"Animal Spirits" – What Keynes Penned, Its Relevance Today

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I have been approached with questions about what should be done to "restore animal spirits." The assumption, of course, is that a revival of "animal spirits" would lift economic growth. The best place to start in attempting to answer this question is the source of the term "animal spirits." John Maynard Keynes, the well-known economist, used this much quoted term in his 1936 book "The General Theory of Employment, Interest and Money." The original usage reveals the meaning and complexity of the term. Here is the original text, long but worthy to pause and read (emphasis added):

> *"Even apart from the instability due to speculation, there is instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of* ***animal spirits*** *- of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. Enterprise only pretends to itself to be mainly actuated by the statements in its own prospectus, however candid and sincere. Only a little more than an expedition to the South Pole, is it based on an exact calculation of benefits to come. Thus if the* ***animal spirits*** *are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die;- though fears of loss may have a basis no more reasonable than hopes of profit had before.*
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> *It is safe to say that enterprise which depends on hopes stretching into the future benefits the community as a whole. But individual initiative will only be adequate when reasonable calculation is supplemented and supported by* ***animal spirits****, so that the thought of ultimate loss which often overtakes pioneers, as experience undoubtedly tells us and them, is put aside as a healthy man puts aside expectations of death."* [Source: "The General Theory of Employment Interest and Money, J.M. Keynes, pgs161-62, Harcourt, Brace, and Jovanovich, Inc., 1953.]

Switching back to the situation today, businesses are cash rich but unwilling to deploy their treasure chest to get the investment engine rolling again at a consistent and strong pace. The trajectory of business spending looked robust as the recovery unfolded only to post milder gains in the first half of this year. Recent surveys point to a decline in business optimism. Consumer spending shows a decelerating trend and the Fed's concern gauge about consumer spending is flashing yellow. What do these observations have to do with "animal spirits?" These are manifestations of the absence of animal spirits.

There is no formal representation of "animal spirits" in macroeconomic theory. Confidence is not a synonym for "animal spirits" but captures a large part of it. A collapse of "confidence" in the market place led to initial stages of the financial crisis which unfolded in the summer of 2007. A series of financial market bottlenecks emerged as doubts about the credibility of counterparties overtook the normal functioning of credit markets. The ultimate result has been a severe credit crunch in the U.S. economy. The reduction of credit amounted to roughly $934 billion between

October of 2008 and June 2010; the magnitude and severity of the credit crunch is a new experience in the post-war period. A confidence crisis that brought about the credit crunch has to be turned around. In other words “animal spirits” that would guide business and household spending have to be restored. Confidence has to return for people to act spontaneously as Keynes notes in his discussion about animal spirits.

In “Animal Spirits: How Human Psychology Drives the Economy, Why it Matters for Global Capitalism,” Akerlof and Shiller explore a new avenue to understand the workings of the macroeconomy and Keynes’s notion of “animal spirits” is the inspiration for their thesis. The authors of this book make an important point about animal spirits and policy making in the context of a credit crunch. In a garden variety recession, expansionary monetary and fiscal policies have the ability to revive economic activity. However, the combination of an economic recession and a credit crunch needs a special remedy. The loss of confidence in the financial sector has reduced the availability of credit. The objective is to make credit available for those who under *normal conditions* could avail of it and currently are unable to obtain credit. This translates into making credit available to households and small businesses incapable of obtaining credit at the present time due to tight underwriting standards. Currently, bankers are constrained by projections of future capital requirements and likely losses from loans on their books. Extension of credit to individuals should restore “animal spirits” and sow the seeds of a virtuous cycle of economic activity such that businesses and households would resume spending. The Fed’s various innovative programs, put in place since the collapse of Lehman Brothers, addressed a part of the lack of credit in the economy. But, these programs and two rounds of quantitative easing have not stimulated the growth of credit and restored “animal spirits” adequately to put the economy back on the path of self-sustained growth.