How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*

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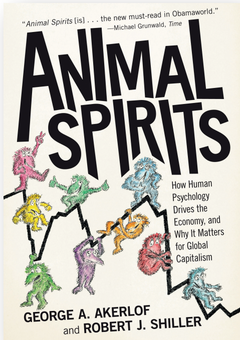

George A Akerlof & Robert J Shiller
Animal Spirits

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Taking a look at the 2008 crisis, the authors – Nobel laureates Shiller and Akerlof – compare the global economy to a roller coaster, with its highs and lows, with the adventure park's management giving free rein to the ups and failing to impose any speed limits, resulting in some people being oblivious to the fact that they were even on a roller coaster, only realising it as they began to plunge.

Current economic models are only capable of giving insight into the functioning of the economy if individuals have economic motives and give rational answers to them. However, traditional models fail to provide an answer in other cases (e.g. in case of non-economic motives and rational answers, economic motives and irrational answers or non-economic motives and irrational answers).

In order to understand the workings of the economy, say the authors, we must understand the deep underlying emotional factors (Animal Spirits) that are the driving forces of human thoughts and actions, as economic events are often driven by psychological forces. The authors' assumption that changing thought patters may stand behind economic events

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fully contradicts traditional economic theory. Akerlof and Shiller identify five Animal Spirits that shape the economy. The first is confidence and its multiplier effects. Economists explain every economic crisis that has affected the United States by a loss of confidence, but they failed to understand precisely what confidence meant and think that confidence is rational, while in fact its main feature is precisely that it is irrational, as truly confident people often disregard certain information and act according to their true beliefs. The second factor is fairness, as individuals strive to be honest, to meet their own and other people's expectations and therefore avoid unfair conduct in the realm of business as well. Corruption and bad faith, i.e. the dark side of economic life are the third factor to be taken into account. The drawback of capitalism is that it does not necessarily produce what people really need, but what they think they need and are willing to pay for. If people are willing to pay for authentic drugs, capitalism will produce these drugs, but if there is demand for useless placebos, it will also meet this demand. This is why consumer protection is of the utmost importance. An illustrative example is that in the 1930s, the most popular card game was based on cooperation, while bluff-driven poker has become the most popular game nowadays. One of the key preliminary assumptions of modern economics is that people see through inflation, but in fact this is oftentimes not the case. For example, employees see wage reductions as unfair even in the event of deflation. Taking this phenomenon into account would yield an entirely different macroeconomy and lead to entirely different economic policy conclusions, so this is the fourth factor to be taken into account. Human thought is comprised of stories with their internal logic in dynamics, which ultimately shape our behaviour. Due to their decisive role, these stories – the fifth psychological factor – should also be taken into account in economics.

Before the crisis, everyone widely subscribed to the classic economic theory suggesting that "everything is alright", as free competition based capitalism is perfect and stable, and people make rational decisions on the market according to Adam Smith's free market theory. We see what happens when people are irrational, wrong or misled.