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Book Review

The New Macroeconomics
Reconstructing and Restating Macroeconomics

by Elias T. Balopoulos
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reviewed by Ioannis A. Mourmouras*

This is a landmark book that aims to reshape the current state of macroeconomic analysis. In this amazingly comprehensive book, Professor Balopoulos provides us with a lucid new macro-theory that is neither sloppy nor doctrinaire. The macroeconomic system developed and analysed in the book under review is not only thought provoking, it is also stunningly coherent and innovative. The New Macroeconomic System proposed by Professor Balopoulos (an authoritative academic and an ex-Minister of National Economy) is based on new postulates that entail quite drastic implications for the workings of the economy. He, like many other influential economists, is quite unhappy with both the theoretical and practical relevance of recent developments in the field. For instance, Mankiw (NBER, 2006) presents the state of macroeconomic debate today as “a truce between intellectual combatants, followed by a face-saving retreat on both new classicals and new Keynesians” and as “a profound defeat that lies beneath the surface ignored by both sides”. On the policy side and the impact of macro-theory upon it, Laurence Meyer’s (an outspoken governor at the Fed during the period 1996-2002) recent views have certainly many other advocates: “Recent developments in business cycle theory, promulgated by both new classicals and new Keynesians, have had close to zero impact on practical policymaking” (in his *A Term at the Fed: An Insider’s View*, 2006).

Professor Balopoulos’ new theory is based on the following four postulates: i) The classical marginal productivity theory, although perfectly valid ex ante, is not valid ex post. ii) The market interest rate is structurally dependent on the natural interest rate to such extent that it cannot play the role of an equilibrating price as claimed by conventional macroeconomics. iii) The general price level equilibrates the money market, not the goods market. iv) The main markets of the economic system, notably the goods, labour and capita, are not option but price-set markets.

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The basic implications of the new theory can be summarised in the following: economic fluctuations are an inevitable implication of the very structure of the economic system, which is characterised by structural and technological rigidities. Involuntary unemployment is the normal case of the workings of the economy. Self-adjustment is highly cyclical and sluggish, so that the use of the macroeconomic policies will normally be required for economic stabilisation.

The book is organised in two parts that form a logical sequence, although they can be read and understood separately. Part One deals with: i) A critical analysis of the main macroeconomic theories. Topic coverage includes the early Keynesian model, monetarism, new classical and new Keynesian economics, real business-cycle theory and endogenous growth theory. By reading this part of the book, one clearly understands both the areas of disputes among theories and their deficiencies. ii). A convincing reconstruction of the above macro theories aiming at improving their theoretical foundations and their ability to explain the stylized facts. This part of the book, with its clear and accessible style, is suitable for advanced undergraduate students as well as for graduate courses in macroeconomics.

Part Two of the book deals with the development of a new macroeconomic system. In what follows, I shall focus and critically examine the author's main results on (and implications for) economic growth, the business cycle, inflation, unemployment and the role of economic policy.

Professor Balopoulos on growth and the business cycle

One of the most important contributions of the book under review is the integration of business cycle with growth theory, something, that is fair to say, is in line with a recent strand of research in macroeconomics (e.g. Aghion and Howitt, 1998, MIT). This strand of the literature is perhaps the only kind of macroeconomics that would matter in the future. This is a highly attractive feature of Balopoulos' new book. Short-run fluctuations play a central role in his long-run model. His starting point is the observation that in conventional macroeconomics the case of an excess supply capital is inconceivable in the sense that it is inconsistent with rational behaviour. It is to the self-interest of profit maximizing firms to substitute capital for labour up to the point where there exists no spare capital. In other words, most of the existing literature assumes an ex post flexible embodied technology. Balopoulos instead, by postulating that the embodied technology (capital - labour ratio) is ex post inflexible, derives the result that factor prices are structurally inflexible, i.e. determined by separate structural equations, to the effect that involuntary capital and labour unemployment is the normal case for the economy. What effectively Balopoulos does is to bring forward *putty-clay* technology as a central component in a dynamic general equilibrium framework and to work out its implications. This line of research distinguishes between the ex ante notion of the neo-classical production function, characterised by a flexible (*putty*) technology, allowing thus for the determination of factor prices and its ex post notion, characterised by an inflexible (*clay*) technology, allowing thus for the determination of factor demands. Once a particular technology is installed, ex ante *putty* becomes ex post *clay*. Regarding the business cycle, this is an inevitable implication of the core structure of the economic system and has little to do with market imperfections or co-ordination failures. The business cycle is governed not by a single autonomous adjustment process, but by the simultaneous operation of several autonomous adjustment processes, that may be stabilising or de-stabilising and thus capable of generating swings and auto-correlation in the real and nominal economic aggregates. This integration of the short run with the long run, fluctuations with growth, will, I predict, revolutionise the terms of the debate and this is a great achievement of the book.

Professor Balopoulos on unemployment and inflation

As argued above, factor prices can affect factor demands only indirectly through their effects on the capital labour ratio and profits. In other words, cyclical unemployment will be rather the normal case. Such cyclical unemployment is involuntarily and has little to do with market imperfections. Since the self-adjustment properties of the labour market are shown to be sluggish, dealing with cyclical unemployment normally requires active policy intervention. Regarding inflation, Balopoulos boldly sets out the view and demonstrates that a dirty non-endogenous monetary regime is a prerequisite for the coexistence of both demand-pull and cost-push inflation and also for the existence of a trade - off between inflation and unemployment. With the money supply assumed exogenous and the money wage rate flexible, the monetary nature of inflation prevails, so that it is cost-push inflation that adjusts to be equal to monetary inflation. Exactly the opposite holds under an endogenous money supply and the rigid money wage rate, in which case the cost-push nature of inflation prevails. In effect both demand-pull and cost-push inflation necessitate monetary validation (i.e. inflation is always a monetary phenomenon).

Professor Balopoulos on the theory and relevance of policymaking

What is the role of economic policy in terms of stabilising the economy? According to Balopoulos, a successful strategy has to rely not only on monetary policy and the management of private sector expectations, but also on fiscal policy. The latter plays a predominant role in economic stabilisation, both as an effective component of aggregate demand (i.e. Ricardian equivalence does not hold) and as the only appropriate instrument for dealing with asymmetric shocks. What about monetary policy? The author is an advocate of rather active (feedback) policy rules than of passive rules. In terms of the pre-commitment - discretion literature, he is in favour of constrained discretion. For instance, control of inflation would come from the management of inflationary expectations by the central bank and through money wage targeting (which in turn presupposes a consensus among social partners).

What is the relevance and significance of all the above for the real world? Balopoulos persuasively argues in his book that low inflation rates of the 90s around the world have to do with weak trade unions, globalization and productivity gains rather than with the enhanced credibility of independent central banks. He also points out convincingly that the Growth and Stability Pact of EMU, unless accompanied by a counter cyclical monetary policy by the European Central Bank, may be an obstacle in promoting economic growth and prosperity in Europe.

In sum, this is a fascinating book. It is one of a few genuine attempts in putting the integration of growth theory with business cycle theory at the centre of macroeconomics. For research reference or classroom use, it sets new standards in macroeconomic theory. The book is ideal as an advanced textbook, but it will also be valuable for everyone in the field, no matter how senior. Professor Balopoulos' book gives us an excellent run for the money.