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Book Review

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Book review

Dullien, Sebastian, Neva Goodwin, Jonathan M. Harris, Julie A. Nelson, Brian Roach and Mariano Torras (2018): *Macroeconomics in Context: A European Perspective*, London, UK (688 pages, Routledge, softcover, ISBN 978-1-138-18516-0)

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This is the European amended version the US second edition. The new author is Sebastian Dullien, who has done an impressive job in adapting this introductory textbook to the European market. Perhaps the most striking feature of this textbook is the importance given to the recent economic history, notably in Europe. The book provides also a large amount of institutional details, for instance the description and role of all the various financial institutions: universal banks, savings banks, coop banks and private and investment banks, as well as index funds, hedge funds, pension funds, insurance companies, reinsurers, securities brokers, building societies and the mysterious shadow banking system. The authors provide clear descriptions and explanations of the subprime financial crisis and the euro crisis, along with the evolution of the European fiscal rules and the development of the European monetary integration. The book takes a balanced view, showing the pros and cons of the various arguments around these rules and the creation of the eurozone. The weaknesses of the current institutions of the eurozone are clearly shown, to the extent that one is left with the impression that what ought to be done to improve the situation is unfortunately unlikely to occur for political reasons. The only thing missing is a discussion of what the European Central Bank did or did not do to avoid the crisis from early 2010 until August 2012, when Mario Draghi announced that he would do anything that would be needed.

I have commented on some aspects of the US second edition in a previous article (Lavoie 2015), and I have reviewed the first edition of *Microeconomics in Context* and *Macroeconomics in Context* (Lavoie 2009). While the new version keeps the best features of the previous editions, it may be interesting to verify whether some of the weaknesses or drawbacks identified in the earlier editions have been corrected in the European edition. First, the US edition explained the downward slope of the aggregate demand curve as resulting from a wealth effect. In addition, there was no explanation of why price deflation was dangerous. The European version corrects this, as the downward slope is explained by the reaction function of the central bank for large countries, and by gains in competitiveness for small countries. In addition, there are long passages that explain why central banks did their best to avoid price deflation, in particular to avoid the disastrous effects generated by debt defaults. I should point out that all editions of this book make use the AD/AS framework in the price inflation and output space, and not in the traditional price and output space.

Second, the US edition suffered from some contradictions as it sometimes seemed to endorse the traditional view of money creation, with causality going from bank reserves to deposits and finally to credit creation. As a consequence, readers were misled about the potential effects of quantitative easing, as they were left under the impression that

banks could lend reserves. By contrast, the European version has the causality right, rejecting the standard money multiplier story, with loans making deposits which then lead to the creation of reserves. The authors are explicit in advocating reversed causality, saying that ‘reserves are not a constraint to banks’ lending’ (p. 368). As a consequence, the implementation of monetary policy is well explained and corresponds to what central bankers such as Ulrich Bindseil (2014) are now telling us, with changes in (short-term) interest rates only requiring a change in the corridor set by the central bank, and no necessary change in the quantity of central-bank money. Indeed Bindseil/König (2013) note that post-Keynesians have long been arguing along these lines.

Third, the US edition gave its full approval to the quantity theory of money and to the view that increases in the growth rate of the supply of money or central-bank money would lead to increases in price inflation. The European version did not go as far as it could have in its critique of these theories. It discusses whether the velocity is variable or not, without ever considering the much stronger argument based on reversed causality, that is, the view that increases in output and prices cause increases in the money supply. Furthermore when hyperinflation in Germany in the 1920s is provided as an example of inflation induced by an excessive quantity of money, there is no discussion of the alternative view, based on the inflationary impact of a depreciating currency in dire circumstances.

Finally, on the fiscal front, the US edition gave what in my view was an excessive amount of space to the crowding-out argument, implicitly based on the IS–LM model. The critique of crowding out only tried to constrain its effects through arguments around the elasticity of private investment relative to interest rates. In the European version by contrast, crowding in is given pride of place. This is a nice change, but the authors could also have made use of Kalecki’s profit equation, to show that, all else equal, an increase in the government deficit leads to an increase in the profits of firms.

There are a few more criticisms that I noted as I went through the European edition. The first concerns the presentation of the loanable funds model, offered as an alternative to the aggregate expenditure model. It is pointed out that the flexibility of prices, and that of interest rates, will equalize the demand for and supply of loanable funds and thus preserve full employment. For instance, it is claimed that ‘[w]ith saving and investment always in balance, there is no reason to think that the economy would diverge from full employment’ (p. 300). While students may see that the interest rate brings the loanable funds market into equilibrium, they will be hard pressed to find any argument in the book showing that this will be so at the full-employment level.

A second concern is that banks are sometimes being presented as being equity constrained, as in ‘banks were lacking the capital base they needed to make loans’ (p. 301) or ‘because banks had to write down their capital because of losses on their loan portfolios, they were unable to lend as much’ (p. 357). This gives the impression that while the standard money multiplier is gone, it has been replaced by an equity multiplier, tied to the Basel capital adequacy ratios. While several post-Keynesians may agree with it, I doubt it is a correct interpretation of what is going on, except under some exceptional circumstances. Sticking to the issue of money, one might also regret that the textbook has no discussion whatsoever of the ideas defended by the neo-Chartalists – modern monetary theory – on the origins of money and credit.

I noted a couple of further points. It is said that ‘Keynes acknowledged the potential for crowding out’ (p. 346), especially in periods of expansion. My impression is that this is misleading. Keynes recognized the danger of crowding out, but this was a psychological crowding out, in the sense that if entrepreneurs believe that increased public deficits will have a detrimental effect on the economy, they will lose some of their animal spirits and private investment may thus decrease. Finally, in the box devoted to post-Keynesian

economics, it is said that post-Keynesians insist that economies are subjected to hysteresis effects and path dependence. This is certainly true, but these hysteresis effects in a recession are then attributed to demoralized workers who lose their working skills. This sounds more like the arguments put forward by New Keynesian economists. Post-Keynesians maintain that hysteresis effects also exist on an upward path, and instead attribute these to capacity and dynamic Kaldor–Verdoorn effects.

These criticisms are all minor qualms, as I pointed out in my comments in the session devoted to textbooks at the 21st FFM conference in Berlin in November 2017. With my colleague Mario Seccareccia I myself adapted a US introductory textbook to the Canadian market some ten years ago, so I fully appreciate the immense effort required to do such an adaptation, in the present case to the European market. The book is of high quality, and as I said earlier, full of very useful institutional and historical details. Europeans who teach introductory macroeconomics in English should surely be grateful to Sebastian Dullien for having given his time to provide them with this new introduction to macroeconomics.

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