How might "animal spirits" affect the investment decision?

Principles of Macroeconomics (ECO-2A05)

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The investment decision, also known as the capital budgeting decision is the choice of investing in tangible or intangible assets to generate profits (Brealey et al., 2009). When deciding whether to invest in a company, investors and entrepreneurs have to weigh up the costs and benefits of the capital budgeting decision. This requires looking at the company's balance sheet and previous performance on other investment initiatives. Although this is the rational way of deciding, when animal spirits are high, other irrational reasons take over causing sunspot equilibrium. Animal spirits is a concept formed by John Maynard Keynes, it is the optimistic views of investors; their decisions are based on instincts and predispositions. They are investment decisions that are not based on quantitative evidence of future profits but rather on feelings that are not factual. (Black et al., 2009).

This essay will firstly talk about Akerlof and Shiller's (2009) five attributes of animal spirits and how they affect investment. It will then mention how the business cycle and Gross Domestic Product (GDP) are affected by animal spirits. It will further explain the impact of animal spirits on interest rates and investment. Finally, it will explicate the influence of animal spirits on the stock market.

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Akerlof and Shiller (2009) mention the attributes of animal spirits and how they affect investment and other economic decisions. These aspects are confidence, fairness, corruption, money illusion and stories.

Confidence is a trusting instinct that is based on more than rational calculations; it is a belief that an action or future action will be right. It is linked to the business cycle since when there is a boom people are more confident to invest, as they believe they will be successful. Whereas, a downturn or recession reflects low animal spirits and thus little confidence in the economy. An example of this is the falling consumer confidence towards the Iraq invasion of Kuwait, which led to the rise in oil prices; this wave of pessimism sparked the 1990-91 recession resulting in reduced consumption and output (Akerlof and Shiller, 2009). This fall in confidence can be seen in the Michigan Consumer Sentiment Index preceding the recession, the shaded areas represent recessions.

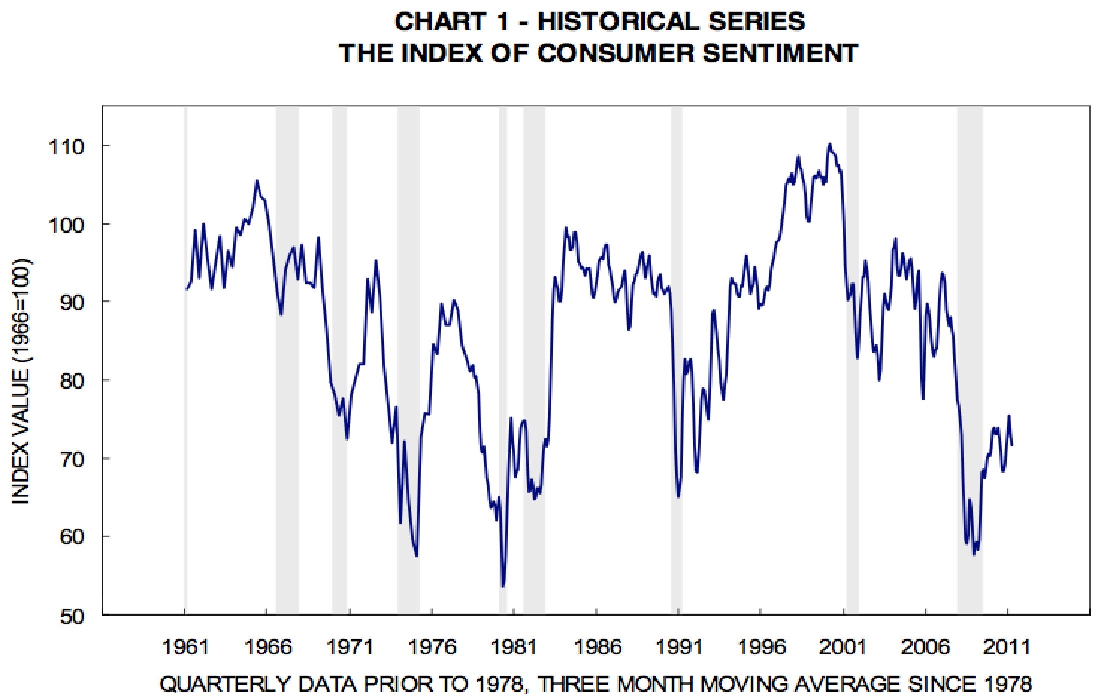

Figure 1: The Index of Consumer Sentiment, 1961-2011 (Surveys of Consumers, 2011)

Fairness is the second aspect of animal spirits, it is the perception of what individuals observe to be fair or not. It affects their views and thus their confidence, which determines investment decisions and hence animal spirits (Akerlof and Shiller, 2009).

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The third attribute, corruption is the exploitation of power for private gain. This can keep animal spirits high as consumers are affected by the false illusion that businesses or economies are thriving until true intentions are exposed and consumer confidence falls. For instance, the Enron scandal of 2001 saw the manipulation of accounting practices to report high profits and increase stock prices (Akerlof and Shiller, 2009).

Money illusion, the forth characteristic, is when financial decisions are made based on nominal dollar terms rather than real terms (Beattle, 2011). Debt contracts, wage contracts and accounting are based on money illusion, which means it does not take inflation into account (Akerlof and Shiller, 2009). Since investment decisions are also based on rational judgement made from analysing company accounts, money illusion can manipulate this, making investment decisions more attractive, which can increase animal spirits.

The final characteristic of animal spirits according to Akerlof and Shiller (2009) are stories. The way stories are portrayed can influence how they are received and understood and thus how stories are acted upon. The confidence Mexican President Jose Lopez Portillo (1976-82) built, led to economic affluence as Mexican Real GDP rose 55% over his 6-year rein. His story of how the weak would triumph the powerful helped build confidence in his people, it worked well as new oil reserves were found in Mexico at that time, in addition to the increase of oil prices in 1979. This fuelled imaginations about the future of Mexico and its growth, increasing animal spirits further (Akerlof and Shiller, 2009).

Investments are very volatile and account for much of the oscillation of GDP and the business cycle hence contributing to economic growth (Dornbusch et al., 2011). The volatility of investment can be explained as the changing confidence (animal spirits) of investors, (Auerbach, 2008). An example is the 2007-09 recession, in which animal spirits depreciated as large U.S banks were filing bankruptcy as a result of bad debts, which was caused by sub-prime mortgages to vulnerable people (Verick and Islam, 2010). This led to credit rationing as banks became concerned with loan defaults (Dornbusch et al., 2011). Investment and therefore growth, decreased rapidly as the global economy spiralled into recession. This example illustrates how the business cycle is related to fluctuations in confidence and trust of consumers in companies and financial institutions (Akerlof and Shiller, 2009). The following figure depicts the relationship between investment and GDP.

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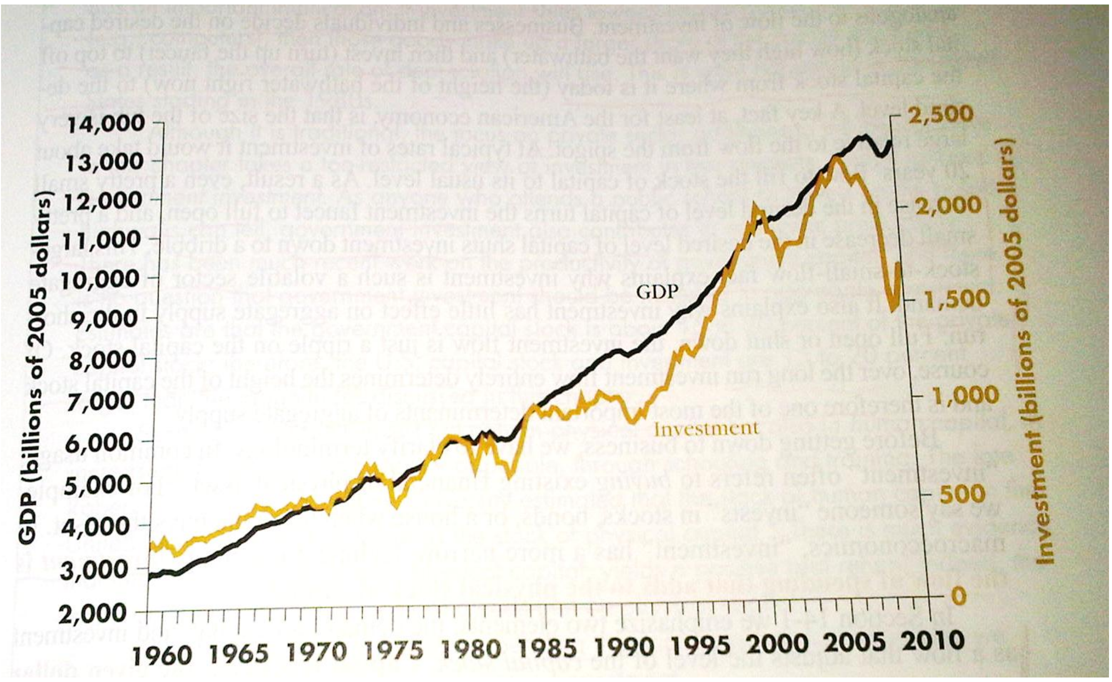

Figure 2: Relationship of private investment to GDP, 1959-2010 (Dornbusch et al., 2011)

The movement of investment is conventionally known to follow interest rates, as interest rates rise, investment falls and vice versa. Although, as Keynes argued, investment can move independent to changes in interest rates if business and consumer confidence is high. An example of this is during the 2007-09 recession when the UK, U.S, Europe and other countries cut interest rates in an attempt to gain confidence by stimulating investment and increasing growth. Since animal spirits were already low this policy failed to take instant affect (Sloman and Wride, 2009). This shows how animal spirits affect investment despite changes in interest rates; the following graph helps depict this.

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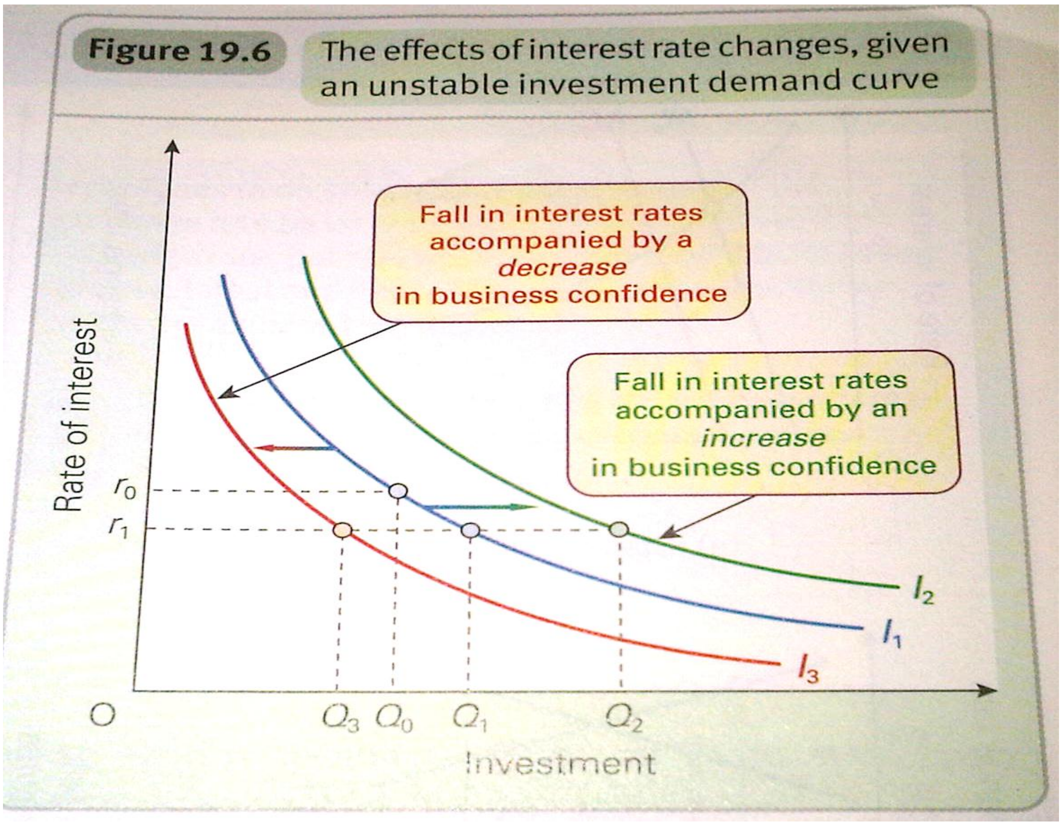

Figure 5: The effects of interest rate changes on investment and business confidence (Sloman and Wride, 2009).

Animal spirits can largely affect behavior of the stock market, and help in causing substantial fluctuations affecting investment decisions. It can also be said that the stock market correlates to the business cycle as recessions usually result in a fall in stock markets. An example of this is the dot-com bubble during 1998-99; it started by the excitement of the Internet and the large media coverage surrounding the enthusiasm of the new technology. This sparked a rush of investors towards Internet related companies, without paying attention to details of business plans or expected profits (Beattle, 2011). The bubble burst in 2000 causing a recession as dot-com companies reported losses and consumer confidence decreased causing a fall in investment. The figure below shows how high animal spirits caused the spike in the Nasdaq stock market during the dot-com bubble.

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Figure 3: Fluctuations in the Nasdaq, 1995-2010 (Madslien, 2010)

The following figure illustrates the correlation between consumer confidence and investment in the S&P 500 index. The close relationship represents the impact of animal spirits on investment.

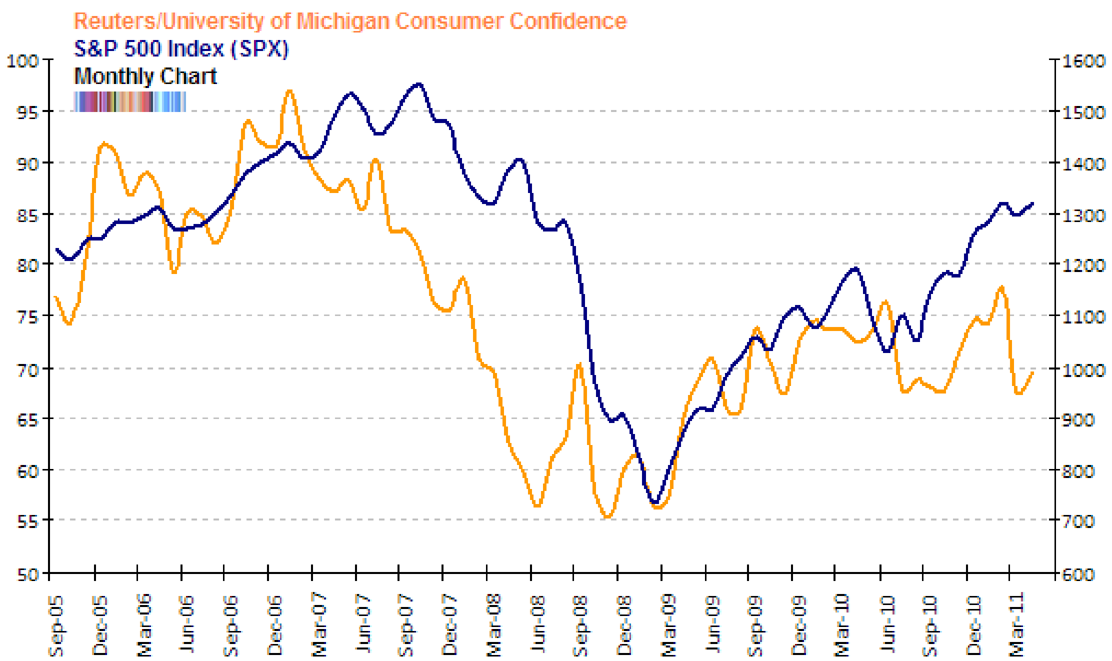

Figure 4: relationship between Reuters/University of Michigan consumer confidence and the S&P 500 Index, 2005-2011 (Surveys of Consumers, 2011).

In conclusion, animal spirits affect the investment decision in many ways such as the five attributes previously mentioned by Akerlof and Shiller. It explains how confidence and fairness helps in determining whether to invest, in addition to corruption, money illusion and stories. Since investment is very volatile it can lead to variations in the business cycle and thus GDP. Animal spirits occasionally are autonomous to interest rates and affect investment in different ways. It also can lead to large fluctuations in stock markets causing extreme confidence or panic depending on market sentiment.

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