



Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism

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General Overview:

“Animal spirits” are those elements in the economy that are difficult to measure and quantify – elements like confidence and trust, fairness and corruption, and the role of stories. The authors assert that conventional economic theory has ignored the role of animal spirits to its detriment, for animal spirits help to explain much of what has caused our dire current economic conditions.

Taking animal spirits into consideration on a personal and institutional level will allow people to make better economic decisions, and lead to necessary reform and regulations of the financial institutions.

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Introduction

In Keynesian macroeconomic theory, while most economic activity results from rational economic motivations, much is governed by “animal spirits,” i.e. noneconomic motives. Keynes believed these “animal spirits” were the main cause for economy fluctuations and the main cause for involuntary unemployment.

During the 1970s, the New Classical view of economics arose. In that view, animal spirits should not be considered at all, and thus, the belief that government should not interfere with people’s self-interest influenced national policies across the globe. However, behavioral economics explains how the economy really works when real people act on their human instincts.

The Animal Spirits

In the original use of the term, “animal spirits” refers to a basic mental energy and life force. But in modern economics, it refers to the restless and inconsistent element in the economy, which results from noneconomic motives.

Confidence

Newspapers and pundits tell us that when the economy goes into recession, it becomes necessary to “restore confidence.” Economists have a particular interpretation of the term, using “confidence” to describe how people act on the information at hand to make rational predictions about the future; how positive those predictions are correlate to the measure of confidence. But the very term implies behavior that goes beyond a rational approach to decision-making. At the level of the macro-economy, in the aggregate, confidence comes and goes, sometimes justified, sometimes not – for example, the confidence that caused the recent worldwide real estate bubble. Confidence is the first and most crucial of the animal spirits.

Fairness

Economists know how seriously people take fairness, but for economics as a whole, the notion of fairness has been pushed aside into a back channel of economic thinking. Yet studies of fairness indicate a strong possibility that such concerns will override the effects of rational economic motivation.

In one study, respondents were given a vignette in which a hardware store increased the price of snow shovels in the wake of a snowstorm. The respondents were asked whether such action was acceptable or unfair. Using elementary economics, such a distinction would be irrelevant; the rise in demand should entail a rise in price. However, 82% of the respondents thought the increase in price was unfair and demonstrated that the store was taking advantage of its customers. This response suggests that fairness considerations can trump rational economic motivation.

Corruption and Bad Faith

Some long-term economic fluctuations may be traced to changes in the prominence, and acceptability, of outright corruption. There are also even more significant changes over time in the prevalence of bad faith; that is, economic activity that, while technically legal, has sinister motives. Capitalism produces not what people need, but what they think they need and are willing to pay for.

Today, most consumers are sufficiently knowledgeable that, for the most part, they do not buy things frivolously and many products are subject to safety requirements as a matter of law. But the one field desperately in need of consumer protection, and in which it is especially difficult to provide, is the area of securities.

Each of the last three economic contractions in the U.S. all involved corruption scandals that played a role in determining the severity of those recessions: the July 1990-March 1991 recession was tied to the S&L Scandal; the March-November 2001 recession can be linked to Enron Corporation; and the recession that began in December 2007 is linked to the round of scandals involving subprime lenders. These examples show us that the business cycle is connected to fluctuations in the standard of good behavior as well as fluctuations in predatory activity.

Corrupt behaviors arise because of the perception that people can get away with such behavior, that there will be no penalty. This concept falls within the realm of animal spirits because such cultural changes are difficult to quantify. Indeed, they are rarely connected by economists to economic fluctuation.

Money Illusion

Money illusion happens when decisions are influenced by nominal dollar amounts. In the absence of money illusion, pricing and wage decisions are influenced only by relative costs or relative prices, not by the nominal values of those costs or prices.

Economic textbooks talk about money as a “medium of exchange,” but economists have given little attention to the role of money as a unit of account. Yet that is how most people think of money - contracts, accounting, and many legal provisions are phrased in terms of money. Since accounting is the language of business and the basis for capital decisions, if accounts are in nominal terms rather than in real terms it should follow that the decisions based upon these accounts are based on money illusion.

One of the most important assumptions of modern economics is that people see through the veil of inflation. But given the nature of wage contracts, of price setting, of bond contracts and accounting – all indications of money illusion – this assumption seems implausible.

Stories

The human mind is built to think in terms of narrative, and human conversation tends to take the form of storytelling. Politicians are one significant source of stories, especially about the economy, and these stories can have an impact on the confidence of a nation. While it is considered unprofessional for economists to base their analyses on stories, what if the stories themselves move markets? What if the stories play a real part in how the economy functions? Stories can go viral, spreading by word of mouth and thereby spreading confidence or lack of confidence.

Eight Important Questions and Their Answers

Why Do Economies Fall Into Depression?

Depressions are the extreme versions of recessions, and studying past depressions will place the origins of economic slowdowns in sharper focus.

In the depression of the 1890s, the obvious “trigger” for the depression was the financial panic of 1893. People showed up in droves to withdraw their money from the banks and the banks did not have enough reserves to pay the depositors. At the time, the United States did not have a central bank, which would have served as a lender of the last resort. The run on banks led to chaos, which was the immediate precursor of the economic depression. While scholars dispute the reasons for the severity and length of this depression, there was a sense of unfairness, of rapacity, of selfishness, and of uncertainty about the future.

After the depression of the 1890s, corrections were eventually made that were supposed to prevent a recurrence. While the creation of the Federal Reserve System was intended to prevent the kind of bank run that had started the depression, the new system failed to effectively rein in the biggest stock market boom ever. In an overheated economy, confidence went beyond normal bounds and careless spending by consumers became the norm. Corruption and bad faith ran high. This era peaked with the stock market crash of 1929.

The Great Depression of the 1930s raged on both sides of the Atlantic. Why did it happen? It seems to have been associated with a financial trigger: the worldwide stock market crash in 1929 and its related banking crises. The Great Depression spread from one country to the next through the collapse of the gold standard. Animal spirits were of fundamental importance. There was an intense feeling of unfairness in employment relations and a surge in labor disputes. A sense of instability in business institutions developed, and while there was a need for wage cuts, the public never fully accepted the argument, thanks to money illusion. Money illusion kept people distracted from good economic policy.

The two most significant depressions in U.S. history were characterized by fundamental changes in confidence regarding the economy, in the willingness to press pursuit of profit to antisocial limits, in money illusion, and in changes in the perception of economic fairness. The depressions were intimately linked with these hard-to-measure variables. To the extent that the past events were rooted in human nature, in animal spirits, events like the last two depressions cannot be counted as things of the past.

Why Do Central Bankers Have Power Over the Economy (Insofar as They Do)?

While human foibles can contribute to economic contractions, we still tend to rely on the central bank's ability to set things right. It is viewed by many as the guardian of the money supply. But the money supply is in fact very small: in 2008, the United States' M1 measure of money supply amounted to only \$1.4 trillion, of which \$800 billion was currency.

There are two major ways in which the central bank uses its control over reserves to affect the amount of money and the macro-economy. In open market operations, the Fed expands or contracts the money supply by pouring it into or out of general markets – thereby affecting interest rates but not focusing on any one part of the economy. In rediscounting, or the discount window, the Fed expands credit by lending directly to troubled banks, receiving collateral in return, or contracting credit by accepting the repayment of those loans.

The Fed's open market operations directly affect the interest on what it trades, i.e. short-term, risk-free interest rates. Long-term rates are fairly sensitive to these short term rates, so they are impacted as well. But when the Fed wants to reduce interest rates, as it does in a recession, there is a limit to the usefulness of open market operations.

When the Fed was created, it was empowered to provide credit and also cash for banks that were in temporary need, especially in times of panic. It was the lender of last resort, providing credit when no one else would. The original motivation for providing this elastic currency via the Fed was to deal with confidence and its opposite: panic. The Fed and, subsequently, the FDIC were the clever solutions to liquidity problems that could give rise to bank panics.

Four lines of defense prevent the failure of normal depository institutions from causing a systemic crisis:

1. They are supervised, although the supervision is not foolproof.
2. Institutions are guaranteed liquidity in the event of panic (but not in the event of insolvency).
3. Individual depositors are insured by the FDIC for amounts up to \$250,000.
4. The FDIC has the power to take the bank into resolution, i.e. it can take over the bank's assets and sell them.

But not all institutions of credit are covered by this defense system. A new shadow banking system has sprung up, made up of investment banks, bank holding companies, and hedge funds. The interactions between the Fed and Bear Stearns in 2008 are illustrative of the Fed's concern about the shadow banking system and the possibility that failures there would lead to a financial panic. When Bear Stearns merged with JP Morgan Chase, the Fed gave JP Morgan a \$30 billion line of credit. Why? To avoid a collapse of Bear Stearns, which would create a liquidity crisis and set off a chain reaction.

The credit crunch began for three separate reasons:

1. A standard mode of financing had collapsed.
2. Many financial institutions had themselves invested in the new financial products and were highly leveraged. With the fall in value of their assets, it edged them toward bankruptcy and increased their leverage. The crunch came as they chose to curtail their loans and other securities.
3. Faced with a shortage of credit, customers pulled out cash at an unexpectedly high rate, and meeting these promises put the banks in a further squeeze in terms of their abilities to make new loans.

When faced with the loss of confidence in the financial sector, macroeconomic planners must plan for the amount of credit that is to be granted, corresponding to the credit that would normally be given if the economy were at full employment.

Standard macro models are fairly accurate regarding the monetary-fiscal stimulus needed to achieve full employment. But a second target must also be utilized that targets financial markets. These two targets are needed to give policy makers the confidence and the legitimacy to undertake a bold plan.

Why Are There People Who Cannot Find a Job?

Involuntary unemployment does not conform to many economists' view of economic theory, because they wonder why, if the unemployed are unable to sell their labor, they simply do not ask for a lower wage? Why should the labor market be any different than the stock market or commodities market? The answer is called "the efficiency wage theory," which posits the idea that effectiveness of labor depends on the wage employees are paid. To do good work, a worker must not simply be paid, but also motivated. Involuntary unemployment consists of the gap between the supply of and the demand for labor at the wage that firms are willing to pay.

Under this theory, when unemployment is high, the supply of labor vastly exceeds the demand for it. Thus, we would expect in these times that relatively few people would quit their jobs. Statistics bear this theory out. Additionally, the complex interaction between employer and employee – items relating to fairness and sense of duty – restrict the independence of the employer to set wages freely; the employer must always consider

the effects of the wages on the current workforce. If they make wages too low, employees' willingness to consider the tasks of the workplace their personal responsibility will be undercut. This theory helps to explain why the market's idea of a fair wage is almost always higher than the market clearing wage.

Why is There a Trade-Off between Inflation and Unemployment in the Long Run?

An obvious example of money illusion is that people think wage cuts are unfair; thus, wages are downwardly rigid. Employers think twice before they give their workers wage cuts and union wage contracts rarely provide for them. In those instances where firms have instituted wage cuts, and the workers have viewed them as fair, they have been seen as a last resort, necessary to save their jobs. If workers resist wage cuts, their wages will be higher only when inflation is lower.

Natural rate theory, which most economists follow, has one key assumption: that people do not have money illusion. Natural rate theory does offer a correct insight in that wage and price setting will both be affected by inflationary expectations. But the idea that these inflationary expectations always affect wage setting and price setting one-for-one should be met with skepticism.

Why is Saving for the Future So Arbitrary?

The one way, at least in the past, in which almost everyone could become moderately rich was to save a lot of money and invest it for the long term in the stock market, where the rate of return after adjustment for inflation has been 7% a year. Yet many people, particularly young people, either have not thought about the long-term possibilities of compound interest or cannot seem to attach a clear meaning to saving for the future. We look to our animal spirits – confidence, trust, and fear – for indications of how much we should save. People have a hard time knowing what to save, envisioning themselves in a distant future, and thus are susceptible to different cues in making their savings decisions.

Economists developed the notion that individuals balance the extra benefits of spending at different dates, i.e. save when they are young, build up a nest egg, and dissipate it when they are older. While this is true, the theory says nothing about why saving is so variable, or why, on average, most people under-save, making them vulnerable in old age.

Another theme regarding savings looks to the vast differences in the wealth of nations. In per-capita terms there is more than a 200-fold difference between the per-capita income of the richest countries to the poorest. Some countries, like Singapore and China, have made savings a national priority and have been achieving significant economic growth for decades. Savings and sacrifice are ingrained in their cultural identities; each individual gains self-esteem by making his or her own contribution and there is no shame in being poor, since this is viewed as a transitional state.

Conversely, in the U.S., our lax attitude towards saving is shown in our love affair with the credit card. It is difficult to verify statistically that the rise in credit cards is responsible for the decline in savings, but credit cards do reflect aspects of the American identity that must also be a major factor in the declining savings rate.

Savings policy can be one of the keys to a country's economic growth. Animal spirits explain the puzzle of arbitrariness and variability of spending and saving. Understanding these animal spirits is critical to the design of national policies on saving.

Why Are Financial Prices and Corporate Investments So Volatile?

Obviously, investors are interested in getting rich quickly when the market is soaring and want to protect value when the market is lagging. If people tend to buy when stock prices increase and sell when prices fall, then their reaction has the potential to feed back into more price changes in the same direction, a phenomenon known as price-to-price feedback. A vicious cycle then develops and eventually the bubble must burst. There is also feedback between asset prices in the bubble and the real economy. This additional feedback increases the length of a cycle and amplifies the price-to-price effects.

When stock prices and housing prices go up, people have less incentive to save. The effect of asset prices on consumption is known as the wealth effect on consumption. Asset values also play an important role in determining investment. When the stock market drops in value, companies decrease their expenditures on new plants and equipment. When assets fall in value, debtors will not pay their debt, which then compromises the financial institutions. When these institutions reduce their willingness to make further loans, this causes further drops in the price of the assets.

What does this mean for economic policy? The theories economists typically put forth about how the whole economy works are too simplistic. The time has come to appreciate that capitalism is only allowed to function when regulations assure individuals that when they put their money into the market, they are getting a product with some guarantees.

In the 1930s, the Roosevelt administration set up safeguards to protect the public from the excesses of capitalism. But the financial markets have now changed and become more complex. Rededication to protecting the financial consumer must be one of our highest economic priorities.

Why Do Real Estate Markets Go Through Cycles?

Real estate markets are almost as volatile as stock markets. Such bubbles are driven by the same animal spirits that have been at work elsewhere in the economy. In the late 1990s, the largest home-price boom in U.S. history took place, lasting over a decade before the bust began in 2006. It appears that people had acquired a false, but strong, intuitive feeling that home prices everywhere could only go up. This belief was encouraged by rapidly-spreading stories about real estate wealth, which of course fed the boom.

The evolution of economic institutions related to housing also helps explain why the bubble reached such dimensions. Allegations of unfairness in opportunities for minorities to participate in the boom led to immediate action; the government responded by aggressively increasing the mandated lending by Fannie and Freddy to underserved communities. That meant lowering credit standards and relaxing the requirements for documentation from borrowers, which meant it was easy for mortgage lenders to justify loosening their own lending standards, which led to corruption in the subprime lender market.

Why Is There Special Poverty Among Minorities?

Today, despite the fact that more than half of African Americans have incomes more than double the poverty line, the African American poverty rate is still triple that of the white rate, and black unemployment remains double that for whites. The problems of the poorest African-Americans go beyond mere poverty, extending into crime, drug and alcohol addiction, and welfare dependency. The solution to these problems is America's great unfinished business, so large in scope that any book on macroeconomics would be incomplete without discussing them.

The standard view from economics is that African Americans are poorer because they have few skills and few financial assets and because they face discrimination. But the role of stories, of us versus them, of the search for self-respect and of fairness is absent in the standard economic analysis of poverty.

All immigrant groups have their own stories of discrimination, but for African Americans and Native Americans, the injustice is qualitatively different. What is to be done?

Affirmative Action can play a significant role in breaking down the barrier between the America of whites and that of blacks. First is its symbolism. Affirmative Action indicates that whites care about blacks. Naysayers declare that Affirmative Action is wrong, that government measures are ineffective, and the difference should be left to the market. But these naysayers fail to understand that there are many interfaces between African Americans and federal and local governments, the most obvious of which is schooling. It is precisely because schools have such problems in educating poor minorities that there is a special need for resources to deal with them. When these resources have been made available, they seem to make a significant difference.

Another potential interface is providing more good government jobs for African Americans. We must try to mute these racial differences. In this instance, the market is not enough.

Conclusion

Conventional economic theories exclude the changing thought patterns and modes of doing business that bring on a crisis. These theories exclude the loss of trust and confidence, of fairness, and corruption, of money illusion and the role of stories.

We must incorporate animal spirits into macroeconomic theory in order to understand how the economy really works. On a personal level, an accurate view of our economy is necessary to make correct individual decisions, such as how much we should save, where we should invest, etc. It is also urgent that we set up committees and commissions to develop the reforms and regulations in financial institutions that are so immediately needed.

The solutions to our economic problems can only be reached if we pay due respect in our thinking and in our policies to the animal spirits.

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