

# **Animal Spirits and the Economy**

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**Commission on Growth and  
Development  
April 20, 2009**

# Role of Psychology.

- **Animal Spirits:**

- Confidence.

- Fairness.

- Corruption and bad faith.

- Money illusion.

- Stories.

# Confidence

- Not **just** a prediction.
- Also involves Trust.

# Snake Oil

- **Capitalism does *not*:**
  - **Produce what people *want*:**  
**(as long as firms make profits).**

## Snake Oil (continued)

–Capitalism produces what people *think they want*:

(as long as firms make profits).

# Stories

- **Business cycles and stories.**
- **Dot.com Bubble.**

# Why Do Economies Fall into Recessions?

- **Cycles in psychology.**
- **Current crisis:**
  - **Confidence, Snake Oil, and Stories.**

# Why Does Fed Have Effect: Insofar as It Does?

- **Limitations of open market operations.**
- **Discount window.**

- **Four Lines of Defense:**
  - **Regulation.**
  - **Rediscounting.**
  - **Deposit Guarantees.**
  - **Bankruptcy Management .**
- **Shadow Banking:**
  - **No lines of Defense.**

# Current Crisis

- **Credit crunch.**
- **Humpty Dumpty.**
- **Target for full employment level of demand.**
- **Target for full employment level of credit.**

# Meeting the Credit Target

- **Fed Lending Facilities.**
  - **TALF: Treasury takes junior tranche.**
- **Direct capitalization of banks.**
- **Direct granting of credit by SGE's.**

# Why Do We Need Such Targets?

- **Needed for planning.**
- **Needed for legitimacy.**

- **The Playpen Theorem.**