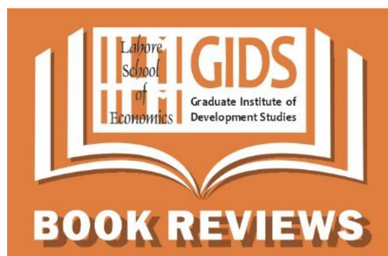

ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM

BY GEORGE A. AKERLOF AND ROBERT J. SHILLER

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Written more than a decade ago the contents of Akerlof and Shiller's work are relevant for anyone wanting to understand the dynamics of the global economy beyond the explanations offered by mainstream economic theories.

Classical economic theory assumes individuals are driven by their economic motives – are economic agents – and behave rationally – have rational expectations. In the *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, distinguished economists George Akerlof and Robert Shiller draw attention to the fallibility of these assumptions. They delve into "animal spirits"; the emotional and psychological factors causing individuals' behaviour to deviate from rationality and pursue non-economic motives. The term has been adapted by the authors from Keynes's General Theory.

According to Adam Smith's invisible hand argument, under free markets rational economic agents engage in transactions that yield mutual economic benefits. However, in practice, macroeconomic variables were observed to deviate from the mutually benefiting outcomes resulting in business cycles. Keynes explained that the volatility was produced by animal spirits. The authors regard animal spirits as the root cause of instabilities in the capitalist system. They identify five aspects of animal spirits: confidence, fairness, corruption, money illusion and stories, to demonstrate how they affect economic decisions.

Confidence is the foundational concept in their narrative. Conventional economics describes it as synonymous to predictions about the future state of the economy, but Akerlof and Shiller emphasise that a supplementary concept often missed is the element of trust; for any prediction to mobilise economic agents, they must perceive it to be true, i.e. trust the prediction. Given information asymmetry and uncertainty, individuals tend to act according to what they trust is, or will, be true rather than a rational prediction. Rightly so, if people do not trust the prediction to materialise, it will have limited power in steering economic activity in a certain direction. The authors introduce the idea of a confidence multiplier, similar to the Keynesian multiplier.

They elaborate that swings in confidence result in changes in income which subsequently create ripple effects by affecting future confidence. For instance, where consumption and investment expenditures decline in response to lack of confidence in an economic recovery, it would lead to further deterioration of confidence and future income. The feedback mechanism amplifies the initial disturbance in the economy, hence prolonging the recovery. Confidence is connected with another animal spirit – stories – which shape individuals' perceptions and expectations. Given stories are the most common source of information they tend to trump rational expectations, even if the ones circulating around might have little to do with facts. By feeding into confidence they influence the trajectory of economic growth or recovery.

Fairness, corruption and money illusion are each discussed by the authors in more specific contexts. Contrasting with the efficiency of wage theory, they suggest that prices and wages are set in consideration of concerns regarding their fairness. Firms pay wages higher than the market clearing rate, or the wage workers would be willing to accept in order to create economic incentives to keep workers motivated to put in effort. The gap between the labour supply and demand at the higher wage rate leads to involuntary unemployment in the economy. Akerlof and Shiller present an alternative idea that workers decision to put an effort or to what extent, also depends on whether or not they feel they are being fairly treated by the employer. Wages also act as indicator for employees of their efforts being recognised by the employer. If wages are considered by the employees to be too low or unfairly distributed among workers, willingness to perform their tasks efficiently would be low. Hence, the fairness perception is embedded in wage negotiations and explain why downward adjustment of wages tend not to occur in practice to clear the involuntary unemployment in the labour market.

According to the authors, under capitalism, even those goods and services are produced and sold that are not a necessity for the people, by creating a perception of need. The primary objective is to earn a profit. This feature of the capitalist economic system creates avenues for corruption and deceit. On the animal spirit of money illusion, the authors bring up the difference between nominal and real value of money. Inflation erodes the real purchasing power of people's savings. Increase in value of assets does not necessarily translate into an increase in wealth if inflation has been rising simultaneously. When prices fall, workers resist nominal wage cuts even at the risk of losing their jobs, though in practice their real wages may have remained unchanged. Such irrational behaviours can only be explained by animal spirits.

The authors have put forth interesting and convincing arguments for explaining macroeconomic deviations from the expectations under rational choice through the use of anecdotal evidence, which makes the book an easy read for non-economists. However, pure

economists trained in conventional methods might find the lack of a formal and testable framework a major limitation in this piece of work by Akerlof and Shiller.

To course correct the destabilising impacts of animal spirits, the authors suggest an increased role for governments. They reason that government interventions reduce uncertainties and information asymmetries that feed into the animal spirits. This argument falls short in accounting for two of the animal spirits associated with government policies: confidence/trust and corruption. Political motives and agendas can steer policies away from the "optimal" or "rational" choice. Poor or biased decision making by the government could potentially result in a graver crisis. This is the essence of work being carried out under the domain of political economy, whereas, the discussion on corruption in the book is limited to malpractices, fraud and misrepresentation in the financial sector against investors. It must also be noted that for the impact of a policy to materialise, the public must trust the policy makers. If a policy risks being seen as temporary or susceptible to sudden changes, it could add to the uncertainty and instead undermine the intended policy objectives.

In developing countries, instances of government-level corruption either by protecting inefficient sectors through subsidies and waivers, or misusing of public finances for personal gains, are prevalent. Stories of corruption lead to deterioration of trust levels between the public and political agents. The reviewer's country; Pakistan, is a fitting example of animal spirits in play. Contradicting policy initiatives, gap between the de jure and de facto polices, frequent business cycles and overall low levels of economic and human development are indicators of animal spirits governing the economy. Case in point, investment in Pakistan has hovered around 15 percent over the last decade and shown a declining trend since the 1980s, compared to neighbouring India, Bangladesh and Sri Lanka that are averaging around 30 percent. Apart from the widely discussed structural issues of the economy, despite numerous government incentives, investment has remained low. The role of animal spirits is worth considering and researchers interested in the subject might wish to study them for a more holistic view.