Review of Linda Yueh, *What Would the Great Economists Do?*, Picador, NY, 2018, 298 pages

By C. Stuart Callison, January 13, 2019, for the UAA Book Club

Introduction: On Our Economic Challenges

The author discusses twelve classic economists whose theories she believes changed their world and which still have some relevance for our current economic problems, focused on the rate and quality of economic growth and development. She includes a lot of interesting details about the life and times of each economist discussed and a discussion about recent economic episodes relevant to their theoretical contributions. These are not included in this summary, which focuses on the policies they proposed.

1) Adam Smith: Should Government Rebalance the Economy?

Adam Smith viewed any attempt by a government to favor one industry or economic sector over another as a distortion of the natural course of a free market economy that would channel economic activities into less productive channels. He would argue against the current attempts by the British and American governments to artificially stimulate a return to manufacturing activity in the face of its relative decline as a proportion of GDP compared with the growing services sector. Just as agriculture has become so efficient that it has declined as a percentage of GDP while its product has continued to grow, so manufacturing has become more efficient in producing more and more output, and foreign trade in manufactured goods has allowed more economic specialization in production on a global scale, freeing up resources for the growing service sector which now dominates GDP in these post-industrial countries. Smith would view attempts to resurrect the manufacturing sector with tariff protections, tax relief and/or financial subsidies as wasteful and futile.

2) David Ricardo: Do Trade Deficits Matter?

Ricardo's theory of comparative advantage is still the underlying explanation as to why and how all countries benefit from foreign trade, even where some countries produce everything more efficiently than other countries do. This argues against restricting trade through tariffs and other measures. However, his was a static model and he did not deal with a dynamic model of trade, as did Paul Krugman later. He recognized the developing conflict between the rich, protectionist landowners, who benefit the most from higher food prices, and the working class, who would benefit from free trade that lowered the price of food. He developed the theory of "economic rent" captured by those who own land, which would increase as food prices rise due to demand increasing faster than supply. But as for our modern situation, his theories had little to say about those in the losing sectors of an economy as trading patterns change, which deserve public attention. Domestic investment patterns can improve a country's efficiency in producing particular goods and services, and thus change its comparative advantage *vis-à-vis* other countries. A commodity trade deficit can be offset by investment and trade in services, for which international markets are still restricted.

3) Karl Marx: Can China Become Rich?

Marx agreed with Ricardo's observations about class conflict between the owners of land and capital and the "proletariat," but he carried them to what he believed to be their logical conclusion: a class struggle that would end in revolution, due to increasing inequalities, and the establishment of a class-less, communist society replacing capitalism. Russia and China, as we know, were the largest economies to adopt the communist system as their governing principle. In Russian it was based on the urban proletariat, but in China it was based on rural peasants. It failed in Russia due to the economic inefficiencies of centralized economic control and the lack of work incentives that led to low productivity and economic stagnation—the outcome Marx predicted for capitalist societies. The Chinese communist leadership has been more pragmatic in adopting market-based reforms while maintaining political control by the communist party. "The notion that intangible output (of services) can be as valuable as manufactured goods was simply not within the conception of Marx or the other Great Economists who preceded him. In this respect, Marx would not have approved of China's shift towards a service economy and, especially, away from communal production and farming." As China becomes more of a capitalist economy, Marx's theories would envision an eventual proletariat revolution by urban industrial workers.

4) Alfred Marshall: Is Inequality Inevitable?

Income and wealth inequality has risen dramatically around the world. Marshall believed that a more equal distribution of wealth and income is highly desirable, but was concerned about the trade-off between policies to achieve such redistribution and their effects on incentives to work. He supported progressive taxation, not sufficient to equalize incomes, but to finance things like education and vocational training to make unskilled labor scarcer and thus better rewarded. Marshall increased the rigor of economic analysis and "taught his students to see economics as offering a set of tools and an analytical way of thinking but not to believe that the textbook reflected the real world. He described his approach as follows:

'a good mathematical theorem dealing with economic hypotheses was very unlikely to be good economics; and I went more and more on the rules—

1. Use mathematics as a shorthand language, rather than as an engine of inquiry.
2. Keep to them till you have done.
3. Translate into English.
4. Then illustrate by examples that are important in real life.
5. Burn the mathematics.
6. If you can't succeed in 4, burn 3. This last I did often.'"

5) Irving Fisher: Are We at Risk of Repeating the 1930s?

Fisher formalized the quantity theory of money, utilizing the equation of exchange, MV=PQ, to analyze how prices (P) are related to the quantity of money (M) in circulation, given a fixed velocity of money in circulation (V) and a certain quantity of goods and services (Q) in the economy. Of course, V and Q are

not really fixed, but for short-term analysis if the supply of money increases faster than real GDP price inflation will certainly occur—and vice versa. Fisher's argument against the gold standard was that it did not allow the money supply to keep up with the real demand generated by a growing economy and thus generated a harmful deflationary situation. He also pioneered *The Making of Index Numbers,* actually the title of one of his books, which allowed the better measurement and comparisons of prices and output. Fisher's theory failed to find general acceptance during his lifetime, but they were later incorporated in Hyman Minsky's theory that unregulated private corporate debt could lead to speculative bubbles of inflated asset prices and financial crises when the bubbles burst, as it did in 2008, which Janet Yellen called a "Minsky meltdown." However, while Fisher's prescription for deflation was to reflate the economy with monetary expansion, Minsky argued that better bank supervision and regulations would prevent such problems in the first place. The 2008 Great Recession generated both responses. Except for Japan, the world has so far avoided a deflationary spiral since the 1930s, thanks in part to the original insights from Fisher and Minsky.

6) John Maynard Keynes: To Invest or Not to Invest?

Keynes switched the focus of economics policy attention "from the long run to the short run, where adjustments were sluggish and governments could thus play a role. He famously observed: '…In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.'" "He homed in on deficient demand, which included weak household consumption and low firm investment, as determinants of the Great Depression. He argued that, even in normal times, the incentive to invest is too weak and the propensity to hoard cash is too strong." The marginal propensity to save is greater than the marginal propensity to invest and the classical economists' assumption that savings automatically became investment is invalid. During economic slumps the government should invest in public works and thus increase demand to move the economy back to full employment. Deficit financing of such investment would not be inflationary if the economy was operating below potential. Monetary policy can lower interest rates to stimulate more investment, but when that fails to work fiscal policies should be used to re-inflate investment and consumption demand to move the economy back to full employment. Unemployment benefits can serve as an "automatic stabilizer" to increase government spending during downturns without the government having to make a deliberate decision to do so each time.

7) Joseph Schumpeter: What Drives Innovation?

Schumpeter challenged to notion that a capitalist economy would trend toward some equilibrium state of perfect competition, arguing that innovation is the "perennial gale of creative destruction" as new technologies replace older ones and keep the economy in a state of constant flux. This, in his view, is the engine of economic growth that "explains how countries become more productive and wealthier over time." But for this to be successful requires "vibrant entrepreneurship and prudent regulation." The process can create social unrest from those engaged in the losing technologies and requires a stable government to provide political oversight, specifically enforcing the rule of law and protection of private property. "He outlined five types of innovation that derive from entrepreneurs:

- The introduction of a new good, for example one with which consumer are not yet familiar, or of a new version of a good that is of better quality.
- The introduction of a new method of production.
- The opening of a new market.
- The conquest of a new source of raw materials or half-manufactured goods.
- The creation of a new organization of any industry, like the creation of a monopoly position…or the breaking up of a monopoly."

The author describes "the challenge of staying on top as innovators," using Finland's Nokia, Canada's Research in Motion (RIM) BlackBerry, America's Kodak and Apple, Korea's Samsung, Japan's Sony and its Walkman, China's Huawei, among others, as case studies. As described in Schumpeter's *Capitalism, Socialism and Democracy* (1942), "entrepreneurial innovation is the dynamic element that drives how economies evolve through a process of 'creative destruction,' which is as visible today as during his time."

<u>8) Friedrich Hayek: What Can We Learn from Financial Crises?</u>

Hayek became a leading proponent of the free market price mechanism to efficiently allocate resources and economic activity and allow entrepreneurship and innovation to achieve greater prosperity. He attacked socialism as leading to central planning and *The Road to Serfdom*, the title of his most popular book. He challenged Keynes about the causes of business downturns and the wisdom of government intervention. Where Keynes would blame weak aggregate demand, Hayek would blame sunk capital misallocated to unsustainable industries by artificially low interest rates. He saw recessions as a necessary evil to liquidate inefficient capital stock, and any attempt to stimulate the economy during a downturn would simply delay the recovery. He did acknowledge the need for government to perform tasks that private markets could not, such as outlawing poison, preventing crime and providing a basic social safety net. But he would have argued against the huge quantitative easing programs with which central banks fought the financial crisis of the 2008 Great Recession.

<u>9) Joan Robinson: Why Are Wages So Low?</u>

Robinson rejected classical assumptions of perfect competition and explained how monopoly and monopsony power allowed firms to pay lower wages and generated lower employment than full employment models would predict. She showed how firms that were not subject perfect competition for labor could keep wage rates below the marginal product of labor for the whole industry and thereby earn higher "rents" from the value of production. Wage stagnation has also resulted from other forces, like globalization, automation and the growth of part-time and temporary employment (disguised unemployment); but Robinson urged governments to adopt other measures to address the imbalance in market power between employers and labor and reduce the exploitation of workers, like minimum wage legislation, increasing competition in labor markets and increasing the bargaining power of workers through trade unions and collective bargaining. But she did note that "The misery of being exploited by capitalists is nothing compared to the misery of not being exploited at all."

10) Milton Friedman: Are Central Banks Doing Too Much?

In his magnum opus work, *A Monetary History of the United States, 1867-1960*, jointly authored with Anna Jacobson Schwartz, Friedman challenged the Keynesian view that the Great Depression was caused mainly by weak aggregate demand, a view that supported Roosevelt's New Deal fiscal policies to increase demand by increasing government expenditures. Instead, he and Schwartz documented the precipitous decline in the amount of money available to the economy due initially to widespread bank failures (that reduced the availability of credit) and subsequently to a tight monetary policy by the Federal Reserve to defend U.S. gold reserves against a weakened dollar (which was still on the gold standard). They pointed to the exit from the gold standard and concomitant 60% devaluation of the dollar as the more important factors leading to recovery. While the Great Depression was essentially caused by a liquidity crisis, the 2008 Great Recession was a solvency crisis. Nevertheless, the Fed injected a large amount of money into the system with its quantitative easing (QE) policies, buying long term Treasury bonds and mortgage-backed securities, thus increasing the money supply and preventing bank closures. Friedman would have approved the purchase of Treasury bonds but probably not mortgage-backed securities. He would have advised against bailing out troubled assets. The Fed intervened directly into the market to bail out some financial firms (Bear Stearnes, Fannie Mae, Freddie Mac, AIG), but not all (allowing Lehman Brothers to fail).

11) Douglas North: Why Are So Few Countries Prosperous?

Neoclassical growth models have not been able to explain why the economies of some countries grow faster than others, some stagnate and some actually decline. Douglas North pioneered research and analysis of how particular kinds of institutions, formal and informal, affect economic progress, and how to improve them. He added country-level politics, sociology and history into the neoclassical mix of labor, capital and technology in order to understand "What accounts for societies experiencing long-run stagnation or an absolute decline in economic well-being?" –perhaps "the key economic challenge of our time," according to Linda Yueh. North concluded that key institutions that promote innovation and economic growth include the rule of law, openness to free trade, security of property rights and the development of public and private capital markets. They "provide positive incentives for people to engage in business and productive activities..." He also believed that good and bad institutions perpetuate themselves, creating positive or negative "path dependence" in economic development that is difficult to change, as this requires political and social change. Not easy, but not impossible.

12) Robert Solow: Do We Face a Slow-Growth Future?

This chapter discusses the prospect of slower growth in advanced economies. The Solow model adds the effects of improved technology to the classical capital and labor model, including improved human capital, for an analysis of total factor productivity (TFP). "How to raise productivity lies at the heart of whether or not we're doomed to a stagnant future." His prescription for how to avoid economic stagnation in the face of an aging population is to promote investment in new capital equipment, research & development, workers' education and skills, and improved infrastructure to keep improving TFP.

Epilogue: The Future of Globalization, with Paul Samuelson

Linda Yueh closes her book with a discussion of the challenges of globalization, noting the backlash against uneven gains despite its enormous impact on overall global prosperity. Middle class living standards in the U.S. have stagnated due to two main factors: globalization and "skill-based technological change." Automation and computerization have replaced many mid-level jobs, while at the same time global trade has moved manufacturing jobs overseas where wages are lower. What would the Great Economists say? Yueh runs down her list: Adam Smith and David Ricardo would urge countries to focus on the benefits of globalization and adjust. Karl Marx and Joan Robinson would note the populist revolt against capitalists who have benefited from trade while the working classes have lost and would want to change institutions affecting employment. Alfred Marshall would urge moderate redistribution of income through domestic tax and social benefit programs to reduce inequality but not restrictive trade policies like tariffs and other barriers to trade. Irving Fisher would be wary of protectionist policies that could risk repeating the 1930s. John Maynard Keynes would advocate active government intervention to help the losers from globalization, increasing public investment to create more middle-skilled jobs and boost economic growth. Joseph Schumpeter would agree that all nations should maintain open and competitive markets to speed up the process of creative destruction and promote long-run economic growth. Friedrich Hayek and Milton Friedman would also advocate for the maintenance of free markets and global free trade. Douglas North would examine where trade deals have failed to address the concerns of losers and reform them accordingly. Robert Solow believed that investment is key to stronger growth and better jobs, and he would probably support common standards for investment and agreements to liberalize trade in services. So the Great Economists would defend continued globalization and search for ways to reduce its negative consequences.

Paul Samuelson, called by *The Economist* the "last of the great general economists," popularized the "neoclassical synthesis" of economic theories. His research explained how international trade causes the prices of traded goods and the wages of those who produce them to converge, which partly explains the stagnant wage rates of American factory workers. Samuelson would likely urge the use of domestic fiscal policy to help the losers from globalization through appropriate income redistribution programs. It seems this should also include enhanced education and skills training programs for those parts of society negatively affected by trade and automation, although it is not mentioned here in this context.