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How Human Psychology Drives the Economy and Why It Matters

By

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The recent global financial crisis has made it painfully clear that powerful psychological forces are imperiling the wealth of nations today. From blind faith in every-rising housing prices to plummeting confidence in capital markets, "animal spirits" are driving financial events worldwide. Robert Shiller and I (Akerlof and Shiller 2009) challenge the economic wisdom that got us into this mess, e.g., rational expectations macroeconomics (Sargent and Wallace 1976, Lucas 1976) and an explosion in new unregulated financial instruments and near banks (Aversa 2008), and put forward a bold new vision and policies that will transform economics and restore world prosperity.

We assert the necessity of an active government role in economic policymaking by recovering the idea of animal spirits, a term John Maynard Keynes used to describe e the gloom and despondence that led to the Great Depression (1929-33) and changing psychology that accompanied recovery. Like Keynes, we know that managing these animal spirits requires the steady hand of government—simply allowing markets to work will not do it. In rebuilding the case for a more robust, behaviorally informed Keynesianism, we detail the most pervasive effects of animal spirits in contemporary economic life—such as confidence, fear, bad faith, corruption, a concern for fairness, and the stories we tell ourselves about our economic

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fortunes—and show how Reaganomics and the rational expectations revolution of contemporary macroeconomics failed to account for them.

Animal Spirits offers a road map for reversing the financial misfortunes besetting the macro-economy today. We argue that our national leaders must learn how to channel animal spirits—the powerful forces of human psychology that are afoot in the world economy today—into a more robust economy.

Refererences

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