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Book Review

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Book review

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These are the two latest books written by these two recipients of the Bank of Sweden prize in economic science (often referred to as the Nobel prize in economics). Both books are intended for the public at large, 'intelligent lay readers', and not for a professional audience, although both books are highly interesting, enlightening and entertaining to academic economists. Both authors have already written books in this register, so the fact that they are successful at it is not surprising.

The two books are slightly different in style. Stiglitz's book is more academic and its tone is more serious. It has more than 100 pages of footnotes, compiled by his numerous research assistants, out of a 400-page book. Krugman's book has several graphs, but a more popular and sarcastic tone; there are obvious similarities to his writings in his blogs on the opinion pages of the *New York Times*. What is striking, however, is how much these two New Keynesian authors, especially Krugman, have moved away from their previous academic writings. If one did not know their authors, one could swear that these two books had been written by two heterodox economists, most likely two post-Keynesian authors. Reading them, I had the exact same feeling that I had when listening to a presentation of Robert Shiller at the Eastern Economic Association in the early 2000s, after the NASDAQ crash, when Shiller was predicting another crash, that of the real estate market, basing his analysis on some hard numbers (the evolution of real estate prices relative to residential rents) but also on the behaviour of real estate buyers and bankers, putting forth some Minskyan view of unstable markets. I then felt that Shiller was a kind of closet post-Keynesian, specialized in finance and the real estate. So with Stiglitz and Krugman: it is nearly impossible to see any difference between what they write in their books and what a representative post-Keynesian could be asserting about the crisis and its aftermath.

I start with Stiglitz's book, which, as its title says, deals mainly with inequality and all the negative consequences that it has on the economy and society. Stiglitz's main thesis is that something is wrong with (American) society, and that this is caused in large part by false beliefs. Mainstream economic theory says that markets, free of government intervention, are efficient, stable and fair, and that trickle-down economics will make all Americans better off. But this is all wrong. According to Stiglitz, free

markets are inefficient. They lead to financial crises, high unemployment, falling or stagnating standards of living for the median household, rising inequality and rent-extraction by the powerful. Income inequality in turn leads to more economic instability and to slower growth, in contrast to the claims that some of us were exposed to in the 1970s, when textbooks emphasized the existence of an inequality–efficiency trade-off.

Stiglitz devotes the first chapters to showing that incomes are more polarized, that America as the land of opportunities is now a myth, and that the Gini coefficient has gone up. But why is this so? Stiglitz's main message is that it is the government that makes markets what they are. Over the last 30 years or so, the government has changed the rules of the game. A battle of ideas has been going on, and the Right has won hands down. Relying on behavioural economics, which shows that agents can be swayed by misperceptions, Stiglitz argues that the public has been framed by the ideology of the ruling elite, which modified regulation and the tax structure to its advantage. Politics shape markets, Stiglitz says, making reference to the work of political scientist Tom Ferguson. These legislation changes have also been enhanced by the move towards globalization, and the fact that capital can move from one country to another while labour cannot. The Right has won the war of ideas, as conservative economics is now being taken as a synonym for economic literacy, where egoistic behaviour is the new societal norm, instead of fairness, leading to unabashed rent-seeking behaviour by corporations and their leaders, who have been given free rein through corrosive incentive pay packages.

Stiglitz has always been a true dissident, as his earlier books have also demonstrated, but now he borders on heterodox dissent. He is critical of several mainstream beliefs, and puts forward many claims that have been made in the past by several heterodox authors. First, Stiglitz claims that all markets are born as imperfect markets, a statement which is obviously in line with his previous work on imperfect markets and imperfect information. It is government regulation and intervention that can make these markets competitive and aligned with public interest. This applies particularly to financial markets, which Stiglitz describes as short-sighted, flawed, and suffering from poor judgment. Stiglitz, like Bill Black, the UMKC professor, is particularly annoyed by the fraudulent behaviour of banks, before, during and after the crisis, and he believes that President Obama should have nationalized the banks that were in difficulty instead of rescuing their bondholders and shareholders and allowing them to use taxpayers' money to pay bonuses to their top managers.

Stiglitz turns down many mainstream dogmas. He assures that the US government cannot default on its debt, as would post-Keynesian proponents of modern monetary theory – the neo-Chartalists. He claims that Greece and the Eurozone are victims of a flawed institutional arrangement. He is highly critical of those who believe that deficit reduction will do any good for business confidence, and he argues that the Right's new obsession with deficit reduction is a front for attempting to downsize government. He objects to inflation targeting; he questions interest rate targeting, arguing that when real estate prices rise too quickly, it is better to increase the down-payment requirements on mortgages than to raise interest rates; he refutes the natural rate of unemployment hypothesis (whereas 15 years ago he was still defending it, claiming that it was a useful analytical, empirical and policy concept (Stiglitz 1997)); he says that individuals do not have well-defined preferences, in contradiction to the standard atomistic assumption. Stiglitz writes that recessions are caused by a lack of aggregate demand, and hence objects to weakening trade unions and making labour markets more flexible, on the grounds that reduced wages in a recession would lead to a further

fall in consumption demand and hence in economic activity. He regrets that income distribution variables are not included in mainstream macroeconomic models.

In the preliminary pages of the book, Stiglitz recalls that his PhD dissertation was about inequality, where he showed that under standard neoclassical assumptions, inequality between individuals was bound to gradually disappear. Stiglitz admits that it was already clear to him then that something was wrong with the assumptions. In a recent closed workshop at the Institute for New Economic Thinking (INET), he also admitted that he never believed in the assumption of rational expectations, but quickly realized that his best strategy was to incorporate it in his models anyway. Luckily for us, Stiglitz is not obliged to go through these hoops any more, and he can now afford to sound like a post-Keynesian!

Finally, Stiglitz rejects marginal productivity theory. This, of course, is quite a turn-around, for Stiglitz (1974) wrote a long book review of Geoff Harcourt's assessment of the Cambridge capital controversies, where Stiglitz was defending marginal productivity theory against the attacks of Cambridge Keynesians, arguing, contra Harcourt, that ideology did not play an important role in economic theory. Obviously, he has now changed his mind. This may explain why Stiglitz, while acknowledging the influence of some of his thesis advisors, Samuelson and Solow, also gives credit to some economists that he met during his stay at Cambridge in the mid-1960s, notably Nicholas Kaldor and James Meade. Amos Tversky and Jamie Galbraith are also mentioned among other influences, as well as Paul Krugman, to whom we now turn.

Krugman claims that the purpose of his book is not so much to explain how the crisis happened, but rather to discuss what we ought to do now. Krugman believes that the American economy is still in a state of a depression, akin to Keynes's unemployment equilibrium, where activity remains slow and where unemployment is too high. This situation he finds unacceptable, mainly because unemployment, besides its economic waste, has very large societal and psychological costs, affecting health and happiness, ruining the lives of millions of citizens. Krugman also believes that it is a potential danger for democracy, recalling that Hitler came into power in Germany not because of hyper-inflation but, rather, because of a prolonged period of unemployment.

So where should we be looking for solutions? Krugman agrees with a statement that was made by blogger and economics professor Mark Thoma at the Bretton Woods INET conference: 'new economic thinking means reading old books'! This means reading Irving Fisher, but also Hyman Minsky and Keynes, who are generously mentioned throughout. Whereas in his earlier blogs Krugman seemed rather bored by Minsky's (1986) *Stabilizing an Unstable Economy*, he is rather enthusiastic about Minsky's work now, recognizing that he is a latecomer and wishing that he had read about the financial instability hypothesis much earlier. Michał Kalecki also gets cited favourably. Krugman provides a long quote from Kalecki's famous 1943 article where he wonders about the ability of the capitalist system to sustain full employment, since fiscal policies aiming for full employment would be threatened by calls for 'sound finance', the claim being that large public deficits would reduce business confidence and hurt future employment. This strikes a chord in Krugman, because he is particularly critical of the 'confidence fairy' championed by those who he calls VSPs (Very Serious People), including the UK Prime Minister, David Cameron, and many advisers of the Republican Party.

Like Stiglitz, Krugman is quite appalled by the power exercised by the very rich and the power of the wealthy in shaping politics. Krugman however goes one step further. He believes that money has also shaped the ideas endorsed by the

economic profession, and that the very rich have influenced trends and fads in economic theory. The pressure is put on by donations, fellowships and especially lucrative consulting contracts. The attraction of money, says Krugman, ‘must have encouraged the profession not just to turn away from Keynesian ideas but to forget much that had been learned in the 1930s and 1940s’ (p. 96). Indeed, this is also the opinion of Paul Samuelson (2007), who does not believe that politicians are influenced by academic scribblers, but thinks instead that establishment economists come up with the theories that will please politicians in power and the very rich, turning rightward when the money points in that direction.

Krugman is quite sarcastic with regard to the ‘Austerians’, to use the expression first coined by Rob Parenteau from the Levy Economics Institute, meaning those who favour austerity policies. He makes fun of the predictions put forth by the OECD, the BIS, Rajan (who is said to have forecasted the financial crisis), the star historian Niall Ferguson and Pimco’s Bill Gross, who all thought that long-term interest rates in the US would sky-rocket after the Fed launched QE2. Krugman says he is in agreement with the prudence shown by the new IMF, a view which could be dubbed as ‘new fiscalism’, as my colleague Mario Seccareccia would put it. With new fiscalism, you spend now and you pay later, but you provide a deficit-reducing plan right away. Indeed, Krugman, like the researchers at the Levy Institute, thinks that the 2009 US stimulus plan was way too small, and he criticizes the Obama administration for having moved its focus away from jobs and towards public deficits.

Krugman is highly critical of New Classical economists, those that he calls ‘fresh-water’ economists. Much like Willem Buiter (2009), Krugman believes that economics has entered a Dark Age with the arrival on the main stage of Friedman and then Lucas, and the subsequent fame of authors such as Fama, Jensen, Barro and Cochrane. A new barbarism led by *laissez-faire* purists took over, as economics was subjected to Keynesophobia and a Dr Pangloss view of the world. Real-business cycle models, which are at the heart of the New Neoclassical Synthesis of DSGE models, look absurd: Krugman says that this is because they *are*. Krugman admits that he was himself attracted to New Classical economics as a graduate student, but luckily enough New Keynesian economics then took off, in salt-water economics departments. With their imperfect markets, imperfect information and imperfect rational behaviour, active policy remained possible and desirable.

This said, Krugman, who sees himself as a ‘sorta-kinda’ New Keynesian, recognizes that New Keynesian economists did their best not to stray too much away from the rational agent with rational expectations of the New Classical model that was the standard. As a result, New Keynesian models were not much better in assessing the real world and its financial fragility. Krugman seems to have pursued the same academic strategy as Stiglitz when he says that: ‘I don’t really buy the assumptions about rationality and markets that are embedded in many theoretical models, my own included, and I often turn to Old Keynesian ideas, but I see the usefulness of such models as a way to think through some issues carefully’ (p. 104). This admission is rather stunning! Elsewhere, he has alleged that the IS/LM Old Keynesian model was good enough to fully understand what is currently going on.

Like Stiglitz, there are many mainstream dogmas that Krugman rejects, at least when the economy is in what he describes as a liquidity trap. Krugman does not believe that large increases in high-powered money will lead to price inflation; he does not believe that unemployment today is structural; he does not think that the economy will automatically return to its trend level of output, thus arguing along hysteresis lines that short-run unsolved problems will hurt long-run prospects. Krugman would like the inflation target

to be at 4 per cent; he wants to regulate the shadow banking system; he believes that the current solution to the unemployment problem is to increase aggregate demand by a sustained easy-money policy and expansionary fiscal policy; he asks for the central bank to target long-term rates of interest, for instance the 10-year government bond, at 2.5 per cent as a way to provide confidence to the private sector.

Like post-Keynesians, Krugman highlights the possibility of macroeconomic paradoxes. He deplores the fact that the paradox of thrift cannot be found any more in first-year university textbooks; he describes a kind of paradox of deleveraging, which looks like the one identified by Joseph Steindl and that he attributes to Fisher: 'the more the debtors pay, the more they owe' (p. 46); he maintains that there is a paradox of flexibility, whereby more flexible wages and prices will lead to higher real debt and hence decreased real aggregate demand, thus implying a counter-intuitive upward-sloping AD curve in the price and quantity axes.

On the subject of sovereign default, it is very hard to find any difference between Krugman's views and those of the advocates of neo-Chartalism, except that Krugman recognizes that only rather lately did he become aware of the importance for a country of having its own currency. Krugman attributes this point to a Belgian economist, Paul De Grauwe, which is rather surprising given that proponents of neo-Chartalism have for some time systematically commented on Krugman's blog. Krugman, like the neo-Chartalists, argues that because the European Central Bank is unlikely to purchase bonds from countries in difficulty, there is a risk of a self-fulfilling crisis. This is not the case in countries like the US, the UK or Japan who have their own central bank and who borrow in their own currency. Krugman denies that the Eurozone crisis is the result of fiscal profligacy.

Krugman has put the liquidity trap back into fashion by his frequent use of the expression. What he means by 'liquidity trap' is not exactly what Keynes had in mind however. Keynes's liquidity trap was linked to the fact that bondholders would be reluctant to buy bonds at high prices, and hence at low long-term interest rates, because they would then face the risk of being subjected to overly large capital losses. Krugman's interpretation of the liquidity trap, as defined in two places in his book, is that the saving and investment functions cross each other at a negative real interest rate. This seems to be no different from the explanation of Don Patinkin (1948), who also explained underemployment by the fact that these two functions would intersect at a negative real interest rate. Krugman also seems still to believe in the relevance of the money multiplier story. Nobody is perfect, even Krugman, and Keynesians of all strands will enjoy reading his book.

Both books could be or even should be assigned to students: the Krugman book to more junior students, and the Stiglitz book to more senior ones.

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