Behavioural economics: Cryptocurrency and herding

By Udette Kirsch

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Cryptocurrencies refuse to play by the rules. People rely on experts for all sorts of advice, but when it comes to cryptocurrencies, they seek advice from peers and the internet. So, what causes this behaviour, and what are the implications? Hint: it's rooted in behavioural psychology.

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Recent studies suggest that cryptocurrency investors rely less on expert advice and increasingly follow peer investor communities for guidance.

The daily value of South African crypto trading recently exceeded $141 million for the first time, indicating that many South Africans consider the risks of this complex, unregulated market to be acceptable for the returns which it may deliver.

Digital advocates have hailed cryptocurrencies as the “new gang on the block, who refuse to play along with the traditional rules of engagement”.

For the first time, investors feel “freed” from the constraints of financial regulations and can find their own “facts”.

Given that many people find blockchain technology difficult to understand and struggle to explain the excessive volatility in the crypto markets, it is interesting that they rely mainly on online sources, such as social media and social news aggregation websites, to shape their cryptocurrency investment strategies.

The abundance of information from like-minded investors has heralded an era of information-enabled investors. For the first time, the early adopters of blockchain technology and cryptocurrency understood the underlying opportunities and trends better than their knowledgeable financial advisors.

Its value, in essence, is determined by its unique characteristics and similar opinions.

One of the foundations of behavioural economics is the principle that under conditions of uncertainty, complexity and time pressure, people tend to revert to cognitive shortcuts or mental biases.

This, and the growth in popularity of cryptocurrencies, plus an abundance of available information, is driven by something called the network effect. The network effect implies that the more people who participate, the higher the crypto value becomes.

The second factor that plays a role in shaping the price of cryptocurrency is called social judgment.

Social judgment theory states that you accept or reject a statement on your cognitive map. Having already been primed to the opportunity of cryptocurrency by the network effect, “whales” – early adopters in the crypto world – who have amassed vast crypto investments have the power to artificially create exaggerated price swings or speculative bubbles. ‘Crypto Celebrities’ make a proclamation, and vast numbers of followers follow suit.

This sort of volatility concerns institutional financial minds and scares some investors off but equally attracts large volumes of new trade after some off-the-cuff announcements on social media platforms.

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30 Sep 2021

Fertile soil and the herd that follows it

The market for cryptocurrencies seems to provide fertile soil for investor biases to steer decision-making. An obvious example would be the bandwagon effect whereby investors buy cryptos primarily because others are doing it, regardless of their convictions, which they often override or ignore.

A study by Calderon (2018) confirms that crypto investors display herding behaviour when navigating crypto market ambiguity. Investors tend to hold on to their cryptos, even in highly negative conditions, partly explaining the weak link between information and market outcomes. This is typical herd behaviour.

The downside of herds

The flipside of the potential gains to be made from crypto coins is the tendency for herd behaviour to create opportunities for exploitation. South African crypto investors had to stomach two of the largest crypto scams in the world this year. In January, Mirror Trading International disappeared with about 23,000 digital coins, valued at $1.2 billion and in April, Africrypt allegedly absconded with about $4 billion worth of coins.

Although one could argue that the digital revolution has brought a new level of empowerment to consumers, it seems that it has also intensified people's judgment biases.

There are no real reference points to determine the value of cryptocurrencies, and therefore the pricing mechanisms are driven mainly by collective evaluation of the buyers and sellers.

People tend to jump on the bandwagon and mimic the behaviour of others, often on the basis of anecdotal evidence of success stories on social media, without fully appreciating that the human tendency to herd under conditions of optimism or positive news creating market bubbles and crashes.

There is, admittedly, a range of examples in the traditional financial markets where herding behaviour also drives the decisions of many investors. The difference, though, as many South Africans now can attest, is the inherent risks of an unregulated, complex market where "coin-diggers" – those wishing to make a quick buck – can, and do, capitalise on the flaws in human decision-making nature.

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