

Animal Spirits

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I. Animal Spirits

- Confidence and its multipliers (both + and -)
- Fairness
- Corruption and Bad Faith
- Money Illusion
- Stories

II. Eight Questions and their Answers

1. Why do Economies fall into depression?
 - Changes in confidence
 - Willingness to pursue profits to anti-social limits (corruption)
 - Money Illusion about inflation
 - Changes to perception of economic fairness
2. Why do Central Bankers have power over the Economy?
3. Why are there people who cannot find a job?
 - Efficiency wage theory – efficiency/effectiveness of labor depends on the wages paid
 - Involuntary unemployment will be the gap between the supply of labor and the demand at the wage firms will pay
 - Wages are different from other forms of economic exchange
 - The price is agreed to before the work is started
 - Workers must be motivated not to “spit in the soup” and don’t work well if they feel they are underpaid
 - Most employers overpay what they think is fair in order to insure some sort of quality and loyalty
4. Why is there a trade-off between Inflation and Unemployment in the long run?
 - Money Illusion affects wages – people resist wage cuts during deflation (see previous question)
 - People don’t account for inflation when bargaining for wages
 - Natural Rate Theory assumes no Money Illusion
5. Why is Saving for the Future so arbitrary?
 - Compound interest theory does NOT interest people – they can’t see it or relate to it (humans are programmed to respond to immediate emergencies)
 - Societies have different psychological framing structures
 - Singapore and China have a saving culture
 - The US has a spend culture
 - Social Security is seen as critical because people recognize that they are not good at financial planning
6. Why are Financial Prices and Corporate Investments so volatile?
 - The theories economists put forth are too simplistic and do not account for Animal Spirits
 - Capitalism will sell snake oil if there is a market for it and this is not good for the society. Therefore there is a need for government regulation
7. Why do Real Estate markets go through cycles?
 - Naïve/intuitive beliefs (stories) about real estate dominate in good times
 - The Confidence Multiplier is especially evident in real estate

8. Why is there special poverty among minorities?
 - Humans naturally divide themselves into groups (tribes) and develop us vs them mentalities (variations from the accepted norm are dangerous and to be avoided)
 - 400 years of racial division in the US has created a strong us vs them mentality regarding Native Americans and African Americans
 - Cultures that don't make it turn inward, become angry, and rationalize that the anger is justified and should be defended

III. Conclusions

- The presence of Animal Spirits in the normal functions of the economy must be acknowledged and integrated into our economic thinking and policy.
- We must not only regulate the 'free market' with Animal Spirits in mind, but also recognize the human traits of overconfidence and tribal exclusion.
- Our history is consistent – previous depressions (1893 and 1930) and recessions have similar correlations to what is happening now – and we must continuously acknowledge it. This last comment is perhaps the hardest to implement, as the human animal is programmed to forget the past when dealing with immediate problems.