Book Review

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Post-Keynesian Economics – New Foundations
by: Marc Lavoie
Published 2014
by Edward Elgar
15 Lansdown Road, Cheltenham,
Glos GL50 2JA, UK, 660pp
ISBN: 9781847204837 (hardcover)

In 1992, Marc Lavoie's book *Foundations of Post-Keynesian Economic Analysis* established Post-Keynesian economics with a tour de force. Written in a dense but accessible way, the book enabled economists to understand Post-Keynesian economics. In 2014 and one global financial crisis later, Lavoie wrote a very timely second edition, with a few changes in chapters. Quite obviously, 'The Need for an Alternative' is now so clear that chapter one with that name was replaced by 'Essentials', which ends with a section titled 'An antidote to TINA' (There Is No Alternative). The chapter on credit and money now includes central banks and a chapter on open-economy macroeconomics was added. The book has increased in size by some two hundred pages.

Chapter one starts with methodology of heterodox and Post-Keynesian economics. Commencing with a discussion of the Great Financial Crisis (GFC) and the recantations that followed, Lavoie sketches out the competing paradigms and discusses their differences. He assembles a table with some macroeconomic paradoxes and discusses their relevance – like Minsky's paradox of tranquility (or, stability breeds instability) – in the context of today's economic problems. After briefly discussing some issues in the history of economic thought, the first chapter concludes with an attack on neoclassical economics and the statement that "Post-Keynesian economics is an antidote to TINA". In the first edition, Lavoie concluded chapter one assuming that "a number of neoclassical economists are now groping for an alternative programme" and more would follow if the inconsistencies of neoclassical economics would be fully understood. The second edition therefore marks a welcome return to 'political economy'.

Chapter two begins with a discussion of fundamental uncertainty and rationality, which, needless to say, are crucial concepts. A theory of household choice is formalised using matrices and figures to explain the outcome. Instead of a representative agent, groups consume different goods depending on their respective needs. Income effects are more important than substitution effects and the role of price competition is diminished.

The following chapter on the theory of the firm connects to this theme and stresses non-price competition, access to finance, differences in costs and product differentiation. There is a section on power, and another on growth. While growth maximisation is discussed vis-a-vis profit maximisation, a discussion of debt minimisation in times of crisis is missing. The chapter emphasises decreasing marginal costs, which logically leads to a discussion of mark-up pricing and the target rate of return.

Chapter four transitions to macroeconomics, which dominates the rest of the book. While Lavoie wonders whether it “may seem bizarre to start off by dealing with the topic of credit and money”, I think that no such doubt should be entertained. A discussion of balance sheets provides the proper microfoundations of any macroeconomic ‘story’ based on aggregates. In this case, it is the sectoral balances approach that connects balance sheets to aggregates in the private, public and external (rest of the world) sectors. The reader has also been informed that money is endogenous, (short-term money market) interest rates are set by central banks, that negative changes in asset values can and should cause banks to go bankrupt, that clearing between banks usually works via the central bank accounts of the banks, that there are overdraft economies in which banks are structurally indebted vis-a-vis the central bank, and that there are asset-based economies in which this is not the case. Interest rate setting is described in some detail, as is quantitative easing, followed by a long section on portfolio choices and liquidity preference. The section on financial instability focuses on Hyman Minsky and the shadow banking system. The reader can intuit underlying stock-flow consistent (SFC) models hinted at in previous discussions. Section 4.6 finally provides a SFC view of the economy. The monetary circuit is stressed, focussing on the two quite independent issues of financing investment (‘initial finance’) and the allocation of portfolios (‘final finance’). Post-Keynesians hence do not put the capital market at the centre of their macroeconomic analysis.

Chapter five deals with the labour market, with effective demand determining employment. A Kaleckian model is developed leading to technological unemployment: “as a consequence of technical progress, a given amount of output can now be produced with fewer workers”. The model is then extended and results are examined. It is noted that the business community might misunderstand where profits are coming from and that this would lead to a rejection of Lerner’s functional finance in practice. This is a crucial issue in Post-Keynesian thought. According to Lavoie, writers of modern monetary theory (MMT), which is a Post-Keynesian offshoot, accept all three of Lerner’s claims whereas many Post-Keynesians would only accept the first two:

1 A budget deficit is neither good nor bad.

2 Government is not helpless and unable to raise funds.

3 In the attempt to achieve full employment the public debt will not rise forever.

The chapter ends with a discussion of fiscal versus monetary policy. With zero interest rate policies, monetary policy is relatively ineffective; fiscal policy, on the other hand, is fully effective. Lavoie warns that current account deficits can complicate things as a strongly growing economy surrounded by austerity economies might “raise additional concerns from financial observers”. At this point, the reader is left wondering whether this is a political economy argument or whether there is some economic or financial consequence that has to be feared (like debts denominated in foreign currency). The last warning concerns the distribution of income and the consequences of tax cuts. Given the failure in recent decades to increase economic growth through tax cuts this is now common sense.

Chapter six focuses on accumulation and capacity, and is based on Joan Robinson’s idea of addressing growth and distribution from a Keynesian perspective. Both neo-Keynesian and (Post-) Kaleckian models are presented. Economies are divided into wage-led and profit-led, depending on whether an increase in real wages has a positive effect on the rate of growth and the rate of profits, or not. Other sections discuss stability, technical progress and indebtedness of firms and households. The chapter is by far the most mathematical and requires a PhD in economics (if only because of the terminology and references to economic theories) and some days to digest it. Given that the other sections are very accessible to someone with a degree in economics it seems to be somewhat isolated in terms of methodology. It also is denser than other chapters, with eleven sections fitted into it.

The following chapter on open-economy macroeconomics is also dense but more readable. It starts with a discussion of the balance of payments. It is made clear that international portfolio shifts triggering international capital flows do not change net financial balance. Again, the role of capital markets is found to be relatively unimportant. The next section focuses on the compensation thesis in fixed exchange rate regimes. This is one of the strongest sections in the book, providing an alternative story to the orthodox view of savings (as capital flows) being a driver of the balance of payments, e.g., Bernanke's global savings glut hypothesis and the Mundell-Fleming model. Lavoie notes that there is no automatic mechanism leading to an increase in the money supply and hence in the price level of net exporters that would lead the international trade system towards equilibrium over the long run. This leaves the world economy vulnerable to neo-mercantilist policies. Interest rates and exchange rates are then discussed. Lavoie looks at the international financial architecture, featuring the eurozone, and discusses Keynes's Plan for an International Clearing Union and its similarities with the TARGET2 clearing system in the eurozone. Capital controls are presented as well as absolute and comparative advantage, trade protection, increasing returns to scale and the infant-industry argument. The last sections focus on international trade theory, mainly Godley's trade and fiscal stance, Thirlwall's law and a Kaleckian model of an open economy. There is no section on development, although the issue appears multiple times in the chapter.

The last chapter deals with inflation theory. Inflation is seen as a result of conflicting claims from competing groups on production. Post-Keynesians reject the idea of natural rates of interest and unemployment, and the Phillips curve. The money supply does not determine the price level, nor does the change in the money supply drive the inflation rate. Another theory dismissed is that of (government) debt monetisation leading to higher rates of inflation. The recent increases in the monetary base by central banks confirm this view, as does the missing inflation following expansionary fiscal policy. Post-Keynesians stress power relations between workers and employers and the relative income distribution. A conflicting claims model is used to show the results of the outcome of the bargaining process. The chapter ends with a discussion of changes in the price level in an open economy.

In his concluding remarks, Lavoie discusses the future of Post-Keynesian economics and strategies to diffuse the works of heterodox economists. His five policy objectives – fair distribution of income and wealth, financial stability, full employment, sustainable inflation and external balance – are a very good fit for the problems of our day. Given that students demand more pluralist economics, the recent success of MMT in getting the attention of a wider audience, the disappointing development of the euro zone's economies and the intellectual bankruptcy in wide parts of the discipline, Marc Lavoie has written a timely second edition. Economists looking for answers to problems that were created when the world was ruled by neoclassical thinking will have to look for answers that come from outside of the comfort zone. This book presents an excellent introduction to Post-Keynesian economics leading to a solid foundation to build progressive policies. It addresses economists rather than the wider public, so hopefully this book triggers a flurry of additional literature to break its contents down into parts that more easily lend themselves to persuade the public that there is an alternative.