After asking [Alan] Greenspan a few questions, the chairman of the House Committee on Government Oversight and Reform, California Democrat Henry Waxman, summed up. ‘In other words,’ he said, ‘you found that your view of the world, your ideology, was not right. It was not working.’

‘Precisely,’ replied Greenspan. ‘That’s precisely the reason I was shocked, because I had been going for forty years or more with very considerable evidence that it was working exceptionally well.’

Justin Fox 2009

The financial and economic crisis through which the world is passing has brought a renewed interest in the 1936 masterpiece of John Maynard Keynes, The General Theory of Employment, Interest and Money. But this does not herald the return of the false version of Keynes that prevailed in the 1960s and 1970s, which alleged that his argument is dependent on the assumption of sticky wages, or that his policy position can be represented by the so-called Phillips Curve. Rather, the present interest is focused on what he had to say about uncertainty and its relation to decisions to invest, best summed up by Keynes himself in the words ‘animal spirits’.

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3 In response to this interest, three leading scholars of Keynes have written new books — Peter Clarke, Keynes. The Rise and Fall and Return of the 20th Century’s Most Influential Economist; Paul Davidson, The Keynes Solution. The Path to Global Economic Prosperity, and Robert Skidelsky, Keynes. Return of the Master.
Akerlof and Shiller have drawn upon this phrase and the ideas associated with it to promote their view that contemporary macroeconomics is deficient because it is based on the assumptions of rational thinking and economic motives, failing as it does to take account of certain psychological or behavioural propensities that are also responsible for economic decisions. According to the authors:

The real problem...is the conventional wisdom that underlies so much of current economic theory. So many members of the macroeconomics and finance profession have gone so far in the direction of ‘rational expectations’ and ‘efficient markets’ that they fail to consider the most important dynamics underlying economic crises. Failing to incorporate animal spirits into the model can blind us to the real sources of trouble. (p.167)

The aim of their book is to reconsider the ‘fundamental message of The General Theory’ — that ‘the economy is not just governed by rational actors, who “as if by an invisible hand” will engage in any transaction that is to their mutual economic benefit, as the classicists believed’ (pp.viii–ix). Instead, like Keynes, they assert that ‘much economic activity is governed by animal spirits.’

In The General Theory, Keynes dealt with the issue of ‘animal spirits’ — he mentions the term on three separate occasions — in Chapter 12, which is headed ‘The State of Long-Term Expectation’, surely the most important chapter of the book. There, Keynes spoke of:

…the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits — of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. (p.161)

And he went on: ‘if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die; though fears of loss may have a basis no more reasonable than hopes of profit had before.’ (p.162) Keynes wrote:

We should not conclude from this that everything depends on waves of irrational psychology. On the contrary, the state of long-term expectation is often steady...[but]...We are merely reminding ourselves that human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for
making such calculations does not exist; and that it is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance. (pp.162–3)

What do Akerlof and Shiller mean exactly by ‘animal spirits’? ‘People’, they contend, ‘have noneconomic motives. And they are not always rational in pursuit of their economic interests…these animal spirits are the main cause for why the economy fluctuates as it does.’ (p.ix) The authors present the essence of the problem in the following arresting way:

Picture a square divided into four boxes, denoting motives that are economic or noneconomic and responses that are rational or irrational. The current model fills only the upper left-hand box; it answers the question: How does the economy behave if people only have economic motives, and if they respond to them rationally? But that leads immediately to three more questions, corresponding to the three blank boxes: How does the economy behave with noneconomic motives and rational responses? With economic motives and irrational responses? With noneconomic motives and irrational responses? (p.168)

For Akerlof and Shiller, ‘the answers to the most important questions regarding how the macroeconomy behaves and what we ought to do when it misbehaves lie largely (though not exclusively) within those three blank boxes. The goal of this book’, they proclaim, is ‘to fill them in.’ (p.168)

In Part One they nominate five categories of animal spirits: confidence, or the lack of it; fairness; corruption or bad faith; money illusion; and ‘stories’. These ‘irrational’ and ‘non-economic motives’ are claimed to be major influences in the determination of economic decisions. Confidence (or its reverse), they argue, tends to grow as the momentum of activity builds in one direction or the other and soon dominates economic decision-making; a sense of fairness as to how well people are treated can also influence economic decisions, as in wage negotiations; corruption relates to how people take advantage of others, as in the case of the sale of sub-prime mortgages to persons who have no possibility of servicing their debt; money illusion is when decisions are made on the basis of nominal values rather than upon the basis of real values; and economic decisions are often based on stories, such as the common assertion that house prices will continue to rise, as they had in the past.

4 Those with a knowledge of the history of economic thought will recall at this point the famous article by J. H. Clapham, published in the Economic Journal in 1924, which bore the title ‘Of Empty Economic Boxes’ (Clapham 1924).
In Part Two — which contains the substance of the work — the authors apply their examples of animal spirits to various macroeconomic situations, the intention being to demonstrate the significance of animal spirits for particular market outcomes and historical events. They examine eight questions which, they claim, cannot be answered satisfactorily without invoking the idea of animal spirits. The questions (p.6) are: ‘Why do economies fall into Depression?’ ‘Why do central bankers have power over the economy (insofar as they do)?’ ‘Why are there people who can’t find a job?’ ‘Why is there a trade-off between inflation and unemployment in the long-run?’ ‘Why is saving for the future so arbitrary?’ ‘Why are financial prices and corporate investment so volatile?’ ‘Why do real estate markets go through cycles?’ And ‘Why does poverty exist for generations among disadvantaged minorities?’ When applying animal spirits, for example, to fluctuations in share prices, investment spending and prices for real estate, the authors claim that a combination of confidence (optimism and pessimism), stories (house ownership is the best investment a person can make, and prices for houses never fall) and bad faith (teaser loans that are reset after a year or two) needs to be highlighted.

The government, Akerlof and Shiller argue (as Keynes did earlier), must be called upon to tame the ill-effects of our animal spirits. ‘We have forgotten’, they assert, ‘the hard-earned lesson of the 1930s: that capitalism can give us the best of all possible worlds, but it does so only on a playing field where the government sets the rules and acts as a referee.’ (p.173) ‘Such a world of animal spirits’, they claim, ‘gives the government an opportunity to step in. Its role is to set the conditions in which our animal spirits can be harnessed creatively to serve the greater good. Government must set the rules of the game.’ (p.173)

But what form should government intervention take? Here the authors are somewhat vague, eschewing ‘detailed answers’. One concrete proposal is that the monetary authorities should set a target for the growth in credit, the object being to contain both irrational exuberance and pessimism. ‘This target’, they argue, ‘should correspond to the credit that would normally be given if the economy were at full employment. The target should not be merely a mechanical credit aggregate, but should reflect the more general condition that credit be available for those who, under normal conditions, would be deserving of it.’ (p.89)

Akerlof and Shiller have written a book that deserves to be read widely. It is not a long book — some 176 pages of text, with another 40 pages of notes and references — and is written in a style that will appeal to non-economists, devoid as it is of jargon and mathematics. Yet there are aspects of the argument that are not beyond criticism. For what is offered is a series of examples of how the idea of animal spirits can be applied to issues of concern in macroeconomics, rather than a coherent and integrated model of the dynamics of the macroeconomy.
Above all, there is a tendency to argue by definition: a decision is often simply asserted to be irrational or based on a non-economic argument. Others, however, might equally assert that the action taken was entirely rational or based purely on economic considerations. In short, this is a prospectus for further research, rather than a comprehensive treatise that establishes a new and integrated apparatus for thought and analysis.

Reference