An economic bestiary

Macroeconomists need to apply some new lessons and relearn some old ones.

Illustration by Jac Depczyk

No two economic crises are identical. But the same questions recur. How did we get into this mess? How can we get out of it? How do we avoid another? Some answers repeat themselves too. You can be pretty sure that sooner or later someone, quite possibly an anguished economist, will declare that economics itself has gone astray. The wisdom of some past master, whether celebrated (John Maynard Keynes, for example) or neglected (Hyman Minsky, perhaps), has been forgotten, and the economy is paying the price.

A new book*, “Animal Spirits”, by George Akerlof of the University of California, Berkeley, and Robert Shiller of Yale, follows this rule to the letter. The authors seek to answer the first of those three old questions and thus to provide some pointers about the other two. They do indeed believe that economics has lost its way. And their chosen economist is Keynes.

So far, so familiar. But this book is rather more than the usual lament about the failings of economics. Its authors are two of the discipline’s leading lights. Mr Akerlof won a Nobel prize in 2001, in part for a classic paper explaining how, if sellers know more than buyers, markets may fail. (It was turned down by three leading journals before finding a home.) Mr Shiller sounded a warning about the “Irrational Exuberance” of the tech-boom stockmarket in a book of that name—and did the same for the housing market in a second edition. With a collaborator, Karl Case, he drew up a widely cited set of indices of American home prices.

The lesson that Messrs Akerlof and Shiller draw from Keynes is not just the standard one, of the usefulness of deficit finance in recessions. They borrow their title from “The General Theory of Employment, Interest and Money”:

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 the weighted average of quantitative benefits multiplied by quantitative probabilities.

Too much economics, say Mr Akerlof and Mr Shiller, has been built on the premise that humans are rational calculators. That is not a new criticism, even from economists. Over the past couple of decades Homo economicus has evolved into a being more like H. sapiens, as economics has drawn on psychology, biology and even neuroscience. “Behavioural” economics has shaped public policy—for instance, in encouraging people to save or in shaping the choice

of investments in their pension pots. Behavioural economists have earned Nobel prizes. Mr Akerlof and Mr Shiller, however, complain that this evolution has been confined mainly to microeconomics. It is time for macroeconomics to catch up.

One, two, three, four, five

Keynes mentioned animal spirits only twice, in a paragraph on what motivates people to invest and speculate. From this single thread, Messrs Akerlof and Shiller spin five classes of spirit. First and closest to the original is confidence. This goes beyond a rational estimate of next week's share price, or the price in ten years' time of what a new factory might produce. And confidence, or the lack of it, builds on itself—in a way similar to Keynes's multiplier, but defying easy quantification. Second is fairness. Even if economists know that fairness matters, too little of their work reflects it. Third is corruption, or bad faith: what explains a Charles Ponzi or an Enron? Fourth is money illusion: economists have come to assume that people see through inflation, but they don't, especially when it is low. The fifth they call "stories". Economists are loth to suppose that people are irrational enough to latch onto plausible tales and forecasts—for example, that house prices will never go down. So their models won't spot the consequences of misplaced belief until it is too late.

Messrs Akerlof and Shiller list eight questions which, they say, cannot be well explained without an appeal to animal spirits—but can be tackled with them. These range from why markets for housing and shares swing wildly (a combination of confidence, stories and bad faith) to why, contrary to standard theory, there appears to be a long-run trade-off between inflation and unemployment (mainly, a mix of money illusion and fairness).

The most topical of the eight, however, is the power of central banks. The animal-spirits version of the credit crisis is a mixture of bad faith, a collapse of confidence and a change from a happy economic "story" to a thoroughly miserable one. Credit has dried up—so that applying the fiscal and monetary stimulus consistent with full employment is not enough. The Federal Reserve should also have a target for credit. Unless credit flows again, fiscal and monetary measures will not suffice: companies can't borrow to build factories and consumers can't borrow to buy cars. The Fed was set up, Messrs Akerlof and Shiller point out, to maintain confidence after the financial crisis of 1907. That, rather than the fine-tuning of interest rates in steady times, is its most important task.

How much do animal spirits help? Most of the time, the unrealistic assumption of rationality serves economists fairly well. They should, however, be more prepared to depart from it, especially in times like these—even if that makes behaviour more difficult to describe in elegant equations. Messrs Akerlof and Shiller have therefore done their profession a service.

Yet their ideas carry risks too. To a politician seeking to rein in free markets, animal spirits are a gift. The authors sum up their view of the role of government thus: "The role of the parent is to create a happy home, which gives the child freedom but also protects him from his animal spirits." For liberals (in the European sense) that is not a wholly comforting thought.

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