BOOK REVIEWS

Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism

George A. Akerlof and Robert J. Shiller
Princeton, N.J.: Princeton University Press, 2009, 264 pp.

Probability theory suggests that large numbers of independent economic agents should lead to greater macroeconomic stability. The likelihood that economic outcomes would deviate from their true central tendencies should decrease as the number of economic decisionmakers increases. The United States and many other economies have many millions of such decisionmakers. So why do large economic business cycles occur?

Many economists have offered answers to this question. Perhaps market actors alternately face good and poor economic choices because of external macroeconomic shocks; perhaps their decisions and interactions are dominated by herd behavior; and perhaps their actions are sometimes driven by nonrational motives that steer them far from normal levels. During the Great Depression of the 1930s, J. M. Keynes dubbed the last of these explanations "animal spirits." The book by professors Akerlof and Shiller is an attempt to dissect that term and expose its core content and meaning.

The subject of "animal spirits" lies at the heart of macroeconomics. With a recession underway as backdrop, the book's discussion about the roles of market institutions and governments is highly topical. And the authors are renowned economists, particularly in the subfields of labor and financial markets. Both are credited with a deep understanding of economic history, the history of economic

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thought, and today's global economic environment. That makes this book a "must read" for anyone seeking insights into recent economic events and seeking ways of crafting government policies to prevent another similar economic downturn.

Markets versus Government

The book presents two contrasting paradigms: free markets and socialism. Under the former, government intervention is minimal with the expectation that the "invisible hand" of private rational decisionmakers will work successfully to equilibrate markets and maintain macroeconomic stability. Under socialism, government intervention is at its maximum—with the government owning and operating productive enterprises. The book argues that free-market systems are likely to pursue excesses eventually leading to distress and turmoil. Such systems are unlikely to experience prolonged economic stability. At the other extreme, socialist states are likely to stifle citizens' creative activities and reduce economic growth.

According to the Akerlof and Shiller, the government should play a paternal role. It should provide an optimal economic environment—with just sufficient intervention to create a "happy home" within which the private-sector "child" is free to be creative but with little chance of its own "animal spirits" posing a danger to its well-being.

The authors complain that Keynes' identification of "animal spirits" as the cause of economic fluctuations was suppressed in the pedagogic cramming of Keynesian economics into the straitjacket of classical economic analysis to facilitate its understanding. That made easier the resurgence and dominance of the new classical doctrine for three decades after the 1970s. The current economic crisis is the result of allowing markets to "become drunk," as President G. W. Bush once noted.

Unfortunately, this description of events forgets that those three decades of relatively unfettered markets delivered tremendous economic growth and prosperity for millions of Americans and others around the world. Notwithstanding the ongoing recession, many of us are still benefiting from that period's robust economic performance, and we will continue to benefit from it in the future if the current recession terminates soon. It also forgets that periodic recessions play a potentially positive role in weeding out weak and uncompetitive businesses, which imparts greater resilience to the economy and sets the stage for the resumption of economic progress.

The authors also neglect the fact that "animal spirits" reside not only within market actors but also within political actors as well. The systematic dismantling of lending standards in the housing finance sector began during the Clinton administration—wherein high-leverage, low- or no-doc loans were first permitted under expectations of unabated future home price appreciation. Such a "deregulation" of housing finance occurred because of political motives to pander to unqualified borrowers with uncertain incomes and low collateral seeking home purchases in poorer neighborhoods. The Bush administration's emphatic support for creating an "ownership society" continued the political support of questionable home-loan structures. That spurred the home-price bubble by helping to coordinate mortgage lending, securitization, and insurance sectors into dispersing mortgage risks throughout the world. One might even validly claim that rational market actors do not stand much of a chance when faced with government policies designed to coordinate their beliefs and actions, which many now identify as the "bad decisions" responsible for excess home lending and the subsequent recession.

Relatively minor macroeconomic fluctuations may result from small and random technology and preference shocks that are correlated with each other, sometimes positively and sometimes negatively. However, large economic fluctuations could be the result of massively coordinated decisions by *rational* actors in response to a significant economic or policy shock. The current recession may be a case in point. A sustained surge in oil prices—from $20 per barrel in 2002 to $70 per barrel in 2006 to almost $150 per barrel in early 2008—may have led potential homebuyers to exit from the market. Perhaps they could no longer afford a high-energy-use lifestyle in the far flung suburbs with long commuting and home-energy costs that the spike in energy prices ordained. This is not "animal spirits" but a rational and collective revision of home purchase decisions, now sustained by self-fulfilling expectations of declining home prices. Stories of the ripple effects of the public's revision of price expectations and demand in the housing sector on the rest of the economy are now legion.

A Known Known or a Known Unknown?

Economics is a social science wherein we can only sometimes measure cause-and-effect relationships—and even then, rather imprecisely. The "unexplained" component of such measurement attempts is relegated to the "error" term of econometric regressions. Similarly, when all means for measuring and predicting turning points fail, we economists throw in the towel by invoking "animal spirits." The book attempts to place on a high pedestal the very thing that economists confess to being ignorant about.

Thus, "animal spirits" are nothing more than a catch-all for things we do not, perhaps cannot, know. Indeed, the book's authors report their lack of confidence in tests of whether changes in measured "confidence"—whether through surveys of consumers or interest rate spread on risky and riskless securities—are capable of providing meaningful and consistent results. Lack of measurability prevents "animal spirits" from entering statistical alchemy, let alone science. The claim that "confidence" is different from "expectations about the future," and that sometimes the former is more important than the latter would be valuable only when measurable—to form testable hypotheses about the sources of economic fluctuations.

Given the difficulties in quantifying "animal spirits," the authors provide a description of behavioral attributes and social norms that characterize and drive "animal spirits." These include standards of good behavior, bad faith, corruption, fairness, the prevalence of money illusion, and beliefs in stories about all such attributes that wax and wane in cycles and affect the population's collective confidence in their future economic prospects. Such changes in confidence influence real economic choices and activity to generate business cycles.

The authors' detailed description of the content of "animal spirits" is quite impressive. However, I question the authors' claims of the measurability of these different phenomena ("epidemics can be predicted like the spread of a virus given knowledge of the number of infected people and the number susceptible"). How can economists measure the number of people who have heard and believe certain "stories" about economic issues and how can they know how many of them are susceptible to believing them and altering their economic behavior? It all remains rather nebulous—not quite worthy of the label "science."

Granting that "loss of confidence" is playing an important role in worsening the current recession, it is difficult to make policy decisions without being able to measure their likely effect and reliably predict the recession's persistence. That inability, again, stems from the lack of any close association between observable economic variables and "changes in confidence." How would policymakers know how strong their fiscal stimuli should be? And how should they know when it is time to withdraw government support of credit, housing, and other markets? The book provides no guidance on these important questions.

Should Government Regulations Guide Individuals' Choices?

The authors' economic philosophy is captured by the phrase: "If there's a macroeconomic void, the government must fill it." This recommendation to adopt a government solution to the financial crisis ignores the fact that the governments are no better and, for good reasons, likely to prove worse in guiding economic activity and ensuring "healthy capitalism" by controlling credit provision, as the author's imagine. Indeed, vested interests and relationships would impose lawmakers' preferences on market operations—by preventing inefficient firms in financial and other sectors, especially auto, insurance, and banking, from failing. Such interventions are likely to weaken market capitalism and perpetuate an expanded government role to the detriment of long-term economic growth.

The authors believe that individuals are basically incapable of making or unwilling to make proper economic decisions for themselves. Hence, paternalistic government programs and policies must step in to save people from making mistakes. They paint a disheartening picture of Americans as being unable to make any rational decisions about saving for the future. In their view, government subsidies for saving and the Social Security program are necessary because of peoples' utter inability to plan their own financial future and their proclivity—in part, because of credit cards—to undersave. The Chinese way is held up as a model with the government exhorting, indeed forcing, people to save up to 50 percent of their earnings to eventually develop an economically strong nation. It appears that "animal spirits" warrant strong government actions to curb individuals' proclivities to spend out of their incomes. The book's discussions regarding individuals' saving behavior and its policy conclusions stand in direct opposition to libertarian precepts—freedom from a government imposed "national purpose" in wealth accumulation, or in any other area.

Selective Endogeneity Bias?

The authors' views on Social Security reform proposals—especially, privatization—stand in sharp contrast to their views on the relationship between stock price movements and economic activity. On Social Security, they claim that privatization is undesirable because people habitually undersave, always expecting to be supported by the government. This raises a classic chicken-and-egg problem—one that the authors do not pose. They are adamantly opposed to the possibility that recent observed declines in western economies' saving rates may be the *consequence* of government policies that provide people with a large crutch for old age consumption and subsidies for saving in tax-qualified plans. Both policies reduce the needs and incentives for personal saving—the former by providing a substitute source of old-age support and the latter by enriching today's generations, thereby stimulating their consumption expenditures.

China, in contrast, is operationally much less of a welfare state. Unlike western developed nations, it provides no population-wide old age, health, disability, survivor, and other protections. Indeed, surveys of Chinese households reveal that they save large fractions of their incomes for precautionary reasons—to deal with bad health episodes and long-term retirement needs.

When it comes to describing stock price cycles, however, the authors follow age-old and widely accepted Keynesian insights of interdependence between market participants' own opinions about future prices and other participants' beliefs. They note several feedback loops that sustain and exacerbate upward and downward movements of stock prices well beyond those justified by market fundamentals—the economic status of firms and the economy in general. These feedback loops include price-to-price loops, wealth effects on consumption and investment, and credit and leverage ratio correlates with overall economic performance. The authors perceptively criticize the Basel I and Basel II accords as ignoring the possibility that business cycles make evaluations of risk-based capital requirements uncertain and unanchored. And, again, the authors are correct to point out that most people fail to realize that such macro-feedbacks are occurring—whereby increases in real earnings may be the *consequence* of stock price increases, not fundamentals that make stock price increases appear rational and justified.

Given their perceptive comments regarding the direction of causation between stock prices and general economic activity, it is rather surprising that they fail to acknowledge the possibility that public policies on subsidies for saving and Social Security provision may constitute the *causes* rather than the consequences of low national saving in western countries. Adherents of the precepts of behavioral economics could coin a term for this trait among economists: "selective endogeneity bias!"

Take Away Message

Overall, the authors' perspective and recommendations appear to ignore the crucial insights of Joseph Schumpeter who argued that recessions could play a vital role in market economies—one that helps to promote long-term prosperity via the process of "creative destruction." Progress requires eliminating weaker and poorer decisionmakers in favor of stronger, more perceptive, and resilient market actors—among individuals, firms, and market institutions. Extending a system of government guarantees, increasing regulations against risk taking, and shielding less efficient market participants from losses weakens the economy. It enlarges an undergrowth of frail economic actors and institutions that eventually will burn even more intensely once a sufficiently large shock overwhelms the tighter regulatory framework that the authors recommend. Eventually, the futility of the authors' clarion call for a regulatory system that forever insulates us from economic booms and busts will be revealed.

The key caution to readers of this book is that although "animal spirits" may be a feature of private economic actors, they also pervade government institutions and regulators. Those institutions are, on occasion, just as susceptible to cyclical and politically motivated tightening and relaxation of regulatory norms and policies. A new government regulatory system instituted in response to the recent recession, intended to "cure capitalism's ills" may influence slightly the duration and frequency of business cycles but won't eliminate fundamental economic uncertainties and won't release us from the vicissitudes (nor deny us the benefits!) of periodic business cycle swings.

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Striking First: Preemption and Prevention in International Conflict
Michael Doyle
Princeton, N.J.: Princeton University Press, 2008, 175 pp.

In this concise book, lead author Michael Doyle and three distinguished commentators wrestle with one key question: "Under what circumstances is preventive war justified?"

The question itself is hardly revolutionary; for several centuries, scholars have attempted to differentiate preemptive wars—those launched in anticipation of an imminent attack—from preventive wars—launched before a particular threat materializes. The former are generally justified as self-defense forms; the latter historically have not been.

In the past decade, however, the world's sole superpower, the United States, has launched at least two wars—against Serbia in 1999 and Iraq in 2003—that did not meet the accepted criteria of preemption. Not surprisingly, these two wars, in particular, have prompted many scholars to ask whether our existing norms against preventive wars have been overcome by events. More provocatively, in a world where nonstate actors appear to pose a greater threat to peace and security than do states, do the rules designed to constrain states need to be revisited? Is there too little war in the world, or too much? Do states resort to war too frequently, or not often enough? Doyle's book is a useful discussion of these issues, but it focuses too much on legalistic rationales for preventive war without contemplating its limited utility in the first place.

Doyle, the Harold Brown Professor of International Affairs, Law, and Political Science at Columbia University, developed the book from a series of lectures given at Princeton in November 2006. He begins with the *Caroline* incident of 1837, an attack on an American ship along the U.S.-Canadian border that helped define international standards governing preemption. Doyle reviews the particulars of