Book Review

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Against the Troika: Crisis and Austerity in the Eurozone
by: Heiner Flassbeck and Costas Lapavitsas
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Greek economist Costas Lapavitsas and German economist Heiner Flassbeck have co-authored this book on crisis and austerity in the eurozone. The book is timely: Lapavitsas is a member of the Greek parliament for Syriza since the January 2015 elections. It is hard to predict the results of the on-going challenge to austerity policies by the Greek Government, led by another academic economist *cum* finance minister (Yanis Varoufakis, editorial board member of this journal). Nevertheless, the future of Europe might depend on it. A successful *Grexit* might cause a succession of countries going *off euro* to restore growth rates, employment and prosperity.

The book by Flassbeck and Lapavitsas is a blue print for the new Greek Government, and any Eurozone government that feels the urge to improve the situation of its people.

The book, which is a quick read, is structured in two parts. The first six chapters explain how Europe got into this position, along with policy alternatives and why they have no been implemented. The last six chapters are economic policy advice to *The Left*, as the authors address them. In this review, I will summarise and discuss the first six chapters rather briefly and then focus on the policy part.

Flassbeck and Lapavitsas begin by summarising contemporary economic conditions in the eurozone along with the responsible policies. After the global crisis banks received liquidity support from the ECB and states received emergency loans in return for austerity policies: privatisation, deregulation and outright wage cuts plus more rules to discipline public finances. As a result, the authors claim that the monetary union now ‘promotes recession, high unemployment and low growth across Europe’ (p.3). Imposing austerity on France and Italy would push Europe into recession, which would put the European Union (EU) in a tight spot.

This political analysis seems to be without flaw, as at the moment France and Italy are warned to reduce their deficits. In chapter two, the authors examine why, if the Economic and Monetary Union (EMU) has delivered disastrous results, it came into being in the first place.

Flassbeck and Lapavitsas revisit the literature on optimum currency areas (OCAs), pointing out that freely floating exchange rates are not feasible for small open economies and that hence fixed exchange rate regimes are preferable. In a European system of fixed exchange rates, an anchor can and did arise with the German *deutschmark*, with the

Bundesbank at the steering wheel. Since its decisions were heavily geared towards the German situation, it was thought that in a monetary union the Bundesbank would be replaced by a European central bank that had the whole currency area in its view. The Bundesbank was following the monetarist doctrine, thinking that it could control both monetary aggregates and the inflation rate. Fiscal policy would not matter for monetary policy. Monetarism was then succeeded by inflation-targeting and neoliberal doctrines, by which the authors seem to imply deregulation, liberalisation and less government invention.

Flassbeck and Lapavitsas focus on wage developments for why the EMU has failed. They argue that wage growth should follow the trend growth of productivity plus some inflation rate target. This golden rule would have led to balanced trade accounts and stable demand. Neoclassical policies of wage reduction would only lead to downward spirals where reductions in domestic demand overpower the gains in foreign demand achieved by increased competitiveness (lower wages). It should be possible for all countries to follow the golden rule, in line with the inflation target. The authors then blame Germany's beggar-thy-neighbour policy for the eurozone crisis. Its subdued unit labour costs led to a rise in German net exports and a rise in foreign debt elsewhere.

With persistent current account deficits a country will not find it possible to repay foreign debt as they aptly illustrate with the balance of payments identity. Thus, Flassbeck and Lapavitsas deny that Germany's policies made it a winner – it was only able to thrive while the real estate bubbles in Ireland and Spain were going strong. The economic growth that resulted benefitted mostly capital owners rather than workers. So, after the bubbles burst, Germany would have to adjust rather than the deficit countries.

Flassbeck and Lapavitsas find that the reaction to the crisis was flawed due to a focus on stocks of government debt and balance sheets while ignoring the flows. In order to move into a net exporter position, the eurozone countries had no exchange rate to devalue. Pushing down prices via wages is unfeasible because it reduces domestic demand and increases the real value of domestic and foreign debt. Cutting government debt would not help much either, since the Greek private sector would lose wealth and probably react by consuming less. Flassbeck and Lapavitsas argue for Germany to reflate by abandoning their export model, which would also cure the euro zone's deflation problem.

Chapters 5 and 6 focus on a history of failure, namely, the policy approach towards European macroeconomic imbalances. In chapter 7, the authors suggest what should happen. Effective debt restructuring is singled out as the key issue. Abandoning austerity is also high on the priority list, as is staying inside the EU/EMU framework. The authors call this the 'impossible triad', since the first two are potentially in conflict with the third. The ECB/EU has two trumps in their hand, controlling Greek banks' access to liquidity and also that of the Greek Government. So, the Greek Government would have to make some credible moves towards exit in order to be credibly threatening exit. Confrontational exit, which the authors seem to think somewhat likely, is dealt with in the next chapter.

Capital controls would be vital in the transition to a sovereign currency as well as circulating euro-denominated scrip. Flassbeck and Lapavitsas then produce a comprehensive checklist which is not without problems. Balance sheets denomination and solvency issues arise for all sectors, and the devaluation that follows the introduction of a new currency must be managed in order to minimise social costs. A balance of payments crisis that would require loans from the IMF should be avoided since it would bring back austerity policies. The authors suggest a safety net provided by the EU as an incentive to stay in EU/EMU.

In the last part of the book, Flassbeck and Lapavitsas examine Greece's recent history more closely and propose necessary reforms. These are an alternative to the Washington Consensus consisting of a write-off of euro-denominated national debt; the return to budget deficits; nationalisation of banks; pro-poor growth policies; industrial policies; and better government. This, the authors hope, would provide Greece and Europe with a ray of hope. Flassbeck and Lapavitsas end with a comparison of the euro with the gold standard, where countries that broke free were awarded until the whole system collapsed.

Flassbeck and Lapavitsas call for a change in macroeconomic regime. In the current regime, monetary policy is used to dampen/increase aggregate demand in times of weakness/excess. With the wage rule the authors propose, macroeconomic imbalances will not arise to the extent seen in the first years of the euro because prices follow wages. However, wages in the euro zone have been subject to change because of changes in credit-financed investment. Real estate bubbles in Ireland and Spain increased wages in the construction sector and other industries followed so as not to lose their workers. This connection would still work in Greece, so either one would have to ration credit or determine wages with a clear focus on the macroeconomic situation. In the latter case, firms would have an incentive to pay more than what was agreed upon with the unions; in the former case, the difficult question of how credit is rationed has to be decided. Flassbeck and Lapavitsas stay silent on these issues.

While this might be an improvement, it nevertheless seems to me that inside existing currency areas such an arrangement is not the rule but rather the exception. The USA has no rules on macroeconomic balances of the states and does not allow wages to be set by macroeconomic considerations. This left me wondering whether the proposed macroeconomic regime is only feasible in conjunction with Grexit. Asking the Greek Government to reform Europe's EMU in order to make it compatible with the proposed regime might be too much to ask for the moment, both in terms of economics and politics.

Book Review

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Reconstructing Your Worldview: The Four Core Beliefs You Need to Solve Complex Business Problems
by: Bartley J. Madden
Published 2014
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Do not let the brevity of this book fool you; its 100 pages of text are packed with useful advice for anyone interested in reconstructing, reconceptualising or rethinking their worldview – a necessary task for economists. For those of us already engaged in reconstructing our worldview this book can help consolidate and lead to a constructive dialogue with other like-minded individuals. This book also makes a great supplement for any course, at any level, especially one emphasising critical thinking. In fact, I plan on requiring this book in my undergraduate principles of economics and my graduate (MBA) Managerial Economics, which says something about the book's versatility, and perhaps also says something about the state of economics education, that such a book works well at both the introductory and the advanced level.

Mr. Madden, a retired managing director at Credit Suisse/HOLT, offers four core beliefs, each integral to reconstructing one's worldview, and each palatable to most *IJPEE* readers. The four core beliefs, taken together are necessary to develop insights to solve real world problems.

After a nicely done introductory chapter, four chapters are devoted to explaining each of the core values. The chapters are peppered with real world entrepreneurs, thinkers, mavericks and business people (what does this say about economics that we even have to mention this?). The sixth chapter integrates the four core values to solve a current dilemma: how to re-align the US Federal Drug Administration with its core mission of providing 'better drugs, sooner, at lower cost'. The final chapter summarises and adds some provocative concluding thoughts. The book's ten pages of notes are informative and the 98 references will provide ample resources for further study.

The first core value is:

> "perceptions are rooted in assumptions that are [based] on what has proved useful in the past, based typically on an application of linear cause-and- effect analysis (if X, then Y). However, an automatic reliance on our assumptions can inadvertently lead to bad decisions, especially so whenever a significant change in context occurs" (p.10).

If economics is to be reconceptualised we must question everything, especially the foundational assumptions. It is folly never to question assumptions while assuming they remain valid even if the context has changed (p.94). One need look no further than neoclassical economics, still ensconced in the assumptions and methodology of the 19th century.

The second core value is:

> "Our perceptions, our thinking, and our use of language are intertwined to such a degree that unraveling the assumptions behind the words can be a useful step in building knowledge. This also facilitates a creative use of language to generate new opportunities for a future unshackled from obsolete assumptions" (p.28).

In order to reconceptualise economics, understanding its language is crucial: Does it elucidate, constrict, or confuse? Is the language conducive to moving forward or is it an obstacle? Does the language bully the neophyte [Fullbrook, (2009), p.19] or can the language move us forward? Madden writes,

> "We all use descriptive language to create 'facts' and to describe our reality; this type of language, more often than not, binds and constrains us. Rewriting the future involves dealing with the past so that it no longer constrains us. In this way we can create space for new possibilities" (p.38).

I can think of no core value more necessary to reconstruct economics than this. The *IJPEE* has published two articles on deconstructing the language of economics (Wheat, 2009; Kapeller and Steinerberger, 2013) and we hope to publish more.

The third core belief is:

> "Systems thinking is invaluable as a means to complement linear cause-and-effect analysis applied to isolated components of a system, to address the tendency toward an excessive focus on local efficiencies that can easily degrade overall system performance, and to powerfully identify and focus on fixing the key constraints" (p.42).

Much of economic pedagogy is concerned with partial equilibrium analysis while using simple calculus to optimise initial constraints. Systems thinking helps solve complex problems from a holistic perspective, and at least from my vantage, no problem is more pressing than global warming. Thus, "understanding complex ecosystems is not possible through a mindset that assumes that one individual acts on another in a neat, linear cause and effect chain" (p.56).

The fourth core belief is,

> "Human behavior is purposeful, so it can be productively analyzed as a living control system that acts to maintain the perceptions of important variables as close as possible to preferred levels. In short behavior is control of perception. A control perspective reveals the underlying weakness in viewing the world primarily as stimulus – response experiences" (p.60).

Our purpose, argues Mr. Madden, is to control our surroundings in order to achieve favourable outcomes; but to do so we must adequately understand the assumptions, world view and system behaviour replete with positive and negative feedback loops. Perception is how our mind experiences the world. What we perceive affects what we do and what we do affects what we perceive. Behaviour is control of perception.

Madden then uses the four core values to help understand and re-align the efficacy of the FDA's mission. This chapter is based on his book, *Free to Choose Medicine: Better Drugs Sooner at Lower Cost* (2012). But this is not an ideological paean to Milton Friedman, as Madden earlier had written,

> "I continue to believe that a primary, and harmful, result of the methodology of positive economics has been to provide mathematically inclined researchers 'cover' in constructing mathematically elegant theories based on unrealistic assumptions that, in fact, stymie more insightful inquiry." (Madden, 2006)

Mr. Madden uses the four principles to argue that the FDA has strayed from its original mission and thus proposes specific legislation to increase competition, enhance consumer decision-making, and attenuate the top-heavy, excessively bureaucratic control of the FDA. Perhaps Mr. Madden can next turn his attention to the energy industry?

Although Madden does not provide an explicit recipe, his four values can be used to critically study any problem such as global warming, poverty and inequality, and the most recent financial crisis.

It should be evident that significant overlap exists among the four values, e.g., "critical assumptions are often camouflaged, rather than clarified, by language" (p.74) and taken together should foster pluralist and holistic thinking among our students, which comports nicely with Hill and Myatt's (2010) clarion call for 'revolution from below', that is, active engagement from students. One quick, illustrative example: Madden discusses the importance of systems thinking with insights from Eliyahu Goldratt and Jeff Cox. Madden writes,

> "In my opinion, Goldratt's most important contribution is the TOC (Theory of Constraints) thinking process. In the most fundamental terms, the primary TOC objective is to answer three questions: what to change; change what; and how to cause the change. This is a departure from standard approaches to problem solving, especially those seen in economics and finance that set up a problem as one of maximizing some variable given existing constraints. Goldratt was adamant that such compromises, based on accepting constraints, should be avoided. Instead, one should devise logical maps to help generate insights, enabling one to dissolve conflicts and any related compromises" (pp.50–51).

Wow! I wish someone had told me this before I began my undergraduate studies in economics.

Madden concludes his book with wonderful advice that all students should follow:

> "The best way to implement the ideas in this book is not just to think in an abstract manner about the material. Rather be extraordinary attentive to the assumptions behind the words, observe problem situations firsthand in minute detail, ask 'why?' repeatedly in a systematic drilling-down to discover root causes of problems, and regularly experiment. In this manner, you will both experience and demonstrate the practical value of an improved worldview to yourself and to others" (p.101).

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