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Reviews

Animal Spirits: How Human Psychology Drives the Economy, and Why it Matters for Global Capitalism, by George A. Akerlof and Robert J. Shiller (Princeton University Press, Princeton and Oxford, 2009), pp. 230.

This entertaining book takes up the theme that psychology matters for economics. Akerlof and Shiller introduce this idea in the guise of 'animal spirits' that they define to mean five things: (1) **confidence** (beliefs about what will happen can independently influence outcomes); (2) **fairness** (wage setting depends on concerns for what others receive); (3) **antisocial behavior** (some bankers are criminals); (4) **money illusion** (people are confused about money prices versus real prices); and (5) **stories** (people believe what friends and the media tell them).

In the first five chapters, the authors elaborate on each of their five meanings of animal spirits. In the following eight chapters they use their ideas to address eight different questions ranging from why economic depressions occur to the state of poverty amongst minorities. A recently added postscript to a chapter on the power of central bankers presents their solution to the current financial crisis.

I will make three points in this review. First, although there is much to be said for the authors' proposal that psychology matters, their definition of animal spirits is far too broad. In spite of its faults, there is much to like about neo-classical economics, and jettisoning almost all of it at once, as the authors do in this book, will be too radical for many, including myself, to accept. Second, there is an extensive existing body of research, developed over the last 25 years, that integrates animal spirits into economics using a much narrower definition than the one proposed in this book.[1] This body of research achieves most of the goals of Akerlof and Shiller without giving up on the idea of rational behavior. Third, although the authors are on target in their attack on orthodoxy, they do not provide a credible alternative theory to classical or Keynesian economics. Instead, their policy advice is based on Keynesian ideas that were tried and failed in the 1970s.

Let me start by defending neoclassical theory, which, in spite of its many faults, also has many successes. At the core of neoclassical economics is the idea of rational choice. Akerlof and Shiller want to replace rational choice with behavioural economics, an approach that argues that psychological (and in some cases neurological) evidence can be used to judge the validity of economic theory. Behavioural economists assert that what makes individuals truly happy can be different from what they in fact choose to do. In Akerlof and Shiller's words, '…capitalism…does not automatically produce what people really need; it produces what they *think* they need…' (p. 26). To a classical liberal like me, this is a scary proposition since it gives a licence to someone else, someone who *knows my true preferences*, to act on my behalf. Is this the government or the church? Both institutions have claimed that right in the past, with disturbing outcomes.

I personally find it much more credible to believe that markets may sometimes misallocate resources and that this misallocation is directed by self-fulfilling crises of confidence. There is an existing agenda (part of neoclassical economics) that integrates psychology with economics by constructing economic models in which market fundamentals do not uniquely determine outcomes. In these models, it is the self-fulfilling beliefs of market participants that fill the gap. In my view, this idea of a self-fulfilling belief is a more appropriate candidate for what one should mean by animal spirits than the five alternative meanings proposed by the authors. This narrower established definition is already widely used by a large existing body of researchers.

[1] See my entry, 'Animal Spirits' in *The New Palgrave Dictionary of Economics* (2008) for references to this extensive literature, and my 1993 book on the macroeconomics of self-fulfilling prophecies. Recent contributions that integrate news, self-fulfilling expectations and uncertainty shocks into otherwise neoclassical models include Beaudry and Portier (2004), Harrison and Weder (2006), and Bloom (2009).

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The distinction between the established definition of animal spirits and the Akerlof-Shiller reinterpretation is not inconsequential. In the current climate, Keynesian economics is once more fashionable and policy makers across the Western world are again favoring Keynesian policies. It is more important than ever, if we are to play the role of social engineers, that economists get the science right.

It is hard to disagree with the authors' claim that some important ideas from Keynes' *General Theory* (1936) have been neglected by recent macroeconomists. But Akerlof and Shiller go further. They claim that

> …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 … this theory is not vulnerable to attack. … This theory is especially needed in the context of the current recession. Above all policy makers must know what to do. (p. xi)

In the postscript to chapter 7 we learn just what the authors have in mind. They conclude that we need much more of the two kinds of fiscal and monetary stimulus that have been applied already by the Obama administration and, in addition, we need a 'credit target', by which they mean that the Fed should provide much more credit to the private sector through direct lending. Although these policies *might* make sense – and that has been questioned by many – the book does not connect the five meanings of animal spirits together into a coherent theory that explains *why* they make sense. Without this connection we are left with a set of assertions that academics should not have jettisoned the *General Theory* so quickly.

By attacking classical theory on so many fronts at the same time, Akerlof and Shiller have torn down the house and left us without a shelter from the storm. The message of the book is that Keynes was right and that aggregate demand must be managed to restore full employment. It is my personal view that this message is on target. But orthodox Keynesian economics was discredited in the 1970s and there are compelling grounds to be skeptical that fiscal and monetary policy will work today in the way that Akerlof and Shiller believe. In my own research, I have integrated 'confidence' into neo-classical models and the policy implications are very different from those advocated by the authors.[2]

There is much to criticize in modern macroeconomics, but as NYU economist Tom Sargent tells his students, 'it takes a model to beat a model'. Akerlof and Shiller's book criticizes classical economics but does not offer a viable or coherent alternative. Instead they advocate Keynesian policies that were discredited in the 1970s, a massive expansion of liquidity, and a massive fiscal expansion. History has taught us that a massive expansion of liquidity will lead to inflation. Logic tells us that a massive fiscal expansion will lead to a big transfer of resources to the baby-boomers from their grandchildren. The lesson of 1970s stagflation is that neither of these two policies alone can be guaranteed to restore full employment.

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[2] Farmer (2009, forthcoming, a, forthcoming, b).