Taming Those "Animal Spirits"

Lessons learned from economy psyche.

By Patrick S. Duffy

It seems that there's just nothing better than an old-fashioned boom-and-bust cycle in the housing market to reveal what economist John Maynard Keynes dubbed "animal spirits" in the middle of the Great Depression. Harnessed appropriately, it fuels the "naïve optimism" that builders and developers require to place risky bets on new developments, when a constant barrage of economic externalities can derail even the best-laid plans.

But when these spirits turn dark – as they have in this "Great Recession," aggregate human psychology can prevent lenders from lending, consumers from spending and homebuyers from venturing into sales offices far beyond what traditional economics alone would dictate.

It is precisely this type of phenomenon that economists Robert Shiller (the Yale University professor and co-founder of the S&P/Case-Shiller Index) and Nobel Laureate George Akerlof (a professor at UC Berkley), discuss in their recent book, "Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism."

Having recently read this book to review for the *Inman News* service, I also thought its lessons were appropriate for the building industry, given that it was housing which sparked the economic maelstrom in which we still find ourselves. As an adjunct to the review, I was also able to interview Dr. Shiller for a new show I'm hosting on BlogTalkRadio.com, *The Housing Chronicles*.

A primary thesis of the book is the failure of macro-economic theory over the past generation to properly account for these animal spirits, which can be subdivided into confidence, fairness, corrupt/anti-social behavior, the illusion of how money really works, and the stories that people and societies tell themselves to explain their place in the world. Somewhat like the 2005 book "Freakonomics," the authors then apply these theories to questions ranging from why countries fall into depressions to why real estate markets seem to always go through cycles.

In the latter case, they contend the latest housing boom (and bust) was due to a strong intuition that home prices – due to the fact that 'they're not making any more land!' – can only go up (an argument that's been used to defend real estate booms for over a century).

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So what's the solution to prevent these spirits from again running amuk? For starters – and jump-started by the combination of a newly liberal White House and a somewhat compliant Congress – the authors think we're on the precipice of a major shift in macro-economic policy. Instead of the hands-off approach which catapulted Ronald Reagan to the Presidency more than a generation ago, tomorrow's economy will involve a lot more regulation.

Yet in order to prevent this regulation from stomping out the entrepreneurial energy which will lead to a rebound, Shiller and Akerlof also suggest that both individuals and government will have to learn how the economy truly works and then apply that knowledge to such vexing questions as investing in stocks or real estate, the practical administration of Social Security or healthcare, and how to balance financial goals against life's many other decisions.

For builders and developers, this shift could also provide a great opportunity to revive or initiate seminars (or Internet-based webinars) on money management, how to appropriately budget for a homebuying purchase, and how to ignore those animal spirits which arise from short- or medium-term changes in the market in pursuit of a longer-term goal: that of paying off a house in which to live.

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Fast Facts

- Collective animal spirits can either boost or sink an economy.
- In order to spend money or invest, people need to know that there are rules that are followed.
- Look for a major shift in government regulation of financial activities.
- Builders are in a perfect place to offer financial management education to consumers.