Can Behavioural Economics put Humpty Dumpty together again?

By way of being a critical review of:

"Animal Spirits: How Human Psychology Drives the Economy, and Why it matters for Global Capitalism" (George A.Akerlof and Robert J.Shiller, Princeton University Press, New Jersey, USA, 2009 - £14.95, 235 pp plus xiv))

Introduction

Hidden away on p140 of the book, in the middle of a section on how stories of human behaviour are central to understanding financial pricing volatility, is what I take to be the pivotal paragraph in assessing the importance of behavioural economics:

> Most economists don't like these stories of psychological feedback. They consider them offensive to their core concept of human rationality. And they are dismissive for another reason: there are no standard ways to quantify the psychology of people. Most economists view the attempts that have been made thus far to quantify the feedbacks and incorporate them into macro models as too arbitrary, and thus they remain unconvinced (Akerlof and Shiller, 140).

Given that "Animal Spirits" is a sustained attempt to introduce psychological insights into the discipline of economics, this suggests to me that there are three basic options.

- Economics cannot and does not need to incorporate such insights and the critics are correct in remaining unconvinced
- Economics can and does need to incorporate such insights and this will lead to a reformulated and more adequate means of analysing and providing solutions to the current financial crisis
- The attempts to introduce psychological insights will, in fact, so challenge and undermine the discipline of economics that what will emerge (assuming that it is not intellectual anarchy!) will be something new and almost unrecognisable

Akerlof and Shiller are clearly arguing that option two is the correct path to follow, and theirs is an attempt, from within the discipline of macro economics, to reformulate and recast rather than to undermine or destroy. Whilst this makes good sense for professional economists, I wonder whether their stance is quite radical enough. Reviewing the contents of their book may offer some clues as to an answer.

Here are the classic problems of crossing disciplinary boundaries. How good is their understanding of psychology and does it go beyond the level of illuminating anecdotes? If it does, how does one reconcile the different and potentially conflicting models of human nature that underlie the two disciplines? Which particular model of human nature and development are they going to utilise, given that the discipline of psychology itself contains different models? All of this is not to argue that the exercise is not worthwhile and indeed a step in the right direction, but to suggest that there is a need for greater intellectual clarity when entering this type of "blurred encounter" and that things can be learnt from those of us who have already chosen this path. Then the real motivation for addressing these issues right now: can the Humpty Dumpty (as Akerlof and Shiller describe it, p167-8) of the global financial system be put back together again, or are the King's horses and King's men on a fruitless enterprise? Let us keep these questions in mind as we review this important book.

Origins in Keynes

Like so much contemporary reformulating of macroeconomics (see for instance "Keynes: The Return of the Master" by Robert Skidelsky, Penguin Books,London, 2009), Akerlof and Shiller begin their journey by revisiting ideas of Keynes. The phrase "animal spirits" derives from Keynes and is the starting point for the book.

> Keynes appreciated that most economic activity results from rational economic motivations – but also that much economic activity is governed by *animal spirits*. People have noneconomic motives. And they are not always rational in pursuit of their economic interests. In Keynes' view these *animal spirits* are the main cause for why the economy fluctuates as it does (p ix).

The obvious implication of this is that only governments can provide the counterpoint to the worst effects of these excesses in human behaviour. Over time though, economic orthodoxy has eliminated this Keynsian insight from its doctrines, conveniently forgetting that Keynes himself raised this question about the bases of human activity. A reduced Keynsianism has taken over, but even this was overtaken and displaced by New Classical Economics and the global attachment to free markets.

The reigns of Reagan in the US and Thatcher in the UK are most closely associated with this movement. Regulation by government or any other body became anathema and has been stripped down to the point where the worst excesses of human economic activity have been allowed to dominate, the results of which are now all too obvious.

The Spirits themselves

One has to wonder whether the phrase “animal spirits” is adequate or appropriate as a summary of what the authors are concerned to describe. There are five different aspects of human behaviour highlighted in the book, those being: confidence; fairness; corruption and anti-social behaviour; money illusion, and stories. Part One goes on to describe each of these in greater detail, but Part Two is the heart of the text in which the authors lay out how and why each of the above provide an explanation for some of the key questions raised about economic decisions. It is not perhaps immediately obvious that the five categories fit neatly together or that they are all of the same kind. Which is not to say that they are not of interest, but to question whether using the phrase “animal spirits” is a convenient means of avoiding the issue of the proposed commonality that is being explored. The human propensity to tell stories and to utilise narrative as a way of making sense of events does not really seem to be of the same order as the role of confidence when it comes to making economic decisions. “Money illusion” is perhaps even harder to categorise and requires some explanation. I don’t think it is obvious that the five aspects together contribute to a coherent or identifiable theory of human nature. It feels more as if these are the particular aspects that the authors have noted through their observations and that the resulting presentation is somewhat under-theorized.

Similarly with the eight questions that Akerlof and Shiller attempt to address utilizing these psychological insights: they are indeed of importance and interest, but they appear to be the ones that are currently at the top of most agendas rather than constituting a recognizable and coherent theory. So, for instance, why do economies fall into depression? Why do central bankers have power over the economy – if they do? Why is saving for the future so arbitrary? Why does poverty persist for generations among disadvantaged minorities? It is argued that only the idea of animal spirits provides an answer to these and that the notion that humans behave rationally in their economic decisions fails to grasp the reality of economic life. These are pieces of a jigsaw puzzle that stand out in the current crisis, but where and whether they all fit into some wider picture is not so plain to see.

The first “spirit” that the authors focus on is that of confidence. As they say, it seems fairly obvious that this plays a crucial role in economic behaviour. They point out, however, that the deeper meaning of this term takes us into discussions about trust. Trust being something that “goes beyond the rational” (p12) and leads us to discard or discount certain information. One trusts what one believes to be true and it is this which is the basis of confidence. I would not argue with that, but it does reveal that the ideas which Akerlof and Shiller use require deeper insight and analysis. For those like myself from a more philosophical background, it raises the question of how we can know what is true in particular situations, let alone of what “truth” is in the first place. I cannot see how one can employ this term in the context of decision making without entering into issues of interpretation, for instance. Two people, even two “experts” can observe the same situation and come up with different and even conflicting definitions and interpretations. Surely, this is one of the major problems for macroeconomics? How does one know whose account to trust when making decisions about the future? Much of the evidence from recent events is that much supposedly trustworthy interpretation and prediction about the future has proved to be ill-founded. It is possible to identify “experts” who predicted that the bubble would burst, and I have described this is another WTF paper on the website, but they were largely ignored until after the event. People chose to trust the accounts of those who argued that the good times would continue, despite evidence to the contrary. What does this tell us about the nature of confidence, let alone about human nature? The authors need to pursue this question in greater depth I would suggest.

Fairness comes next on the list, and the argument is that people make judgements and decisions based on notions of what is fair, or unfair, and that macroeconomics would do well to take this more into account. “Considerations of fairness can override rational economic motivation” (p22). Once again, one does not want to contradict the evidence that others have presented to support this, but rather to suggest that a more rigorous analysis of this term is called for. What different people consider to be fair will depend on context and probably personal history, leading to certain norms of behaviour that will vary from group to group and individual to individual. This is perhaps less a matter of psychology and more one for discussion within political philosophy. The obvious case would be John Rawls’ notion of justice as fairness from his original groundbreaking text “A Theory of Justice” (Oxford University Press,1971), later pursued and refined in further books and recently discussed by Amartya Sen in another important work "The Idea of Justice"(Penguin Books, London, 2009). It feels as though Akerlof and Shiller are skirting round critical questions without really entering into the complexities of the debates or taking into account ideas from other related disciplines. Which is not a problem provided that one presents one's ideas as the basis for a further research programme.

Corruption and bad faith are the next candidates for animal spirits, and the authors have little problem identifying examples of these in economic behaviour. Capitalism, they suggest, has at least one major downfall. This is that people are prepared to pay for "snake oil" as well as for what they really need. In other words, such things as greed and envy lead us to purchase goods which are not what they appear to be. So, in fact, this section is about much more than simply the human propensity to exploit others in order to create wealth, it is about human gullibility and foolishness. It is not only the producers who contribute to cases of corruption and bad faith, but also consumers who are quite willing to be taken in, provided it appears to suit their own personal (sometimes but not always) financial interests. The most recent examples offered by the authors are, of course, the collapse of Enron in 2001 and then the current crisis. One cannot help feeling that the human propensity to "con and be conned" requires some further exploration – one which might even have a theological as well as a psychological dimension. The question which Akerlof and Shiller correctly raise is that of how governments, or governance procedures, can limit and guard against these inevitable traits in human behaviour, although this can only ever be part of a response to this problem. Using philosophical language, does this provide evidence of what authors such as Zizek, Lacan and Eagleton call "the Real" – that inescapable cut or rift in human nature that leads us to be subject to delusion when our own best interests are at stake?

Perhaps the most difficult section to grasp, for a non-economist at least, is that on money illusion. To an extent this is an internal macroeconomic debate, as the authors point out that money illusion – the capacity to fail to take into account that the actual value of one's assets is altered by inflation – was taken seriously until certain economists decided to discredit it. Milton Friedman, in particular, in the 1960s reversed the earlier interpretation, when talking about reactions to wage increases and price increases. The details of this must be for another occasion, but it does seem that the reasons for adopting this view were as much political as economic. The supposed absence of money illusion is the critical assumption underlying Friedman's natural rate theory, that there is a level of unemployment linked directly to wage and price equations, and this remains a central assumption in macroeconomics. What this suggests is the power of ideas to shape and influence policy decisions, and indeed the need to be ever vigilant of whatever the current orthodoxy claims to be the case.

Akerlof and Shiller's final category is that of stories and therefore of the apparent human need to provide narrative frameworks for personal and communal events in order to create structures of meaning. What they might usefully have done, is to link this with the earlier issues of trust, truth and interpretation. "Truth", for instance, might be what a particular community of interpreters accept as true within the context of the stories that they tell about themselves and their world. Certain explanations and even events are deemed to be credible within some frameworks but not within others. Miracles, for example, cannot be accepted for many who hold strict scientific explanations of the universe, as they would challenge and undermine that world view. Similarly, current economic paradigms allow certain views of what is happening but exclude others. One can recognise therefore the importance of "stories" in shaping our views of recent events, but this takes us only so far and no further. How does one mediate between different frameworks of interpretation, let alone reach a decision about what is trustworthy and true when current paradigms fail to provide convincing explanations or to come up with viable alternatives? As we shall see, Akerlof and Shiller are vulnerable to the criticism that they remain firmly within the current macroeconomic paradigm even though they have a reforming "spirit" and can recognize weaknesses and faults in it. The debates need to enter deeper philosophical territory if they are to yield structured and innovatory insights I would suggest.

Applications of the Insights

The second section of the book is a series of examples of how the animal spirits enable us to understand both past and current economic events and power structures. So the Depressions of the 1890s, the 1930s, are linked to the issues of confidence, corruption, money illusion and fairness. The stories that are told about these events continue to impact upon the interpretations of current events of course.

Whether this is to claim too much for the explanatory power of these ideas is an open question, particularly given that no convincing or definitive agreed explanation of the Great Depression, for instance, has yet to be offered. Then comes what is probably the central chapter of the book, that dealing with why central bankers have such power over the economy – insofar as they do. To the extent that we read all such books at the moment in order to try to understand current events and to begin to find solutions, this is indeed the chapter of greatest interest and import.

What the authors do is to show how the conventional wisdom within macroeconomics that the central banks have control over the economy by changing the money supply, is only partly true. Open market operations – for instance, lowering interest rates, and remember that Akerlof and Shiller are writing from a US perspective and thus talking about the Federal Reserve here – will have only a limited impact in a recession because other factors come into play. As we have seen in the UK , once interest rates go down to virtually zero, there is no further scope for movement in any case. One of the problems in the current crisis is that there has been a massive growth in the shadow banking system and that this seems to elude centralised government attempts to control or to keep it in check. But these investment banks, bank holding companies and hedge funds are just as much subject to loss of confidence and to runs on them as are the conventional banks. This is where panic initially set in, in the US with the problems of Bear Stearns in March 2008. The Fed stepped in, worried that the collapse of Bear Stearns would trigger a liquidity crisis as creditors began to question and doubt the reliability of these banks to honour their financial dealings. But, as we now know, this was only the first domino to fall, and with the collapse of Lehman Brothers on September 15th the whole global economic system was brought to the brink of collapse, and government interventions across the world then had to be brought into play. Whether Lehman Brothers should have been allowed to fail is still a matter of controversy of course. So is it now down to individual governments, using their own internal financial mechanisms, to stem the current outflow of confidence and restore stability to both the banking system and the global economy? Who else could possibly do this?

What the authors argue, and which is consistent with other articles on the WTF website, is that this is a new and disturbing situation, unlike anything that governments have previously encountered or tackled. The usual macroeconomic models failed to predict what was coming and are inadequate to present convincing ways forward. Akerlof and Shiller argue that governments should set themselves credit targets, levels of credit which are going to be required to stimulate economic growth and to restore confidence. Until or unless flows of credit into the global economy are brought up to the necessary levels we run the risk of slipping into a long-running and pervasive depression. This is the only way that Humpty Dumpty can be put back together again. Taking proper note of the animal spirits that influence economic behaviour is essential for this task. In many ways this is already what is happening with policies of quantitative easing and so on, BUT, there are massive political and economic questions about how long this can go on, as indeed there are about other costs that will have to be paid for in terms of tax rises and public spending cuts. In the UK these are now beginning to take shape as the politicians begin to own up to these problems. At what stage will we know that Humpty is safe once more to be placed back on the wall? What are the risks that he will come tumbling down again as soon as government intervention is withdrawn? I cannot see this particular book answering those questions.

The remaining chapters of the book pursue other questions that are of related but perhaps of lesser interest. I am left with the question of whether the animal spirits described here do have convincing explanatory potential, or whether they are in need of considerable further analysis and exploration. One can see that they are a move in the right direction, but in Akerlof and Shiller's hands they still stay very close to the original macroeconomic paradigm of which they claim to be critical. They are part of a reforming project, but one which fails to ask more fundamental questions about the models of economic rationality which are now in the spotlight, or which takes into account the insights and ideas of other disciplines and which now need to be brought into the equation. So the book is a contribution to the debate and moves things on in an interesting direction, but may not have the required impact.

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