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# 4 Book Reviews on global economy and geopolitical readings

*ESADEgeo, under the supervision of Professor Javier Solana  
and Professor Javier Santiso*



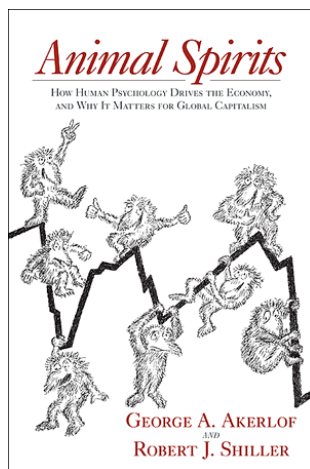
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Obra Social "la Caixa"

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

**George A. Akerlof and Robert J. Shiller (2009), Princeton University Press.**



We will only come to have real insight into major economic events if we face the fact that their causes are mainly of a psychological nature.

For government, acknowledging the importance of *animal spirits* represents the opportunity to reformulate its participation in the economy.

Without government intervention, the economy will undergo massive fluctuations.

The time has come to take into account that what enables capitalism to work are the regulations that ensure that when citizens invest their money in the market, take out a mortgage or buy a car, they receive a product with certain guarantees.

## Basic idea and opinion

*Animal Spirits* explains how the central premise of orthodox economic theory today – that all the individuals who participate in the economy are always driven by economic motives and that their behaviour is always rational – is radically mistaken. The authors show, rigorously and systematically, that many economic activities are governed by what Keynes called “animal spirits”: stimuli that are not economic as such, and decisions that are not purely rational. Only if we bear in mind these five “animal spirits” can we give the right answers to fundamental questions posed by economic theory.

## The authors

George A. Akerlof (1940) is a US economist and professor at UC Berkeley. Together with Michael Spence and Joseph E. Stiglitz, he was awarded the 2001 Nobel Prize for Economics, for their models of markets with asymmetric information. He graduated from Yale (1962) and took his PhD at the MIT (1966) under the supervision of the 1987 Nobel laureate Robert Solow. He has also taught at the London School of Economics.

Robert J. Shiller (1946) is a US economist, professor at Yale University and Fellow of the Yale International Center for Finance. He was a researcher for the National Bureau of Economic Research until 1980 and Vice-President of the American Economic Association (2005). His book *Irrational Exuberance* (2000) was one of the great economics bestsellers of the last decade. He co-founded the investment firm MacroMarkets LLC and developed one of the most frequently used indexes in the US for real estate market prices.

## Animal spirits

Akerlof and Shiller start from Keynes's approach, according to which many economic activities are governed by what Keynes himself called "animal spirits": motives that are not economic as such and decisions that are not purely rational.

If the purpose of economic science is to understand the economy as it actually behaves, in the opinion of the authors the current model is completely unsatisfactory, insofar as it is only capable of explaining how the economy would work if the only type of conduct in existence were based on economic motives and rational behaviour. But economic reality is – and will always be – conditioned by conduct that is neither purely economic nor purely rational.

Consequently, in order to understand the economy it is important to understand how it is affected by these *animal spirits*, since only from this perspective can we reach a correct explanation for the instabilities that underlie capitalism.

Since *animal spirits* are difficult – if not impossible – to reduce to a mathematical formula and introduce into an econometric model, the economic science of recent decades, in its quest to become purer and more *scientific*, has opted to ignore them. But economic history shows us that these *spirits* quite definitely form part of reality, and that when they are not taken into account, economic theories and policies alike therefore inevitably fall into serious error.

Akerlof and Shiller devote the first part of their book to describing "five different types" of *animal spirits* and the way they affect economic decisions. The second and most extensive part is dedicated to demonstrating how eight fundamental questions in economics cannot be properly understood if we overlook these five *animal spirits*. The

traditional answers – those of orthodox classical economics – to these eight questions are replete with errors and misleading because they fail to recognise how economic forces are conditioned by these five *spirits*.

## Part One: The five “animal spirits”

**Confidence.** This is the most determining of all animal spirits for the economy. Confidence is fundamentally “irrational”: it occurs when people do not analyse rationally the information they have at hand, or even if they do, they fail to act by it. Confidence means that people act in accordance with what they *believe* to be true. The current financial crisis is, to a large extent, a consequence of the low level of confidence. Therefore, say the authors, the State must intervene to counteract this lack of confidence and bring the flow of credit back to the level needed to restore full employment.

**Fairness.** The factors involved in wage determination are very different from those specified by neoclassical theory: the main factor is in fact people’s perception of fairness (or so numerous studies confirm). Economists use a theory of fairness – or of fair exchange – that is too restrictive. According to the authors, only a correct (socio-psychological) theory of fairness can account for such elementary facts as unemployment.

**Corruption, fraud and bad faith.** “Some economic fluctuations may be traced,” write Akerlof and Shiller, “to changes over time in the prominence, and the acceptance, of outright corruption.” All the recent economic recessions in the US have been related to some scandal involving fraud or corruption: e.g., Enron and its fraudulent abuse of accounting principles was directly related to the 2001 recession; and subprime mortgages are the base of the recession that started in 2007. It is crucial to meet corruption and bad faith with appropriate punishment.

**Money illusion.** Money illusion occurs when economic decisions are based on the nominal value of money; on the other hand, when there is no money illusion, prices and wages are determined by costs and relative prices, not by their nominal values. For the authors, the fundamental assumption of current orthodox macroeconomics – that the workers are not affected at all by money illusion – should be called into question. There is a multitude of examples that demonstrate that it does indeed exist: some union agreements do not index wages to real inflation, and the same is true of finance contracts (in the case of government bonds the interest rate does not vary to account for inflation).

**Stories.** The human mind is made to think in terms of narratives: sequences of events that have an internal logic and constitute a unified set. And people’s motives – including economic ones – are based on these narratives, which Akerlof and Shiller call “stories”. Our “stories”, individual and collective alike, move markets. Although they

may not reflect objective data, they have a real economic effect. “Stories” are a powerful source of confidence or lack of it, and they spread in the same way as an epidemic does: they can transmit confidence or mistrust at great speed. Many memorable economic booms have been preceded or accompanied by “stories” of a *new age*.

## Part Two: Eight basic questions and their answers

**1. Why do economic systems fall into depressions?** Historically, all depressions have been associated with various *animal spirits*. For example, the depression of the 1890s was a consequence of a breach of *confidence* associated with *stories* about recent economic failures, an increase in *corruption* during the years leading up to it, and a growing sense of the *unfairness* of the policies introduced in response to the crisis.

**2. Why do central banks have power over the economy (insofar as they do)?** A central bank can influence the amount of money in circulation by i) open market operations, through which it affects interest rates and therefore the total volume of credit, ii) direct loans to private banks in difficulties, thus also increasing the volume of credit in the economy and generating confidence. In the first case, the money reaches the whole of the economic system in general, whereas in the second it is transferred to those financial institutions that actually need it and this generates confidence in the system. With a view to the current crisis, the authors recommend encouraging credit by means of this second method.

**3. Why are there people who cannot find a job?** Employers do not usually pay their workers the market clearing wage (the minimum wage the worker would be willing to accept), but rather the so-called *efficiency wage*, which is always a little higher. The reason for this is very straightforward, and has to do with fairness: in this way, employers ensure, in the most practical way possible, worker satisfaction, motivation and performance. With the market clearing wage, supply and demand of labour coincide: everybody finds a job. But with the efficiency wage, the supply of labour will always be greater than the demand, and therefore unemployment will exist.

**4. Why is there a trade-off between inflation and unemployment in the long run?** If there is money illusion, there will be a trade-off between inflation and unemployment – because with full employment workers ask for wage increases. But high inflation will only occur with very low unemployment, which should allow macroeconomic policy to put the employment rate at very high values. But if money illusion did not exist – as the neoclassical orthodoxy holds – the economy would work very differently: there would only be one level of unemployment that generates neither inflation nor deflation, the so-called *natural rate of unemployment*. Thus, according to the neoclassical orthodoxy, macroeconomic policy must always pursue the lowest possible inflation and disregard the level of unemployment, as the latter will stabilise anyway at its *natural rate*. The theory of the *natural rate* has become the foundation of the

economic policy of most of the world's governments and central banks. This is why, according to the authors, macroeconomic policy is not helping to reduce unemployment.

**5. Why is saving for the future so arbitrary?** For orthodox economic theory, saving responds to a rational economic motivation. But people are unrealistic (irrational) in their projections for the future. We are over-optimistic due to the *stories* we are told about our lives. As a result, government must implement policies to guarantee sufficient retirement pensions: without Social Security people would always save too little.

**6. Why are financial prices and corporate investments so volatile?** Share prices are assumed to reflect objective foundations, such as interest rate trends or expected profits. But in fact not only are the fluctuations of the stock market throughout history impossible to predict; it has even been impossible to provide a rational explanation for them after the event. *Confidence*, *fairness* and *stories* (encouraging or otherwise) intervene decisively in investment decisions, and also in the feedback between financial markets and the real economy.

**7. Why do real estate markets go through cycles?** There is no rational reason to expect the real estate sector to be a good investment in general terms; this belief is based on popular narratives. Property investment is unsafe – housing prices can fall, and have often done so – and unprofitable: the stock market yielded an average annual return of 7% throughout the 20<sup>th</sup> century, whereas real (not nominal) housing prices only increased 0.2% per annum in the same period.

**8. Why is there special poverty among minorities?** Economic inequalities between blacks and whites are based on an *us* (the blacks) and *them* (the whites) *story*. The *story* told by the black working class is quite different from that told by the white working class: the latter consider that failure is the outcome of either bad luck or lack of effort in a world with equal opportunities, while the former consider that they have been dealt a bad hand in the game of capitalism (in terms of start-up resources) in a hostile, unfair and inequitable world. The poverty of Afro-Americans is not an individual matter: beyond the lack of resources, they live a special *story*, that of their exploitation in the US. Governments should attack the causes of this poverty, through positive discrimination, the improvement of schooling in these communities, public jobs and a rehabilitation-oriented prison system.