

## [Animal Spirits Are Pervasive](#)

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As a financial consultant who provides conflict-free information to investors, I often see the effect of “animal spirits” in my client’s portfolio. Now, the macroeconomic effect of human emotion on financial decisions is being deliberated. George A. Akerlof and Robert J. Shiller write about this in their 2009 book, *Animal Spirits* (Princeton University Press).

Akerlof, a 2001 Nobel Prize winner in economics and Shiller, the Arthur M. Okun Professor of Economics at Yale University, propose that recognition of human emotions when making economic decisions can help prevent future economic crises. This is a progressive concept and one that is not based on classical economic precepts that treat financial decisions as rational. Instead, it is meant to address real-life situations that include animal spirits. The authors eloquently state how their book is different early on:

“Our book marks a break with ...tradition. In our view economic theory should be derived not from the minimal deviations from the system of Adam Smith but rather from the deviations that actually do occur and that can be observed. Insofar as animal spirits exist in the everyday economy, a description of how the economy really works must consider these animal spirits. That is the aim of this book.”

Though Akerlof and Shiller don’t really designate from where these animal spirits originate, they are emotions that arise from deep within the brain. This is unlike the executive decision-making functions that are located in the front of the brain. The animal spirits are primitive in origin and developed early on phylogenetically. On the other hand, our decision-making capacity is a more recent evolutionary development. Still, there are connections between the two, and one affects the other. For example, confidence is a concept that goes beyond reason. It suggests belief, which necessitates trust, feelings engendered by emotion.

Confidence, fairness, corruption, antisocial behavior, and money illusion are addressed in the five chapters (part I) of the book. As an example of the material covered, in the fairness chapter, game playing experiments are cited. Test subjects will cooperate initially when playing games, but if they learn that not everyone is doing so, they stop as well. Further, subjects that were PET-scanned to determine emotion when the fairness games were played were pleased to see that the unfair players were punished. This has obvious implications for economic decisions.

In part two (chapters six through thirteen), the authors ask and answer eight basic questions that include their reasoning about animal spirits. “Why do real estate markets go through cycles?” is one such chapter. In it, the authors talk about home flipping in the years surrounding 2005 as a clear indicator of a bubble. Still, it was largely ignored, because the enthusiasm of the moment made virtually everyone buy into the craze. This was also true of other debt, including credit card debt. The supply-and-

demand theory was replaced by animal spirits, or at least influenced by them.

The subject of personal emotion influencing investment decisions was [covered by Jason Zweig in \*Your Money and Your Brain\*](#) (Simon and Schuster, 2007) [and also in Richard L. Peterson's \*Inside the Investor's Brain\*](#) (Wiley, 2007). What makes Akerlof's and Shiller's book different is that it is the first to consider the macroeconomic effects of human emotion on financial decisions. As such, it supports the concept that a reconsideration of the accepted economic assumptions and theory is needed—one that includes animal spirits.