The Paradigm Sways: Macroeconomics Turns to History (reviewing three titles)

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I. Introduction

These three books provide excellent analyses of the Global Financial Crisis and its second act, the Eurozone Crisis (jointly, the GFC). In *The Euro and the Battle of Ideas*, Markus Brunnermeier, Harold James, and Jean-Pierre Landau (collectively "BJL") show how the Eurozone Crisis reveals deep-seated and sometimes incompatible European traditions in economic policy. They label the two approaches “French” and “German.” In *The Shifts and the Shocks*, Martin Wolf uses the history of the GFC to analyze the global economy and highlight its vulnerabilities. In *The End of Alchemy*, Mervyn King argues that the GFC challenged basic understandings of money and finance, and proposes fundamental banking reforms.

Given the magnitude of the GFC, new thinking might have been expected. Historian of science Thomas Kuhn called the failure of an explanatory model, and the emergence of a new framework that better fits the data, a “paradigm shift” (Kuhn 1970). These three books suggest that a paradigm shift may be under way in macroeconomics. The new perspective emphasizes
historically based understandings in both economic policymaking and markets. The emergence of such a paradigm would be an exciting development for the discipline.

II. The Euro and the Battle of Ideas

In *The Euro and the Battle of Ideas*, BJL chronicle the Eurozone Crisis as a clash of economic traditions. They begin in 2010 with European efforts to respond to the discovery of financial stress in Greece. European financial institutions and governments were highly leveraged and deeply interconnected, and currency devaluation within the Eurozone was not an option to manage the resulting strains. The crisis in Greece became European in scope, and the European institutions and the Member States struggled to respond effectively. Although a collapse of the Euro was avoided, economic growth remains slow and unemployment correspondingly high in much of the Eurozone, including Greece.

BJL observe that since the crisis the survival European project no longer seems inevitable. According to BJL, Europeans differ in more than just language and culture. Europeans see the world itself, including markets, in fundamentally different ways. Differences in economic worldview track national lines, which BJL schematize in ideal-typical form (borrowing from Max Weber) as "German" or "French." During the general euphoria after the end of the Cold War, and especially the long bull market following the signing of the Maastricht Treaty in 1992, it was easy to paper over such differences. But when Europe was forced to act to save its financial system, those differences in worldview became apparent. Europeans struggled to agree on what should be done, which institutions could act, and who should pay.

According to BJL, the “German” worldview, shared by northern Member States, insists on strict repayment of sovereign debts. The German approach favors the radical cutting of government budgets in order to be able to service such debts (“austerity”). This position reflects not merely interests but an intellectual tradition, which BJL summarize in ten points as:

1. a focus on legal, moral, and political foundations of free markets expressed in clearly articulated rules;
2. a strong emphasis on responsibility and accountability;
3. a concern with the potential for moral hazard arising out of lender of last resort activities;
4. a concern that lender of last resort activities may corrupt monetary policy;
5. a belief that binding rules are needed to shield monetary policy from fiscal dominance;
6. a strict approach to government debt and debt ceilings;
7. a conviction that growth is not achieved by provision of additional money but by structural reforms;
8. a belief that present virtue -- austerity -- will be rewarded by future benefits;
9. the view that net exports are a gauge of competitiveness and economic strength; and
10. outside the Eurozone, a preference for flexible exchange rates with open capital markets.¹

According to BJL, the “French” approach to financial crisis, favored by the southern Member States and most American commentators, is more lenient than the German. French responses favor the restructuring of debt and some debt forgiveness. French policy preferences are also grounded in an intellectual tradition, which BJL summarize in nine points:

1. an understanding of rules as subject to politics, and therefore negotiable;
2. a belief that crisis management requires flexibility;
3. an assumption that constraining the freedom of government to act, and to borrow, would be undemocratic;
4. a view of monetary policy as a tool to serve goals besides price stability, such as growth;
5. the conviction that adjustment to international imbalances should be undertaken symmetrically, with surplus countries doing their part;
6. the conviction that because multiple equilibria are possible, choosing an unpleasant trajectory for the present is likely to perpetuate rather than remove constraints on growth;
7. the view that present virtue tends to be self-contradictory and self-defeating;
8. an understanding of exports that are "too high" as indicating beggar-thy-neighbor mercantilism; and
9. the conviction that the international monetary system should be multipolar, and should include active management of capital flows to stabilize exchange rate movements.²

¹ Brunnermeier, James & Landau, The Euro and the Battle of Ideas, 66-67, 82. The list is complete, but the text has been abridged and rephrased somewhat.
² Brunnermeier, James & Landau, The Euro and the Battle of Ideas, 74, 82. Again, the list is complete, but the text has been abridged and rephrased somewhat.
BJL set forth the polarities within European political economy with admirable clarity. Their book takes seemingly basic ideas and shows where they come from and how they establish habits of thought. For example, BJL contrast the German federal constitutional order with the centralism of the French state. For another instance, BJL point out that the German economy is based on middle-sized regional firms (Mittelstand), while the French economy is more reliant on large national firms ("national champions.") As BJL explain, Germany has a long tradition of relatively collaborative relations between labor and capital. On the other hand, labor relations in France have tended to be more confrontational French tradition. Perhaps most importantly, BJL sharply contrast the German horror of inflation with the more tolerant French attitude.

Given such contrasts, one might think that the German and French positions are deep-seated and permanently opposed. BJL show, however, that economic thought in Germany was once what is now thought of as French, and vice versa. In the 19th and early 20th century, the Germans emphasized a strong state with great discretion to organize the national economy. Conversely, 19th and early 20th century French economic thought emphasized the freedom of markets from government interference (laissez faire).

As BJL explain, both traditions were transformed by the experience of World War II, and the Germans and the French essentially switched positions. After the disastrous experience of the Third Reich, German economists looked to law and strict adherence to rules to prevent the state's abuse of power. And, after the failure of the French Army on the battlefield, compounded by the Vichy Government's collaboration with the Nazis, French economic thinkers became much more concerned with establishing an effective state.

There is great irony here. War between France and Germany was the initial impetus for what is now the EU. The early architects of the European project hoped to create a different kind of politics. At the same time, different understandings of World War II's historical significance have created different views of the state, law and rules. And it is these different world views, schematized by BJL as "German" and "French," that have led to such deep dissension in coping with the Eurozone Crisis. The same event that inspired the EU may prevent it from being fully achieved.

From BJL's perspective, the creation of a single currency under the Maastricht Treaty is simultaneously a great step toward European unity and the context for European conflict. But
fundamental differences between "German" and "French" worldviews have tested the Maastricht framework. When creating credible commitments by Member States to monetary stability, the Germans have emphasized rules, while the French have stressed the need for flexibility. With regard to the "no bailout" clause, the Germans have insisted on the need for Member States to be liable for their actions, while the French have stressed the importance of solidarity. When confronted with sovereign debt difficulties, Germans tend to see fundamental solvency problems, while the French see liquidity difficulties. In perhaps the most pointed difference, the Germans believe true recovery from a crisis requires austerity, while the French favor stimulus.

BJL frankly admit that the original appeal of the European project has diminished, and new reasons for commitment need to be found. In creating a new, more viable EU, the task is to steer between the Charybdis of a divisive nationalism and the Scylla of an alienating superstate. BJL have a number of practical suggestions. Their discussion of trade flows within a currency union, their proposals for Eurobonds, and their ideas for European unemployment insurance all suggest possibilities for a revitalized European project. But BJL provide only glimpses, and a more explicit argument would have been welcome.

BJL end their book on a hopeful note. In some ways, they explain, the German and French perspectives are reciprocal. They conclude: "the German view and the French view actually need each other to be sustainable." Neither the German nor the French economic tradition is finally right. Instead, each view depends upon the counterbalance offered by the other.

In arguing that economic policy depends upon the state of play in a “battle of ideas” that cannot finally be won, BJL have taken a substantial step away from more deterministic notions of macroeconomics. They argue that intellectual traditions and interpretations of history have motivated different responses to the Eurozone Crisis and therefore shaped the evolution of the EU. In BJL’s account, historical understandings shape economic policy.

III. The Shifts and the Shocks

Martin Wolf begins The Shifts and the Shocks with a bold admission:

I lacked the imagination to anticipate a meltdown of the Western financial system. I was guilty of working with a mental model of the economy that did not allow for the possibility of another Great Depression or even a "Great Recession" in the world's most advanced economies. . . . This book aims to learn from that mistake.4

*The Shifts and the Shocks* is an enormous effort -- learned, insightful, and number-heavy -- to develop a deeper understanding of the global economy.

The book is organized in three parts: the first part is essentially descriptive, the second analytical, and the third prescriptive. Wolf begins with "The Shocks": a description of the GFC that focuses on the weakness of the recovery in the high-income countries. He details what went wrong, along with tart commentary, and finishes with an account of how the GFC unfolded in developing countries.

In the second part of the book, "The Shifts," Wolf links the GFC to long-term historical developments. In considering the reasons for the crisis, Wolf is concerned especially with global capital flows. Wolf describes three major drivers of the excessive liquidity leading into the GFC: emerging economies investing in developed countries; the cash generated by the oil boom in the early 2000s; and the search for yield in developed countries with low growth. Beneath such turn-of-the-century shifts in the global economy, Wolf identifies more fundamental long-term shifts. Wolf explores the ways in which liberalization and technology helped create global financial markets. He documents the aging of populations, the rise of inequality and the lack of productive investment in developed countries. Wolf presents the long-term structural shifts in the global economy as a gradual transformation of the international economic environment from a collection of nation-based systems into an interconnected global web. Wolf then explains the GFC in that historical context.

As noted, Wolf finishes the book with a normative turn, "The Solutions." In a virtuoso survey, he examines an array of macroeconomic thinkers, including Knut Wicksell, Friederich Hayek, Henry Simon, John Maynard Keynes, and Milton Friedman. Wolf uses core insights of each thinker to analyze the GFC and explore ways to strengthen financial institutions. For

example, he would like to see some version of narrow banking tried, at least as an experiment. Given the unlikelihood of such an experiment, however, Wolf discusses ways to make financial institutions more robust, including increasing capital requirements and macroprudential supervision.

Turning from financial institutions to capital flows, Wolf would like high-income countries to return to growth at pre-GFC rates, which he suggests would stabilize capital flows and hinder the buildup of imbalances. In the hope of reestablishing growth, Wolf argues against austerity and in favor of debt restructuring. He also argues for larger and more sustained fiscal stimulus. Somewhat more radically, Wolf suggests that international capital flows should be more regulated to discourage risky flows of finance across borders. Wolf would also like the IMF to take a larger role in ensuring against currency risk, thereby reducing the need for countries to self-insure through expensive foreign currency reserves. He maintains that the development of a world currency in lieu of the dollar would not only be helpful, but incidentally would make U.S. monetary policy more nimble.

Wolf's conclusion, "The Fire Next Time," is pessimistic. He points out that because responses to the GFC have been sufficient to contain the damage within seemingly acceptable limits, fundamental reform will not be undertaken without a more severe crisis. Given that the imbalances he sees within the global financial system have not been rectified, Wolf expects such a crisis. Wolf's pessimism did not abate after The Shifts and the Shocks was first published in 2014. In "The Long Goodbye," his supplementary afterword to the paperback second edition, Wolf summarizes the anemic recovery from the GFC and the modest lessons learned. He ends with four concerns. First, economies are excessively dependent on debt. Second, the Eurozone is a failure but cannot be abandoned, and there is no clear way to solve its problems. Third, "elites have failed and, as a result, elite-run politics are in trouble."5 Fourth, "the durability of contemporary globalized capitalism cannot be taken for granted."6 Wolf is pessimistic about global economic policy because, despite the GFC, policymakers are still operating on their old assumptions about how the global economy works.

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5 Wolf, The Shifts and the Shocks, 382.
6 Wolf, The Shifts and the Shocks, 383.
Wolf uses a broad scope of analysis, and considers matters outside the usual realm of macroeconomic discourse. Like BJL, Wolf believes that economic decisions of actors such as banks and borrowers are informed by those actors’ interpretations of their historical circumstances. For Wolf, the economy is not necessarily determined by objective factors. The economy is social, and therefore the product of human understandings.

Wolf works to separate his "opinions about how the world works, which do change, from [his] values, which have remained unaltered." He describes his values as traditional liberal political economics, and attributes them to his father, a Jewish refugee from Austria in the 1930s. As it is for BJL, then, World War II is a foundational moment for Wolf. His essentially traditional understandings of the roles to be played by states, the law, and individuals, however, cannot simply be segregated from the book as personal values. Wolf’s fundamental structural assumptions sit in uneasy tension with his argument that we need new thinking about how the world works. Such internal tensions make the Shifts and the Shocks all the more stimulating.

IV. The End of Alchemy

Two of Mervyn King's central arguments in The End of Alchemy illuminate some of the concerns expressed in The Euro and the Battle of Ideas and The Shifts and the Shocks. Both of King’s arguments are based on the importance of time, and the ways that marketplace actors cope with the future. The End of Alchemy argues that time, and the uncertainty it creates, is a basic aspect of markets. Because that uncertainty is always present, institutions have been established to manage it.

King's first argument concerns the "alchemy" of the title: banks borrow in the short term, at low risk and low interest rates, and lend in the longer term, at higher risk and higher interest rates, and make money on the spread. King contends that the maturity and risk transformations of banking are fundamentally lies. High-risk long-term assets remain high risk. There is no alchemy in the intermediation of banking. When the economy is growing, the illusion works. In a financial crisis, however, short-term liquidity evaporates as bank deposits or other short-term loans are withdrawn. If a bank cannot acquire funding quickly, it fails. Given the centrality of

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7 Wolf, The Shifts and the Shocks, xx.
banking to society, the human costs of such a bank failure can be huge, as amply demonstrated during the GFC.

King puts pressure on Bagehot's teaching that central banks should serve as the lender of last resort to solvent but illiquid banks by lending at a penalty rate against good collateral. King points out that, during a crisis, bank difficulties are usually presented as liquidity problems. Moreover, the value of complex assets that might be used as collateral may be impossible to determine. Given the potential human costs, however, allowing the bank to fail may not be prudent. Contra Bagehot's advice, central banks may provide liquidity to a bank that may be insolvent and without good collateral. Those “bailouts” may then create problems with moral hazard, industry consolidation, and popular outrage.

King sympathetically considers the various banking reforms that were undertaken in response to the GFC. He argues, however, that reforms to prudential regulation, systemic risk monitoring, and bank capital ratios are half-measures because they do not end the “alchemy” of risk and maturity transformation. King also discusses various narrow banking schemes conditionally endorsed by Wolf, which would end the alchemy by requiring banks to hold liquid reserves in the amount of deposits. In addition to difficulties with implementation, however, King believes that such schemes would restrict bank lending. And restricting bank lending, even if it increased financial stability, would be bad for the real economy. For King, the question is how to achieve a more stable system of banks capable of lending at a reasonable cost.

In response, King proposes transforming the central bank from a "Lender of Last Resort" to a "Pawnbroker For All Seasons" (PFAS). In times of crisis, the PFAS would stand ready to lend against collateral held by the banks at an appropriate discount rate. Central banks, and ultimately taxpayers, would therefore not be at risk for bank bailouts. Banks would have to decide, ex ante, on the basket of assets to be held as collateral. The PFAS would decide, also ex ante, on appropriate haircuts for the collateral. In other words, collateral would be "pre-positioned" with the central bank. Then, in the event of a liquidity problem, the PFAS could lend at short notice and with great confidence. Finally, and crucially, short-term bank liabilities, including deposits, could not exceed the value of the liquidity the PFAS was prepared to provide.

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8 King, The End of Alchemy, 270.
Deposit insurance diminishes the likelihood of bank runs because depositors know that their money is insured by the government up to some statutory limit. In much the same way, King’s PFAS should make financial crises less frequent. Depositors and other sources of short-term funding would know in advance that banks had access to a specific amount of central bank funding if necessary. That assurance would remove their motivation to withdraw their funds in times of crisis. King's idea is fascinating, and deserves detailed and pragmatic consideration.9

King’s second argument about coping with time seeks to recast our understanding of money, especially in and after crisis. King begins with the proposition that the world is uncertain (as opposed to risky, understood as probabilistically quantifiable). In particular, capitalist economies are uncertain because capitalism is good at generating technological innovation, and the emergence of new technologies is fundamentally unpredictable. Future markets are therefore inherently unknowable, because actors cannot know what technological opportunities or hazards the market will comprise. If future markets are unknowable, then it is impossible to make fully informed present spending decisions.

Money serves multiple functions, but for King its crucial function is as a store of value. Money enables its holder to make claims in the future. Therefore, money "is not principally a way of buying 'stuff' but a way of coping with an uncertain future."10 Hence the old adage about saving for a rainy day -- we do not know the nature or the timing of the rain. From this perspective, it is a short step to King’s assertion that "in a capitalist economy, money, banking and financial markets are institutions that have evolved to provide a way of coping with an unpredictable future."11

King rejects the orthodox economics concept of "rational expectations" as a description of how uncertainty is managed. He also rejects the insistence of behavioral economics on irrationality. King describes a third option. For King, people are fairly rational but they live in an uncertain world. People therefore adopt rules of thumb, heuristics, to guide their decision making. They estimate things like their anticipated lifetime income, and such assumptions, or

9 A start has been made by Charles Goodhart. See CAE Goodhart, "The Determination of the Money Supply: Flexibility versus Control," Financial Markets Group, London School of Economics.

10 King, The End of Alchemy, 84.

11 King, The End of Alchemy, 155
“narratives,” guide their current spending and saving decisions. Like BJL and Wolf, King finds such assumptions to be informed by people’s understandings of history. King is explicit: "The choices of narrative and heuristic do not constitute a general theory of behavior -- they are highly specific to particular historical circumstances."¹²

King points out that narratives may be revised. People may learn that the narratives they have been using are wrong. For example, when the economy is growing and credit is easily obtained, people may adopt spending rates that are unsustainable. When the economy contracts and credit is withdrawn, people may replace their old narratives or income assumptions with new ones, and spend less. For King, the slow recovery from the GFC represents not a deficiency in aggregate demand, but a narrative revision. Due to the crisis, many people revised their expectations of lifetime earnings downward. As a result, the context of their spending decisions changed, people spent less, and growth lagged.

According to King, different actors operate under different stories or narratives. Based on those narratives, actors may experience the world as more or less uncertain and cause demand for money to rise or fall. In this way, King imports individual historical understanding into the heart of economic activity. "Traditional macroeconomics is the economics of 'stuff.' We need instead the economics of 'stuff happens.'"¹³ King thus suggests an economics of reasonable actors in an uncertain world using money to cope with rainy days.

King's book represents a breakthrough. His understanding that markets are inhabited by reasonable actors in an uncertain world is quite different from the neoclassical presumption that market actors are rationally self-interested and operating in a world of calculable risks. At the same time, King distinguishes his view from that of behavioral economists who rely on psychology to insist that market actors are not very rational at all. For King, actors are fairly reasonable, or generally try to be, but they simply do not know what the future holds. As actors tell and revise their stories about the future, their demand for money changes. As a result, their willingness to spend or save changes. King thus embeds people’s subjective expectations about an uncertain future, which are based on people’s individual interpretations of the past, into every monetary transaction.

¹³ King, *The End of Alchemy*, 301-02.
V. Conclusion

As each of these books shows, narrative understandings of history inform the actions of international institutions, governments, central banks, financial institutions, firms and households. Such narrative understandings are not reducible to objective facts. Instead, they are the subjective understandings of the past that economic actors use to make conjectures about the future. Such conjectures about what the future holds, based on lessons learned from history, shape decisions about things like interest rates, investing, saving and spending. In the approaches of BJL, Wolf and King, markets look less objective and efficient than classical economics has traditionally held. Instead, economic actors depend on interpretations of history and individual experience, and make conjectures about the future. Emphasizing historical narrative, as these books do, thus transforms economics by making it more subjective.

Such a fundamental change in a pattern of thought is what it means to have a paradigm shift. If these three books are any guide, then macroeconomic policy may be taking a "turn to interpretation" similar to shifts in other social sciences in the last third of the 20th century. This is a tremendous and exciting development.

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