Akerlof, George A. & Shiller, Robert – Animal Spirits

Princeton University Press, 2009, [Economics] Grade ★★★★★

Animal Spirits is a book about macroeconomics with an interesting twist. Rest assured this is not another mundane behavioral economics handbook. The book was written in response to the financial crisis and the authors are economics rockstars. Robert Shiller and George Akerlof are Nobel laureates and Keynsians who believe that government has an active role to play in macroeconomic management. The investment community will recognize Shiller as the prescient economist who predicted the collapse of the tech bubble in 2001 and the housing bust in 2008 and who developed the Case Shiller Home Price index. Akerlof introduced important theories showing the impact of asymmetric information, moral hazard and adverse selection.

The term Animal Spirits was popularized by Keynes in his 1936 book *The General Theory* to describe the emotions that govern consumers' willingness to spend and businesses' willingness to hire and invest. It is a catch all for drivers not explained by rational agents acting in their self-interest. The book calls for a revamping of conventional economics to factor these animal spirits into conventional economic thinking. The book was written for policy makers and academics but is an easy read. It is relatively short and contains a superb bibliography and reference section. Its 14 chapters are split into two parts. Part one contains 5 chapters describing 5 identified animal spirits: Confidence, Fairness (which impact wage-setting and the labour market), Corruption and Bad Faith (financial markets), Money Illusion (being fooled by inflation) and Stories, (culture or zeitgeist). The cornerstone of the theory is how "*confidence and the feedback mechanisms between it and the economy amplify disturbances*". Part 2 is a "normative" section structured as 8 questions which the authors answer with their new framework and they include policy prescriptions, some quite insightful. To the investor, section 1 is likely to be more stimulating; it offers a novel paradigm of looking at macroeconomics by including animal spirits into economic thinking. I also enjoyed the authors' views on the Financial Crisis and Chapter 13 which explains why Real Estate markets go through cycles and was a helpful reminder that all asset prices are subject to cycles. The book's post script about Monetary Policy is really interesting and ought to have been included as a chapter.

The book requires some basic understanding of economics but you'll be drawn by the chatty, crisp and anecdotal style - no formulas. The book's topic of choice renders it quite fuzzy at times, and most of it would not stand up to Popperian scrutiny. In terms of the specific tools for the Investor, Irrational Exuberance is more appropriate. You need to have an interest in macroeconomics to enjoy this book. The key point of the book is that psychological biases and sociological norms add up and have real economic effect. The book did lead me to think differently about economics, but I found the Keynesian prescriptions of government less useful. The question I found myself asking was: aren't central bankers and economic policy makers just as susceptible to animal spirits as the rest of us are?

The next time you hear a story in a cab about how inner city house prices are a in a secular long term upward trend due to urbanization, that blue chips are destined to decline due to changes in demographics or if you see confidence slipping on a mass scale, it's worth trying to factor this into your general assessment of interest rates, inflation and GDP. Good luck in trying to find a way to do that!

Henry Makansi, November 12, 2013