Book Reviews

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1 Hall of Mirrors: The Great Depression, the Great Recession, and the Uses – and Misuses – of History

by: Barry Eichengreen
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North Kettering Business Park, Hipwell Road, Kettering, Northhamptonshire, NN14 1UA, UK, 512pp
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Barry Eichengreen, already a well-known economic historian, further adds to his prestige with this comparison of the Great Recession and the Great Depression. Eichengreen sees great similarities between the two, and given that economic institutions were overhauled after the Great Depression but not after the Great Recession, concludes that "we are likely to see another such crisis in less than eighty years" (p.387). In a nutshell, his book vindicates the economics of Keynes, which put fiscal policy at the centre of macroeconomics. After decades of reliance on monetary policy the Great Recession resuscitated Keynesian economics, which was first enthusiastically greeted by some academics and then subdued by others. Without doubt, the paradigm in macroeconomics is shifting, moving towards the positions that Keynes took in his *General Theory of Employment, Interest and Money*. Eichengreen's book elucidates why this shift is happening.

In his introduction, Eichengreen states that the mistakes of the past have helped us avoid a repeat of the Great Depression. Expansionary fiscal and monetary policies were used in both US and Europe, on which the book heavily centres. He rejects a 'mission accomplished' approach to the Great Recession, pointing out that 'this happy narrative is too easy'. Economists did not 'see it coming', to the disgust of Queen Elizabeth II. While problems were building up in the economy, they wrote about the 'Great Moderation', with its benign business cycles due to improvements in central banking; and academic economists and policy makers largely ignored the housing bubble in the USA, although some, like Robert Shiller, warned about it.

Eichengreen regrets that not more was done to counter the Great Recession, given that we know how to deal with it. Of course, the financial system then and now are different, but for Eichengreen the biggest policy failure was how the Treasury and the US Federal Reserve dealt with non-bank financial institutions on the verge of bankruptcy. He is slightly astonished that even with a scholar of the Great Depression at the helm (Ben Bernanke), the Fed could not do more. Eichengreen finds that austerity policies in Europe have been too much of a good thing, stating that "[i]n Greece, where spending was out of control, a major dose of austerity was clearly required" (p.7). He is highly

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critical of the monetary policy response as well, blaming the euro zone's double dip recession – two recessions in a short space of time – on the interest rate hikes by the European Central Bank (ECB) in 2011. Bernanke is made responsible for not trying to stop the real estate bubble with 'direct pressure' (p.63). Eichengreen is also disappointed with the fiscal policy response, which he thinks is due to an intellectual failure to closely examine the situation with its trade-offs of short-term demand support and long-term fiscal consolidation; and to differentiate between countries that could use expansionary fiscal policy and countries that could not.

For Eichengreen a preponderant cause of these intellectual failures is how economics has been taught in the last couple of decades. Whereas Keynes relied on narrative methods, today mathematics rules in academic economics. While the models are very elegant, "little can go wrong unless government makes it go wrong" (p.9). Eichengreen laments that a consensus on expansionary fiscal policy was not reached in the USA, which in turn weakened the case for an effective response that could have at least partially restored the reputation of economists. As for Europe, things were even worse. German memories of hyperinflation were standing in the way of a fiscal stimulus. At the European Commission, Reinhart and Rogoff's paper on public debt was put forward to justify the austerity policies. Little did it matter that almost instantly the paper was torn apart because of simple errors made in the econometric part that left little if anything to work with in terms of policy conclusions.

Nevertheless, Eichengreen sees as a fundamental difference the success of avoiding an economic calamity in the Great Recession as compared to the Great Depression. This has limited both political backlash and pressure for reform. Also, the euro zone is not the gold standard: whereas the latter was abandoned in order to resume growth, the former survived the crisis. However, this statement might be somewhat premature. As it stands, political consensus in countries like Greece, Spain, Italy and France is building around the idea that the euro has to be abandoned in order to return to acceptable economic growth rates. One should not forget that during the 1930s the unemployed were desperate, even in the US and Western Europe, whereas in the 21st century most of the unemployed will somehow get by.

The remaining book is divided into four parts, approximately named boom, bust, recovery and lessons. Eichengreen jumps back and forth between the Great Depression and the Great Recession, underlining parallels and examining differences. This approach is quite useful, since most readers will not be familiar with either episode. In the first chapter, Eichengreen describes the real estate boom of the 1920s in Florida, which includes the famous Ponzi scheme. The history of global imbalances is not so clear-cut. Germany borrowed heavily from the USA in the 1920s, just like the USA borrowed from the rest of the world, including China, in the 21st century. However, the Chinese central bank bought US treasury securities, whereas US portfolio investors bought German private sector bonds and stocks, and US banks made loans to German companies. Whereas these imbalances were crucial in the transmission in the Great Depression, they played a minor part in the Great Recession.

The story told by Eichengreen about the Great Recession is not surprising, as it does not differ from the existing narrative. The financial sector, abetted by models built on shaky foundations – including the efficient market hypothesis – and by warped incentives, helped cause the real estate bubble, with regulators watching from the sidelines. Special purpose vehicles were used to hide rather than manage the risk.

Eichengreen provides ample detail on both Great Depression and the Great Recession, which makes the reader wonder why nobody at the time 'saw it coming'. This is especially so in the euro zone, which he heavily criticises: "The idea that monetary union could proceed without political union turned out to be a fatal mistake" (p.93). Eichengreen recognises that current account imbalances are no cause of worry as the euro zone works just like the USA – the dollar zone – with respect to financial flows. He blames the problems on diverging unit labour costs, especially in Germany, where unit labour costs stopped rising following the 2003 reforms by the red-green coalition under Schröder. Unit labour costs in the periphery were increasing, and the lack of a sovereign currency with an exchange rate meant that bilateral intra-euro zone current accounts would be imbalanced. Eichengreen hence agrees with the wider Keynesian history that puts unit labour cost developments at the center.

In the conclusion, Eichengreen argues for more government, not less. Instead of imposing austerity policy, public spending should offset the decline in private spending in times of crisis. He argues for a temporary, not a permanent increase, mainly because he does not want to see public debt "spiraling out of control" (p.378). This policy would help the unemployed, which he finds fair and just since they did not cause the crisis. Eichengreen also argues that this policy would increase support for existing political and economic arrangements. Given the radicalisation of European and US politics, this is advice that comes too late. Last but not least, Eichengreen would like to see the policies corrected that ultimately caused the crisis. He does not go into detail, but social policies are on his list. Eichengreen does not say whether he sees the decline in union power as a problem; there is no entry in his index on 'unions', which in the European context at least is a little odd. The decline of the European welfare states occurred simultaneously with a decline in union power. Instead, Eichengreen sees a failure of the public to provide education and training, as well as technical change, as the causes of inequality.

Regarding financial regulation, Eichengreen seems to follow the ideas of Hyman Minsky. Long periods of stability lead to greater risks. Eichengreen does not offer a plan forward to regulate the financial sector, even though he writes that advances in risk management have existed only in the minds of market participants. In the context of Europe, he thinks that Europeans should have known better than to adopt the euro since capital flows can always be destabilising. This is at odds with his insight that current account deficits are no cause for concern. The payment system of the Eurosystem (TARGET 2) worked successfully, so that capital flight from the periphery to the core did not cause a breakdown of banks. It did cause sovereign bond prices of the (current account) deficit countries to increase, but this only happened because the ECB did not intervene to stabilise them. Only in the euro zone did bond prices decrease (and then increase) during the second episode of the European Great Recession (2010–2012). In all other countries, central banks pushed interest rates down and bond prices up successfully.

Eichengreen is a New Keynesian, which manifests itself at various times. He does not seem to understand that the ECB and the euro zone are very special because the former does not act as a lender of last resort to euro zone governments. He does not disagree fundamentally with Friedman's dictum that inflation is always and everywhere a monetary phenomenon, which is at odds with his emphasis on unit labour costs. If, on average, productivity in Germany increases at 2% and wages at 1%, what will Germany's inflation rate be? It turned out that it was close to one percent, a full percentage point

below the ECB's official target rate. Eichengreen also seems to think that an increase in government spending will lead to a higher rate of inflation. He writes about policy makers deciding to run a budget deficit, which is at odds with reality: A government budget is drawn up first, determining government spending, but taxes are only collected over the year and depend very much on the level of aggregate demand, of which government spending is one not insignificant part. The fact is that the government does not and cannot control the budget deficit. The euro zone countries have learnt this lesson the hard way. US President Obama chose to ignore the public deficit and was rewarded with relatively strong economic growth and a shrinking deficit.

Another issue that seems to be clouded by economic theory is the issue of capital flows. Eichengreen sees capital flows from Northern to Southern Europe. This wording, however, is inappropriate. The euro zone is a currency area, and just like in the US real estate loans are not caused by flows of capital. The same applies to Europe. Spanish and Irish banks created lots of new real estate loans, while German banks did not. Since Spaniards and the Irish used some of those newly created deposits that resulted from new bank loans to buy German exports, some deposits ended up in Germany. The TARGET 2 system handles this straightforwardly: In good times, Spanish banks owe central bank money to German banks, postponing settlement by paying an interest rate on the net amounts outstanding. If these net amounts are too large for German banks in terms of risk, they might ask for a higher interest rate in the form of covered or uncovered bonds. This has nothing to do with capital flows, where it is implied that savings or deposits are transferred from one country to the other. Eichengreen, hence, builds his analysis on the loanable funds theory, which has been a victim of the crisis. This causes more problems further down the road, when, for instance, he sees the Chinese savings rate as determined by Chinese savers and their behaviour. That in a closed economy savings equal investment is a well-known macroeconomic identity, but Eichengreen reads it backwards. Investment financed by loans creates additional deposits in banks, which somebody will hold at the end of the year. Since savings is defined as income not spent, this is how investment creates savings.

Barry Eichengreen's history of the Great Depression and the Great Recession is a very good New Keynesian account. However, the theory behind the writer weakens the case for an expansion of public spending, the more so if weakness in demand resulting from increased inequality of both income and wealth will make necessary a permanent expansion. Also, the monetary approach to inflation neglects the role of unit labour costs and hence the importance of power on the side of both employers and unions. Given that even at the IMF it is possible these days to publish a paper on the decline of neoliberalism, the book falls short because it does not provide a political analysis of the economic history, and it also does not offer an alternative economic theory with which to search for policy options that can reverse the damage done to the societies of the US and Europe. Eichengreen ends with the prediction that another financial crisis will come relatively soon since none of the problems that led to the last one were corrected. This is probably right, and Eichengreen hits the nail on the head when he says that history matters. However, all political power groups know this, and there is no insurance against drawing the wrong lessons from history, as the European experience shows. Maybe economic theory has to change first before the lessons of history can be properly learned?

2 John Maynard Keynes

by: Hyman P. Minsky
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The 2014 movie *Boom Bust Boom* featured Hyman Minsky as perhaps the greatest intellectual 'winner' of the Great Financial Crisis (GFC). Hyman Minsky was not well-known during his lifetime (1919–1996), teaching at the University of California Berkeley and Washington University of St. Louis before becoming a distinguished scholar at the Levy Institute of Bard College, NY. Modern textbooks of (macro)economics do not contain his name or his ideas, and even Post-Keynesian textbooks usually ignore him. Who, then, was Hyman Minsky, the economist?

A proper investigation should start with his 1975 book, *John Maynard Keynes*. Minsky was a Keynesian, or perhaps even better: one who had read and understood Keynes. Minsky's other influence was Schumpeter, his teacher at Harvard as a PhD student. Schumpeter was famous for his *Theory of Economic Development*, (see my review in this journal last year: Vol. 6, No. 3, pp.309–312), which contains a discussion of investment financed by loans, featuring a monetary theory as an alternative to neoclassical theory. Since Keynes in *The General Theory Keynes* did not explicitly offer an alternative view of money, while of course recognising that savings do not create investment, Minsky argued that it needed to be supplemented in order to "emphasize investment in a world where business cycles exist and engender uncertainty" (p.18). Existing conventional Keynesian doctrine, including the neoclassical synthesis, does not capture the spirit of Keynes and hence fails to present his thought to the next generation of economists.

Minsky devotes the first chapter to the standard interpretation of Keynes, highlighting the IS/LM model and the neoclassical synthesis. His main critique of the IS/LM framework is that it "violates the complexity of the investment-determining process as envisaged by Keynes" (p.36). As will become clear later on, Minsky found Chapter 17 fascinating, but could not find it in the IS/LM framework. Minsky acknowledges that in *The General Theory* the determination and definition of monetary quantities and the rate of interest are unclear, with which I agree after a thorough reading of chapter 13. Minsky then discusses the neoclassical synthesis, focusing on the real balance effect. A fall in the price level increases wealth which then increases consumption as people feel richer. However, investment is bound to fall since it depends on expected prices. In a deflation this would negatively affect investment. Minsky also recognises Keynes' similar insight in his *A Tract on Monetary Reform*: "A decline in wages and prices will tend to set off a money-decreasing, debt-deflation process [...] wage and price-level flexibility is disequilibrating" (p.54).

The next chapter is on fundamental perspectives. Minsky begins with a discussion of equilibrium vs. business cycle. Keynes sees his *General Theory* in the latter camp, whereas IS/LM advocates see it in former. Keynes distinguishes boom, crisis, deflation, stagnation, expansion and recovery, and Minsky wonders why *The General Theory* does not contain a systematic investigation of the business cycle. Minsky also identifies with

Keynes's fundamental insights on uncertainty, quoting Keynes, in which "there is no scientific basis on which to form any calculable probability whatever". He stresses that Keynes saw conventions as an approach to deal with uncertainty. This connects to the renewed debate on non-ergodicity, which Paul Davidson and the Post-Keynesians are engaged in currently.

The chapter's last section is on investment and disequilibrium. Minsky points out that Keynes did not accept the view that investment is stable if technical productivity is stable. Disequilibrium arises from the financial side of the economy, with portfolio preferences, financing conditions and uncertainty driving investment. Minsky imagines "Keynesian economics as the economics of [permanent] disequilibrium" (p.68).

In the remaining part of the book, Minsky departs from Keynes, standing on his shoulders to build a financial theory onto *The General Theory*. Minksy emphasises – along with Schumpeter – that deposits are created by bank lending, and that these deposits indirectly finance some position in capital assets. He laments that Keynes has obscured the argument by using the interest rate for both the terms on money loans and as a proxy for the price level of assets. Minsky then discusses ch. 17 of *The General Theory* ('The Essential Properties of Interest and Money') which is the book's central issue. Minsky later writes, "[I]t is finance that acts as the sometimes dampening, sometimes amplifying governor for investment. As a result, finance sets the pace for the economy" (p.130). So, how does finance do it?

Minsky builds on Chapter 17 stating that "the total return expected from ownership of an asset over a period is equal to its yield minus its carrying costs plus its liquidity premium". So assets lead to income flows (yield), have a carrying cost and a liquidity premium if they are easy to sell, without a fall in the price. Most longer-term assets have significant yields, a low carrying cost and a low liquidity premium, whereas money features a yield of zero, almost no carrying costs but a substantial liquidity premium. What is the connection? As long as the expected total return of ownership of an asset is higher than the interest rate of money, it makes sense to financially invest in that asset. Assets with an expected total return below the interest rate of money will not be invested in.

As financial investment occurs, liability structures are fixed, implying cash-payment commitments based on the expected total return of assets. At some point in time, "firms will have cash-payment commitments over a period which exceed its expected cash receipts from operations" (p.87). If that firm chooses to sell assets in order to gain cash, a downward-spiral can be triggered. As asset prices fall, expected total returns are diminished and hence more assets are sold. Minsky's world is one of two price levels: current output prices adjust sluggishly, whereas financial asset prices adjust instantaneously. This will have consequences for capital investment.

Minsky's theory of investment also starts from chapter 17 of *The General Theory*. The yields of capital assets (taking into account their supply price) used in production have to be higher or match the yields of capital assets held in portfolios. As long as this is so, physical investment in capital goods will continue. Minsky prefers this approach to the concept of the efficiency of capital. Capital goods are financed through debt; and this is how Minsky connects investment to liability structures. Lender's risk limits the amount of credit a single client can get from a lender; and borrower's risk limits the amount of credit demanded because the borrower understands the uncertainty regarding uncertain cash flows and certain debt payments, along with the effect of an increase in investment

on the yields of competing investments. As Minksy states, “The pace of investment is most sensitive to these borrower’s and lender’s risks” (p.111). It is quite obvious that he offers a description of credit cycles with no use for the idea of long-term equilibria. The economy is unstable – and if it is not, it will be!

The last three chapters provide more insights into Minsky’s interpretation of John Maynard Keynes. Speculation plays a central role in capitalism as owners of capital assets, banks, financial institutions, firms and households all speculate. They all manage assets and some also liabilities. Sometimes they all want to shift their portfolio in the same direction. This is when panic-induced selling leads to debt-deflation, to which the central bank can respond as a lender of last resort. In addition, Minsky also attacks the idea that downward wage flexibility can improve things in a situation of unemployment; he argues that positive rates of inflation are necessary for an economy led by private investment; and he revisits the social philosophy of Keynes, concluding that “[w]hen conservatives are Keynesians, then tax and spending policies may well be used to give life to rentiers rather than to abet their euthanasia”.

Given the shortness of human life, the genius of writers on the subject of business cycles will probably only recognised *ex post*. Minsky is surely one of them. And his book *John Maynard Keynes* is well worth reading.