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### Book Review

Book review: De Grauwe, Paul (2012): Lectures on Behavioral Macroeconomics, Princeton, NJ (144 pages, Princeton University Press, ISBN 978-0-691-14739-0)

European Journal of Economics and Economic Policies: Intervention (EJEEP)

### Provided in Cooperation with:

Edward Elgar Publishing

*Suggested Citation:* King, John E. (2013) : Book review: De Grauwe, Paul (2012): Lectures on Behavioral Macroeconomics, Princeton, NJ (144 pages, Princeton University Press, ISBN 978-0-691-14739-0), European Journal of Economics and Economic Policies: Intervention (EJEEP), ISSN 2052-7772, Edward Elgar Publishing, Cheltenham, Vol. 10, Iss. 1, pp. 122-123, <https://doi.org/10.4337/ejeep.2013.01.10>

This Version is available at:

<https://hdl.handle.net/10419/277261>

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## Book review

De Grauwe, Paul (2012): *Lectures on Behavioral Macroeconomics*, Princeton, NJ (144 pages, Princeton University Press, ISBN 978-0-691-14739-0)

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This slim volume provides a clear and accessible introduction to the strengths and weaknesses of the ‘behavioural macroeconomics’ project in mainstream economic theory. Its virtues are considerable. First, in chapter 1, Paul De Grauwe explicitly repudiates the assumption of rational expectations, on both epistemological and ontological grounds. In his behavioural model, ‘agents have cognitive limitations’, and therefore use ‘heuristics’ (rules of thumb). But they ‘are no fools. They use simple rules only because the real world is too complex to understand, but they are willing to learn from their mistakes’ (p. 5). Thus their animal spirits – ‘waves of optimism and pessimism of investors that have a self-fulfilling property and that drive the movements of investment and output’ (p. 12) – are not evidence of irrationality. Second, De Grauwe abandons the representative agent and (rather reluctantly) disclaims any attempt to ‘model the micro-foundations of information processing in a world in which agents experience cognitive limitations’ (p. 7; see also pp. 40–44 and 93–94 on the methodological issues that are involved). Third, in chapter 2, he rejects Ricardian Equivalence and instead asserts the effectiveness of fiscal policy. The government expenditure multipliers that emerge from his simulations are overwhelmingly positive, with a modal value of two and a mean that may be even larger (figure 2.8, p. 55). Fourth, in chapter 3, he criticises the mainstream advocacy of inflation targeting as the sole function of monetary policy and argues that central banks should also be responsible for ‘some output stabilisation’ (p. 69). Fifth, in chapter 6, he maintains that asset price inflation should also be of concern to the monetary authorities, and briefly considers alternative instruments to supplement the rate of interest in targeting asset price bubbles (p. 105). Sixth, as he concludes in chapter 8, his behavioural business cycle is endogenous. It yields large movements in output that are ‘generated within the model. It is, therefore, more powerful’ than DSGE models, which rely on exogenous shocks (p. 122). Thus, in De Grauwe’s model, money is not neutral and the Phillips Curve is not vertical. There is a great deal here with which post-Keynesians will agree.

But the weaknesses are also evident. Although he is a strong critic of the standard DSGE model and especially of its RARE microfoundations – representative agents with rational expectations – De Grauwe continues to use the standard three-equation model ‘that in its basic structure is the same as the mainstream new Keynesian model’ (p. 3). Unsurprisingly, he reports that ‘our behavioural model leads to the same results as the standard new classical model when prices are perfectly flexible’ (p. 77), so that the ‘need for output stabilisation ... arises *exclusively* because of price and wage rigidities’ (p. 69; stress added). Like that of the new classicals and new Keynesians, indeed, De Grauwe’s is a strange sort of capitalist economy, with no workers or

capitalists, no profits or wages, no employment or unemployment (though the existence of involuntary unemployment is presumably implicit in the concept of an output gap). There are no references in the three-page subject index to any of these terms, nor to 'banks', 'finance', 'consumption' or 'investment', though the latter four concepts do make occasional appearances in the text. Rather surprisingly, given that the author is Professor of International Economics at the London School of Economics, there is no external sector. Moreover, De Grauwe's 'supply shocks' are confined to unexpected variations in productivity growth, since there is no space in the model for distributional conflict, wage-push inflation or fluctuations in primary product prices. His explanation of the Global Financial Crisis is equally circumscribed: it 'was not the result of an exogenous shock but resulted from excessive optimism that built up before 2008 and led to unsustainable consumption and investment' (p. 125). He has nothing to say about financialisation, the growth of debt, rising inequality in income and wealth, or global imbalances, and it is difficult to see how his model could begin to get to grips with the continuing crisis of the Eurozone. In fairness to De Grauwe, this *is* a very short book: about 80 pages of text, after allowance is made for lists of variables, references, blank pages between chapters and approximately 37 pages of charts and diagrams. His model can and hopefully will be extended to include at least some of the missing variables and neglected issues.

To conclude: it appears from this volume that behavioural macroeconomics, while not really heterodox, is on the outer fringe of orthodox economic theory. It will be interesting to see what the mainstream reviewers make of it in the leading journals.