Book Reviews

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1 Can We Avoid Another Financial Crisis?

by: Steve Keen
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Steve Keen's short new book deals with a big (and timely) question: *Can We Avoid Another Financial Crisis?* Keen retells the state of the discipline in the 2000s, when economists congratulated themselves for the Great Moderation, supposedly brought about by efficient financial markets with brilliant regulatory oversight and prudent policy-making, based on central banks moving short-term interest rates to achieve their inflation target. What could possibly go wrong? Ten years after the sub-prime crisis, the discipline of economics has still not come to grips with the consequences of the great financial crisis (GFC). Most economics students are not exposed to a realistic treatment of how money, finance and fiscal arrangements work. One way to rectify this deplorable situation is to read Keen's new book.

The book is divided into six chapters. The first chapter revisits the recent history of economics, with the financial crisis as the start of the crisis of economics. The second chapter contains a discussion of the connections between microeconomics and macroeconomics. Chapter 3 discusses an alternative view of the 2000s, as private debt soared and financial fragility increased. Chapters 4 and 5 deal with private debt and its political economy explicitly. Chapter 6 concludes cynically, as the chapter title warns. With 148 total pages, this is a quick and easy read. Since Keen uses plain English, non-economists might want to read it, even though the exposition is quite dense and packs a lot of facts that might not be so easy to digest.

The first chapter summarises how economists went from Robert Lucas' 2003 AEA presidential address boasting that "economics' central problem of depression prevention has been solved" – to the biggest financial crisis since WWII. Keen presents a history of economic thought from the 1930s to the 21st century, with a focus on dynamic stochastic general equilibrium (DSGE) models and the forecast errors made by policy makers and institutions before the GFC. He counterposes the theories of Hyman Minsky and John Maynard Keynes, both arguing that the economy is unstable. The chapter ends with a discussion of what a model of the macroeconomy must look like – should it be built on microfoundations?

The answer is provided in Chapter 2. Keen notes that microeconomic aggregations of the neoclassical type do not incorporate distribution. Therefore, microeconomic foundations will tend to overlook distributional issues. Also, the idea that macroeconomic

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properties must emerge from microeconomic properties is ridiculed and rightly so. Keen's example featuring water consisting of water molecules (H_2O) is brilliant. The emergence of snow on the macro level must be explained by 'snowflake' molecules if one takes the micro level seriously. In complex systems, however, the whole is more than the sum of its parts. Keen proceeds to build a small macroeconomic model from three 'core definitions': the employment rate, the wage share and the private debt to GDP ratio. Defining core relationships between these variables, his private-sector-only model is completed. Among other things, it predicts that a financial crisis can follow a period of low and stable inflation.

In Chapter 3, Keen examines fundamental variables for recent macroeconomics. He finds that private debt grew exponentially before the crisis, caused in part by the real estate boom and that during times of quickly increasing debt GDP would also increase quickly, thus reducing unemployment. The resulting boom in the economy looked good to most observers, who failed to see that the boom was not sustainable. Policy makers then failed to correctly judge the coming financial crisis. Keen examines the US economy, Japan (where the financial bubble burst earlier) and Australia, where a crisis was postponed by more borrowing.

Chapter 4 deals explicitly with private debt. Keen argues that banks can create deposits when they make loans without having to use savings and/or central bank money. He recounts his debate with Paul Krugman, who disagrees with this view. Keen correctly points out that monetary theory has a large influence on any macroeconomic theory, since macroeconomics builds directly on it. Keen develops the idea of nations as 'debt zombies', which are 'characterised by a very high level of private debt (more than 150% of GDP) and credit-based demand before the crisis (equivalent to about 15% of GDP)'. In 2008, the US, Denmark, Ireland, The Netherlands, New Zealand, Portugal, Spain and the UK were 'debt zombies'. Candidates for 'debt zombies' today are Ireland, Hong Kong and China, followed by less probable candidates like Australia, Belgium, Canada, South Korea, Norway and Sweden. Keen points out that economic problems in China stemming from low or negative growth of private debt would potentially disrupt the world economy.

With this, Keen turns to chapter five on the political economy of private debt. He rightly points out that the obvious solutions – a bigger government, a less powerful financial system – will demand politically hard choices and intellectually challenging turnarounds of prevailing views. Nevertheless, there would be no other choice. If private debt does not grow, then private expenditures will be relatively low. Demand will not be enough to stabilise the unemployment rate, given that productivity growth is low and a reduction of working hours is nowhere in sight. In his conclusion, Keen sees stagnation at the global level as debt-zombies-to-be will eventually turn into crisis economies and slow down the world economy. Keen blames this development on "mainstream economists [who] have clung to delusional ideas about the nature of capitalism, even as the real world, time and time again, has proven them wrong."

Mainstream economists notwithstanding, Bernie Sanders in the USA and Jeremy Corbyn in the UK both came reasonable close to governing. Probably, Keen is too pessimistic because he overplays the power of academic economists. Also, the next recession might trigger a rethinking as interest rates hover near zero in most developed countries, with fiscal policy the only tool left, apart from currency devaluation. Whether Keen is right or wrong with his prophesy, his book is excellent. He correctly points out

that economists have played a large role in bringing about a financial system that powers an economy dependent on private debt. The alternative, an economy relying more heavily on public debt, would be able to mitigate many of the bad effects of private debt. How to bring this about, however, would require another book.

I highly recommend *Can We Avoid Another Financial Crisis?* to anyone (especially students of economics) looking for a short, readable introduction to the state of the world economy and macroeconomics.

2 Financial Crises, 1929 to the Present

by: Sara Hsu
Published 2017
by Edward Elgar
The Lypiatts, 15 Lansdown Road,
Cheltenham Glos GL50 2JA UK, 238pp
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This timely second edition of a book on the history of financial crisis moves the reader through historical episodes of financial crises. Starting with the Great Depression in the 1930s, narrative accounts of the episodes are given. The book's strengths lie on the descriptive side, so the book is more economic history than anything else. There is a lack of economic theory and empirical validation, despite references to Minsky and Kindleberger, among others. The book is addressed to students and professors of economic history, financial and regulatory economics. I find that the book is best used in economic history.

The book is divided into ten chapters, starting with an introduction, followed by eight chapters on historical episodes and a concluding chapter on the prevention of financial crises. Hsu discusses the definition of financial crisis by following Charles Kindleberger and Hyman Minsky, highlighting the 'unstable nature of finance' and 'undue financial fervour'. Prominently featured is the idea of leverage, i.e., increasing external debt over time. It is credit expansions that generate business cycles and, ultimately, financial crises. Finance is seen as 'generally unstable' and 'increased instability leads to crisis'. While this view is certainly not without merit, the reader probably expects a somewhat more comprehensive introduction to the question of how financial crises happen. Is there no data available on leverage to back up Minsky's claim? Would it not be insightful for the reader to see the correlation between GDP growth and debt build-up? Hsu concludes the introduction with a post-WWII history of the international monetary system. Writing about the evasive capital flows of today she points out that the argument for free trade does not carry over to free capital. Since I believe that the efficient market hypothesis needs a replacement, this important point should be featured much more prominently in the introduction.

Chapter 2 covers the Great Depression and its aftermath. The account is fairly standard. Nominal wage rigidity is wrongly attributed to "non-indexed debt contracts and slow adjustment of wages", whereas it really was a negotiated compact between unions and employers, initiated by the US government that froze wages. Pertaining to the direction of causation, Hsu sides with Bernanke and against Kindleberger: from financial to real. This framing in terms of the neoclassical dichotomy is somewhat disturbing as many economists have stressed that interest is paid out of profits, so that financial

dealings depend on expectations and realisations of real developments. Hsu also seems unaware of Koo's (2003, 2011) work on balance sheet recessions and the problem of decreased loan demand in times of economic crisis, which connects to the Keynesian theme of a decreased level of investment. There is also no connection to inequality, which reached a historical high in the USA in 1929, similar to 2007. Her book index does not have an entry for 'inequality'. Hsu emphasises the quantity equation and the evolution of real wages, which lead away from a Keynesian perspective on the Great Depression, blaming exorbitant real wages for the high level of unemployment instead of a lack of demand. Adherence to neoclassical economics is a consistent theme of the book. Hsu claims that economic theory would not promote government intervention before the publication of *The General Theory* in 1936, notwithstanding contradictory evidence. In his 1933 letter to FDR, for example, Keynes describes the 'techniques of recovery' and concludes that more debt-financed government spending is needed.

Chapter 3 deals with the inter-crisis period of 1950–1970. Hsu discusses the Bretton Woods system and the Keynes plan (Bancor) and rising rates of inflation. The narrative is that of a failure of Keynesian economics, along with the rise of Milton Friedman and less government intervention as a logical consequence. Given the results of neoliberal policy that we experience today, it is somewhat disappointing that Hsu does not challenge the conventional account of Keynesian theory defeated by the neoliberal consensus. Chapter 4 focuses on the 1980s Latin American debt crises and the US savings and loans crisis. This time, the account is more precise and Hsu rightly points to high level of public debt in foreign currency as the main culprit. In Chapter 5, we move to the crisis of the European exchange rate regime of 1992 and the financial crises of the Nordic countries in the early 1990s, followed by a standard account of how Japan started its decade-long stagnation, stressing that "fiscal policy was carried out with little impact", and failing to recognise the role of wages for deflation in Japan. The last section of Chapter 5, 'Economic theories of the early 1990s', mentions only Mundell's work on optimum currency areas (from 1970s) but fails to mention critical accounts of the European Monetary Union.

Chapters 6 and 7 discuss the late 1970s Asian financial crisis and subsequent troubles in Russia, Brazil and Argentina, along with the Great Recession of 2008. With 35 pages, this is the book's longest chapter. Hsu's narrative is basically correct, with some finer yet quite important, points missing. There is no discussion of inequality nor recognition that many sub-prime borrowers would have qualified for lower-interest rate standard loans but were financially illiterate and so did not recognise that they were targets of predatory lending. Hsu only states that there has been a lot of fraud associated with applications for certain types of loans. She recognises that incentives were skewed towards short-term gain while ignoring long-term benefits and she rightly puts the real estate bubble at centre stage. Hsu blames mortgage lenders for pushing risky mortgages and rating agencies for giving misleadingly high ratings to dubious financial products. She blames the Fed for not regulating real estate markets and setting its interest rates below the appropriate level, as those economists following the Taylor rule approach to inflation-targeting do.

Discussing the 'Troubled Asset Relief Program' (TARP), Hsu writes that "the additional liquidity would be used [by banks] to generate loans and alleviate the credit crunch." This view was disputed by many contemporary commentators who pointed out that banks cannot and do not lend reserves to the private sector. Another theoretical weakness is her discussion of the Eurozone, where according to Hsu "Irish banks had

borrowed from abroad, mainly Germany, to finance the lending boom.” Monetary theory tells us that banks can extend loans without borrowing central bank money or attracting savings deposits, so this is an incorrect approach to the Eurozone crisis. German savings did not finance investment in Spain, Ireland or elsewhere. This is a very important issue of the debate and connects to the TARGET2 discussion, which is not prominently featured but should have been as it highlights the connections between the monetary dimension and the current account. Concluding this chapter, Hsu forgets the incredibly important lender-of-last-resort function of central banks. The difference between the Great Depression and the Great Recession was mainly that banks were ‘too big to fail’ this time, whereas in 1930s they were shut down, destroying deposit and hence purchasing power by the private sector. Pointing out that the ‘structural problems’ within the Eurozone have yet to be addressed is correct, but is too vague. After years of ‘structural reforms’, why are there still structural problems?

The penultimate chapter on global imbalances is a mere six pages. It features accounts of Ben Bernanke (savings glut) and Yannis Varoufakis (surplus recycling), which are both based on a very odd reading of the balance of payments by the original authors. Hsu describes them well, but fails to point out their weaknesses. Finally, on the last page before the conclusions, inequality appears in the context of increased risk. This is too little too late for a topic of such proportions with a direct connection to financial crises.

The concluding chapter on how to prevent financial crisis is a laudable effort. Hsu revisits some recent developments of economic theory and the resultant economic policies. She points out that nationalisation of banks in the Nordic countries seems to have worked well. She thinks financial stability is ‘wildly difficult to achieve’ since ‘goals are heterogeneous’. Early in the crisis the Chinese central bank president proposed a new Bretton Woods-style monetary system. One wonders about the reticence of the USA and the EU countries. Hsu views the US financial sector as the major force blocking international monetary reform along the lines of Keynes’ Bancor proposal. She proposes to reform the IMF and implement countercyclical fiscal policy. Her discussion of ‘fiscal space’ (i.e., the ‘space’ that government has to increase spending) puts her firmly into the camp of those believing in Ricardian equivalence; and her discussion of ‘tail risk’ puts her into the camp of those who believe in managing risk as opposed to those who argue that we live in a world of fundamental uncertainty.

Hsu ends by pointing out that “real economic gains are based on real production and we must reorient our focus to this aim.” While sympathetic to this proposal, any reorientation must be based on theory and in Hsu’s historical account the theoretical foundations are sometimes flawed. I can recommend this book to readers interested in economic history with a sound understanding of money and banking. For those looking for an account of financial crises and their theoretical underpinnings, the book falls short on theory. I recommend Aliber and Kindleberger (2015) and Minsky (1975 [2008]) as better choices.

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