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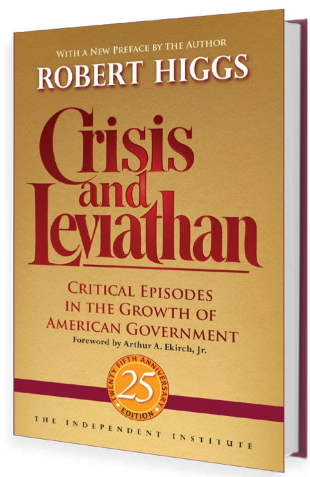

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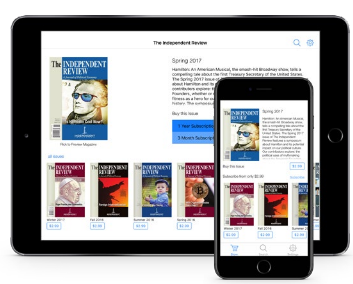

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REVIEW ESSAY

Animal Spirits

Arnold Kling

George A. Akerlof and Robert J. Shiller are highly creative economists who have spent much of their careers exploring what is now called "behavioral economics," meaning the intersection between psychology and economics. Their new book, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism,* is a summary of what this approach has accomplished, written to be accessible to an intelligent layman and keyed to the 2008 financial crisis.

The book represents both an assault on mainstream economics and an assault on the disposition toward free markets and minimal government. I am more persuaded by the criticism of mainstream economics than by the criticism of free markets.

Akerlof and Shiller wish to claim John Maynard Keynes for membership in the school of behavioral economists. "Keynes appreciated that most economic activity results from rational economic motivations—but also that much economic activity is governed by *animal spirits.* People have noneconomic motives. And they are not always rational in pursuit of their economic interests. In Keynes' view, these *animal spirits* are the main cause for why the economy fluctuates as it does. They are also the main cause of involuntary unemployment" (p. ix, emphasis in original). However, this view was later dropped as "Keynes' followers rooted out almost all of the animal spirits—the noneconomic motives and irrational behaviors—that lay at the heart of his explanation for the Great Depression. They . . . minimized the intellectual distance between *The General Theory* and the standard *classical* economics [in which] people act only for economic motives, and they act only rationally" (p. x, emphasis in original).

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Akerlof and Shiller position their work as a revival of the lost Keynesian tradition. "With the advantage of over seventy years of research in the social sciences, we can develop the role of animal spirits in macroeconomics in a way that the early Keynesians could not. And because we acknowledge the importance of animal spirits, and accord them a central place in our theory rather than sweep them under the rug, this theory is not vulnerable to attack" (p. xi).

Readers familiar with Keynes will realize that Akerlof and Shiller have taken poetic license with the term *animal spirits*. For Keynes, it characterized the entrepreneur's decision to undertake investments in the absence of sufficient information to gauge the probability of success. To me, the term has always carried a connotation of man's attempted grasp for immortality, not unlike rearing children or donating funds to a university for a building that will bear one's name. However, after alluding to the narrower interpretation of the term pertaining to entrepreneurial investment decisions, the authors state, "But in modern economics animal spirits has acquired a somewhat different meaning; it is now an economic term, referring to a restless and inconsistent element in the economy. . . . Sometimes we are paralyzed by it. Yet at other times it refreshes and energizes us, overcoming our fears and indecisions" (pp. 3–4). I would have preferred that Akerlof and Shiller use a different term for the broader set of irrational influences on economic behavior. Clarity is served by limiting the term *animal spirits* to entrepreneurial investment under uncertainty.

Under the broader rubric of animal spirits as they define it, Akerlof and Shiller cite five factors that cause behavior to deviate from rationality, devoting one chapter to each of them: confidence, fairness, corruption and antisocial behavior, money illusion, and stories.

Concerning confidence, they write: "When people are confident they go out and buy; when they are unconfident they withdraw, and they sell. Economic history is full of such cycles of confidence followed by withdrawal" (p. 13). In their view, consumer confidence is an independent causal factor that mainstream macroeconomists have mostly ignored. One implication is that when confidence is low, fiscal and monetary policy levers have to be worked harder. "As a result, the usual fiscal multipliers, from increased government expenditures or from decreased taxes, will be smaller—probably much smaller" (p. 17).

Akerlof and Shiller believe that economists underestimate the importance of fairness. "[Akerlof and Rachel Kranton] have shown that a great deal of what makes people happy is living up to what they think they should be doing. In this sense most of the time people want to be fair. . . . People get upset . . . when they think others are not being fair" (p. 25). The authors think that this concern for fairness is one reason wages do not adjust downward to clear the labor market of involuntary unemployment.

Another important issue is corruption (outright criminal behavior) and bad faith (predatory behavior that falls within the letter of the law). "But the bounty of capitalism has at least one downside. It does not automatically produce what people really need; it produces what they *think* they need, and are willing to pay for. If they are willing to pay for real medicine, it will produce real medicine. But if they are also willing to pay for snake oil, it will produce snake oil" (p. 26, emphasis in the original). They see people as particularly vulnerable to snake oil when it comes to securities markets and saving for the future. "Just as it is possible to hawk fraudulent medicine by claiming that it does something that it will not do, it is also possible to hawk stocks, bonds, or credit by misrepresenting the corporate books" (p. 28). They regard government vigilance and laxity as determinants of the extent of corruption and bad faith. "Memories of major government crackdowns against corruption fade over time. In a time of widespread corrupt activity, many people may get the impression that it is easy to get away with it . . . [and] corruption feeds back into more corruption" (pp. 38–39).

In the chapter on money illusion, Akerlof and Shiller suggest that in addition to individual shortcomings in overcoming money illusion, various institutional rigidities make economic activity not neutral with respect to inflation.

Finally, they stress the importance of stories. "Social psychologists Roger Schank and Robert Abelson have argued that stories and storytelling are fundamental to human knowledge. People's memories of facts are, they argue, indexed in the brain around stories" (p. 51). They recall Shiller's study of the Internet bubble (Shiller 2000): "The stories of young people making fortunes were a contemporary reenactment of the nineteenth-century Gold Rush. The steady progress of technology, which has dominated economic growth for centuries . . . has never attracted the public's interest. Those stories are not popular. . . . But with the Internet, the economy literally got carried away with the story" (p. 55). Indeed, stories are a powerful communication tool. Shiller's *story* of the Internet bubble is itself an excellent illustration.

Each of the next eight chapters asks a question that the authors claim can be answered only with reference to the five types of animal spirits. All but one of the questions deals with macroeconomic or financial puzzles. The last chapter, which seems out of context, asks, "Why is there special poverty among minorities?"

The first question asks how something such as the Great Depression can occur. Akerlof and Shiller believe that there is something to the popular notion that the economy became overheated in the 1920s and that this overheating caused a crash. They define an overheated economy as one "in which an increasing fraction of people have lost their normal skepticism about the economic outlook and are ready to believe stories about a new economic boom. It is a time when careless spending by consumers is the norm and bad investments are made, with the initiators of those investments merely hoping that others will buy them out. . . . [C]orruption and bad faith run high, since they rely on trusting behavior on the part of the public and of apathetic government regulators. This corruption, however, is mostly recognized publicly only after the fact, when the euphoria has ended" (p. 65). When such a bubble of confidence collapses, the mood swings too far in the opposite direction. People have so little trust that investment and economic activity contract. In describing the collapse of confidence in the 1930s, Akerlof and Shiller go so far as to cite criticism of the New Deal. "Economic historian Robert Higgs concludes that in the United States, 'Taken together, the many menacing New Deal measures, especially those from 1935 onward, gave businesspeople and investors good reason to fear that the market economy might not survive in anything like its traditional form and that even more drastic developments, perhaps even some kind of collectivist dictatorship, could not be ruled out entirely.' Such worries drove business investment to very low levels and brought corporate plans for expansion to a standstill" (p. 70, quoting Higgs 1997). However, whereas Higgs (2006) discounts the role of World War II itself in ending the Depression, the authors write: "When Keynesian borrowing and spending finally took place—to fight the war—unemployment vanished" (p. viii).

Regarding the current economic crisis, the authors write, "The public now looks to the still-existing financial structure of depository banks, bank holding companies, insurance companies, retirement funds, hedge funds, investment banks, and others to fill in the void that has been left by Humpty-Dumpty's sudden fall. It is our belief—echoing Keynes' view of the role of macro policy—that if there is a macroeconomic void the government must fill it" (p. 90). They argue for what they call a "two-target" approach. One of the targets is the level of aggregate demand, at which conventional fiscal and monetary policy should be aimed. The other target is a credit target, which means ensuring "the financial flows—the issuance of commercial paper, bonds, and other instruments—that are associated with full employment" (p. 96).

Although elsewhere they cite the work of Hyman Minsky (1986), this emphasis on financial flows is inconsistent with Minsky's ideas, which otherwise have some similar components. Minsky, like Akerlof and Shiller, believed that aggregate mood swings affect investment. He referred to "hedge finance," when firms are cautious and fund expansion out of retained earnings; "speculative finance," when firms borrow prudently to fund expansions; and "Ponzi finance," when firms borrow to pay off previous loans. After a period of Ponzi finance (which seems to characterize the 2005–2007 experience, at least as far as mortgage loans are concerned), the economy reverts to hedge finance. If this view is correct, then financial intermediation is likely to shrink, and business profits instead are likely to be the key to recovery.

Other chapters apply psychological insights to explain unemployment (as indicated earlier, the argument is that norms of fairness inhibit downward wage adjustments) and why there is an unemployment-inflation trade-off (combining downward wage rigidity with money illusion).

Akerlof and Shiller see a need for government to protect consumers from a tendency to make poor financial decisions. They argue that consumers make saving and spending decisions for reasons of cultural conformity rather than optimal lifecycle planning. The authors see financial prices, including the prices of oil and real estate, as inordinately volatile. They attribute this volatility to rapid changes in the dominant "stories" in investors' minds. For example, when oil prices rise, stories of long-term scarcity spread, leading to further increases and more stories. When oil prices start to fall, stories about scarcity disappear from the news media.

In their conclusion, the authors write,

> Indeed, if we thought that people were totally rational, and that they acted almost entirely out of economic motives, we too would believe that government should play little role in the regulation of financial markets, and perhaps even in determining the level of aggregate demand.
>
> But, on the contrary, all of those animal spirits tend to drive the economy sometimes one way and sometimes another. Without intervention by government the economy will suffer massive swings in employment. And financial markets will, from time to time, fall into chaos. (p. 175)

Overall, Akerlof and Shiller have given us an interesting and useful picture of human behavior and how our various foibles may cause dramatic economic outcomes, such as bubbles, crashes, and periods of high involuntary unemployment. However, they combine this sophisticated perspective on the way humans behave in the context of markets with a rather naive perspective on the way humans behave in the context of government. They use parenting as a metaphor for government. "The proper role of the parent is to set the limits so that the child does not overindulge her animal spirits. But those limits should also allow the child the independence to learn and to be creative. The role of the parent is to create a *happy home,* which gives the child freedom but also protects him from his animal spirits. This happy home corresponds exactly to Keynes' position (and also our own) regarding the proper role of government" (p. ix, emphasis in original). The analogy embedded in their metaphor is that adults in government are to adults in the private sector as adults in a family are to children in that family. This parallel would imply that just as parents have more wisdom and greater moral development than children, adults in government have more wisdom and greater moral maturity than adults in the private sector. Unfortunately, the authors do not examine this assumption explicitly, even though it clearly favors government intervention. In fact, once we grant the parent-child analogy, it follows even without doing any economic analysis that government should be in charge.

To see why this view is problematic, consider the problem of human frailty in making investments. As a result of the 2008 financial crisis, many individuals lost 25 percent or more of the value of their individual retirement accounts. At the same time, state and local pension funds lost similar amounts. To me, this similarity suggests that government control over savings does not eliminate the human-frailty factor.

Once we drop the assumption (or should I say the *story* of government?) that human beings in government are fundamentally superior to human beings in the private sector, the case for increasing the scope of government decisions and restricting the scope of private decisions becomes much trickier to make. Public-choice theory, which Akerlof and Shiller ignore, would say that we should examine how the incentives and constraints faced by government decision makers are likely to affect outcomes. Then we can analyze how their decisions are likely to compare to the decisions made in the private sector given the incentives and constraints that operate there.

Shiller and Akerlof have given us good arguments for paying attention to the ways that private-sector behavior is influenced by animal spirits as well as by incentives and constraints. However, their arguments do not override public-choice considerations. Indeed, public-choice theorists might wish to look at how government officials, too, may be affected by animal spirits as well as by incentives and constraints.

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