eagerness to strike free trade deals with the US and Australia and Malcolm Turnbull concurred . And while Donald Trump campaigned on anti-trade policies, these excluded the Anglosphere .

Further, the British economy did not collapse following the Brexit vote, and Trump's policy platform included massive infrastructure stimulus , tax cuts and deregulation . Adding to all this, Congress and the Supreme Court are now Republican.

This is a positive narrative for expectations of future returns, because the Australian economy on the whole does not *compete* with the US and UK economies. Rather, we help to supply their demand. We have business to gain by participating in a strong Anglosphere economic bloc, and we have little business to lose.

What do the Mississippi, South Sea and Shenandoah have in common?

Throughout financial history, there are other examples where powerful narratives have driven the markets. John Kenneth Galbraith, in his history of money and the 1929 crash , tells us of at least three spectacular ones.

When King Louis XV granted the Mississippi Company the profits of the colony of Louisiana, its share price rose so high it reflated the French economy. In his book, The Ascent of Money , Niall Ferguson shows us exactly how the narrative about the unbounded wealth of the Louisiana company drove this spread – in pamphlets, cartoons and posters.

When parliament granted the South Sea Company a monopoly over trade with the Spanish American colonies, its shares became so valuable it was for a time decided *it*, rather than the Bank of England, should assume responsibility for the British national debt. The fact its merchants would have to run the gauntlet of the Spanish navy all the way across the Atlantic was conveniently ignored, while the story of fabulous riches from the new world captured the attention of investors.

The narrative of the Shenandoah Corporation beats them all. The initial call for investments was oversubscribed by a factor of *seven*. Why? Because at that time a story was being told about the ability of fund managers applying "investment science" to obtain amazing returns.

"Trust the experts, they'll make you a mint" is a simple story, connecting emotionally charged ideas together while extending and agreeing with our tendency to defer to the advice of the "wise men".

Ignore the force of narrative at your peril

Governments and investors ignore the power of storytelling at their peril. The financial markets are not driven by the "mechanics" of interest rates and money alone. They are driven by one of the most ancient traditions of humanity – stories.

We can lead an investor to liquidity, but we can't make them drink without telling them a story about why it is so very tasty. And if we want to stop them from drinking a really tasty poison, it's not enough to make the poison a bit harder to get. Either it has to be taken away (verboten), or a simple story, extending and agreeing with preconceptions, has to be told about why poison that tastes really nice is still poison.

Brendan Markey-Towler does not work for, consult, own shares in or receive funding from any company or organization that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

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