

Economic Thinking in an Age of Shared Prosperity

GRAND PURSUIT: THE STORY OF ECONOMIC GENIUS

BY SYLVIA NASAR

NEW YORK: SIMON & SCHUSTER, 2011, 558 PAGES

REVIEWED BY THOMAS M. HUMPHREY

A distinctive feature of the modern capitalist economy is its capacity to deliver sustainable, ever-rising living standards to all social classes, not just to a fortunate few. How does it do it, especially in the face of occasional panics, bubbles, booms, busts, inflations, deflations, wars, and other shocks that threaten to derail shared rising prosperity? What are the mechanisms involved? Can they be improved by policy intervention? Has the process any limits?

The history of economic thought is replete with attempts to answer these questions. First came the pessimists Thomas Malthus, David Ricardo, James Mill, and his son John Stuart Mill who, on grounds that for millennia wages had flatlined at near-starvation levels, denied that universally shared progress was possible. The problem was seen to be labor's prolific reproductive capacity, which condemned the mass of humanity to bare subsistence living. An "iron law of wages" dictated that temporary wage rises above subsistence equilibrium would trigger the very population growth that eliminates the wage discrepancy. Similarly, transitory wage declines below subsistence equilibrium produce starvation and population shrinkage until wages return to their subsistence equilibrium along a perfectly elastic long-run labor supply curve.

Karl Marx and Friedrich Engels accepted the iron law of wages, albeit without its Malthusian trappings. Unwilling to blame poverty on labor's inability to prudently keep its own numbers in check rather than upon its exploitation by capitalist managers, they claimed that capitalists, by threatening to replace employed hands with idle ones drawn from "the reserve army of the unemployed" huddled at factory gates, could force labor to accept subsistence wages while appropriating all surplus value produced by labor for themselves. To Marx and Engels, capitalism creates great wealth, but only for the capitalist 1 percent who seize it from its rightful owners.

This picture changed after the 1840s and '50s when rises in the British

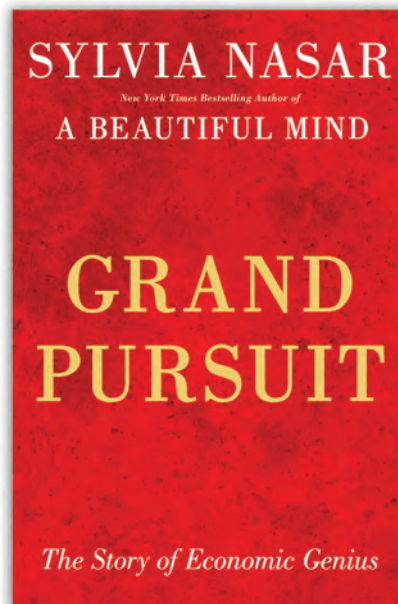
workingman's living standards signaled the demise of the iron law and forced economists to recognize and explain the phenomenon. Britain's Alfred Marshall, popularizer of the microeconomic demand and supply curves still used today, was among the first to do so. He argued that competition among firms, together with their need to match their rivals' cost cuts to survive, incessantly drives them to improve productivity and to bid for now more productive and efficient workers. Such bidding raises real wages, allowing labor to share with management and capital in the productivity gains.

Marshall interpreted productivity gains as the accumulation over time of relentless and continuous innumerable small improvements to final products and production processes. Joseph Schumpeter, who never saw an economy that couldn't be energized through unregulated credit-financed entrepreneurship, saw productivity gains as emanating from radical, dramatic, transformative, discontinuous innovations that precipitate business cycles and destroy old technologies, firms, and markets even as they create new ones. Schumpeter's outcome, however, was much the same as Marshall's, namely an ever growing, ever more affordable volume of goods whose steadily falling prices enable all income classes, particularly the poor, to share in their consumption.

Marshall and Schumpeter highlighted innovation and technological advance. Other economists, notably Irving Fisher, itemized additional necessary conditions — monetary and price level stability, absence of trade barriers, an economic climate conducive to entrepreneurship (recognized also by Schumpeter) — required to ensure that the capitalist machine yielded perpetual, universally shared progress.

With these additional ingredients incorporated into it, the augmented Marshall-Schumpeter model prevailed until the interwar period. Then came the destruction, mass unemployment, poverty, and destitution wrought by two world wars and the Great Depression. Capitalism came under fire, and confidence in the validity and relevance of its explanatory model waned.

Here again economists came to the fore. They devised powerful new theories to diagnose the economic devastation and to prescribe policies to remedy it so that capitalism could be



restored to its former prowess. Such novelties as Fisher's compensated dollar plan to stabilize the general price level by adjusting the gold content of the dollar, his monetarist theory of the business cycle as due to unanticipated fluctuations in the rate of change of the price level, his famous debt-deflation theory of great depressions in which attempts to retire nominal debt result in money stock destruction and price level declines that perversely raise real debt burdens, and his 100 percent reserves proposal all date from this era. So do John Maynard Keynes' ideas of the superiority of domestic price level stability over foreign exchange rate stability, of the liquidity trap, of investment and government spending multipliers, and of the efficacy of fiscal stimulus. Finally, there was Schumpeter's theory of the tax state and his capital levy proposal. All these innovations to economic theorizing were designed to put the derailed capitalist cornucopia back on track. Hard times called for imaginative responses. Economists were glad to oblige. In this way, economic theory contributed to economic progress.

Economic reasoning came to the aid of progress again at the end of World War II. Keynes and others, having studied the disastrous German reparations debacle after World War I, vowed to replace punitive reprisals on the defeated nations with generous recovery assistance. Both theory and experience suggested that such assistance would benefit victor and vanquished alike. The result was the Bretton Woods system, World Bank, International Monetary Fund, and the Marshall Plan, all of which witnessed the launching of the long postwar global expansion of 1946-2006.

Sylvia Nasar, a professor at the Columbia Graduate School of Journalism, former economic correspondent for the *New York Times*, and author of Nobel laureate John Forbes Nash Jr.'s biography entitled *A Beautiful Mind*, the only mathematician/economist's biography ever made into an Academy Award-winning movie, traces the foregoing developments and much more in her beautifully written and intellectually compelling account of the evolution of economic doctrines. (The "grand pursuit" of her title refers to the quest to discover growth's mainsprings, "economic genius" to those who found them or at least advanced the search.) As a history of economic thought, however, Nasar's book, though completely captivating, is somewhat idiosyncratic and unconventional. Unlike standard histories, it focuses on just a few key individuals — Marx, Marshall, Schumpeter, Fisher, Keynes, Friedrich Hayek, Joan Robinson — writing during the period circa 1850-1950, but says relatively little of economists practicing before or since. Both Mercantilist and Physiocratic Schools are omitted. And British Classics such as David Hume, Adam Smith, David Ricardo (except for his iron law of wages), and Henry Thornton get short shrift, as do neoclassical marginalists William Stanley Jevons, Leon Walras, Carl Menger,

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Knut Wicksell, and business cycle pioneers such as Clement Juglar and Wesley Clair Mitchell. Modern analysts including Robert Lucas, Thomas Sargent, James Tobin, Robert Solow, Franco Modigliani, Don Patinkin, Michael Woodford, and many others receive nary a mention. True, Milton Friedman makes an appearance, but mainly as

a young Keynesian in the U.S. Treasury in the early 1940s where he devised income tax withholding at the source in order to facilitate the Treasury's quick receipt of tax revenues. Curiously, little is said of Friedman in his later role as the leading monetarist critic of Keynesianism, the Federal Reserve, and big government. Likewise, little is said of Hayek's profound postwar analysis of the price system as a market coordination, discovery, and information assimilating/synthesizing/economizing mechanism, although much is said of his *Road to Serfdom* critique of statist planning and control. Similarly, Paul Samuelson's numerous pathbreaking contributions to theory are downplayed in order to highlight his erroneous prediction of the U.S. economy's lapse back into depression following demobilization at the end of World War II. And the formulators and developers of recent rational expectations, real business cycle, and New Keynesian dynamic stochastic general equilibrium models are totally ignored.

In place of the missing economists, Nasar substitutes such noneconomists as Charles Dickens, the British novelist/journalist obsessed with the Victorian problem of eradicating poverty; Henry Mayhew, a British investigative reporter whose 88-part newspaper series definitively described the condition of London's poor, circa 1850; and most notably Beatrice Potter Webb, a founder of both the London School of Economics and the Fabian Society. It was Webb who, with husband Sidney, hatched the idea of a tax-financed government social safety net both as a solution to the poverty issue and as a partial corrective of inequality arising from capitalist growth, thus paving the way for Britain's cradle-to-grave welfare state of the 1940s, '50s, and '60s. But perhaps Nasar's most puzzling selection is British economist Joan Robinson, who, after co-inventing (with E.H. Chamberlin) the theory of imperfect, or monopolistic, competition in the 1930s, later renounced that seminal work to become a sympathizer of the communist regimes of Stalin and Mao in the Soviet Union and China, respectively. It's hard to see how Robinson fits into Nasar's theme of the link between economic ideas and rising living standards.

Nasar's unconventional treatment is noteworthy on two further counts. First, in contending that economic thought contributes to economic progress, she comes perilously close to implying that the former causes the latter, as if mere theorizing about progress makes it so. To this reviewer, the direction of causality is exactly the reverse: Technical advance and entrepreneurial initiative drive material

progress, which then stimulates improved economic theory to explain and rationalize the process. Wal-Mart, Apple, and Target, as well as the steel, rail, auto, aircraft, radio, TV, and computer industries, all emerged as the brainchildren and products of the efforts of their creators, not because economists anticipated them beforehand. Second, contrary to standard thought texts, Nasar focuses primarily on the personal histories — the lives, times, eccentricities, and experiences — of her protagonists and only secondarily on their contributions to economic analysis. In sum, she is long on biographical detail, but relatively short on theory. While these characteristics might seem to make her book more suitable to the general reader than to professional economists, such is not the case. Her command of theory is adequate to her task and sufficient to satisfy economists while remaining completely accessible to the general reader. This is especially true of her chapters on Schumpeter, Fisher, and Keynes — the strongest analytical chapters of the book.

Nasar's comparison of Fisher and Keynes highlights the resilience of their ideas, which continue to resonate in policy discussions today where concepts like monetarism, fiscal stimulus, zero interest rate bound, liquidity traps, multipliers, debt leveraging and deleveraging, debt-deflation cycles, fixed vs. flexible exchange rate regimes, gold vs. fiat paper standards, external vs. internal devaluation, sticky nominal wages, etc., are bandied about with abandon. In the 1920s and early '30s, Fisher and Keynes were allied in their monetarism. Both contended that misbehavior of the money stock causes not just inflation and deflation but also fluctuations in output and employment. Both believed that causality runs from money to prices to real activity, with disturbances to activity resulting from the stickiness of nominal wage and interest rates in response to price level changes. Fisher even estimated an empirical relationship between price changes and unemployment, thus anticipating the famous Phillips curve (although unlike A.W. Phillips, he traced causation as running from price change to unemployment rather than the reverse). Both Fisher and Keynes held that money could not be trusted to take care of itself but needed deliberate management by central banks through discount window lending and open market operations. And both contended (1) that policy should aim at stabilizing domestic prices instead of currency exchange rates, and (2) that fixed exchange rate regimes (including the gold standard) are inferior to floating rate regimes from a stabilization standpoint because they deny a nation the power to govern its own money stock, price level, and nominal spending independently of other nations. For that reason, Keynes criticized Britain's 1924 return to gold at the fixed prewar parity — a parity that necessitated painful domestic price deflation ("internal devaluation") and a slump in real activity to correct the pound's overvaluation. Likewise both he and Fisher applauded President Roosevelt's 1933 decision to depart from the gold standard and to let the dollar depreciate on the foreign exchanges.

Both saw their predictions validated when the dollar depreciation, which rendered U.S. goods cheaper in foreign markets, helped spark the partial recovery of 1933-37.

Fisher and Keynes parted company in the mid-1930s when persistent mass unemployment seemed impervious to monetary remedies. Fisher, while continuing to advocate monetary policy as the only way out, nevertheless discovered excess leverage, or overborrowing, as a new obstacle to policy's effectiveness. His debt-deflation theory explained how overleveraged borrowers, attempting to pay off their debts with checks drawn on their deposit accounts, would cause bank money contraction and price level deflation. Such deflation, by raising the real burden of debts, would induce further attempts to deleverage, leading to further monetary contraction and further price deflation and so on ad infinitum in a self-reinforcing spiral. Monetary policy would have to reverse the vicious cycle of debt deleveraging and price deflation before it could make inroads into the depression. Fisher thought Roosevelt's policy of reflating prices to their pre-slump level would do the job.

Keynes took a different route, abandoning monetary policy for fiscal policy on the grounds that a "liquidity trap" rendered the former ineffective and the latter effective in depressions. He argued that with interest rates at near-zero levels (as they were in the Great Depression) money becomes a perfect substitute for Treasury bills in asset portfolios. At that point the demand for money becomes infinitely elastic with respect to the interest rate such that all newly central-bank-created money is absorbed into idle hoards rather than into active circulation in the spending stream. The result is to render monetary policy impotent at the zero bound and to leave fiscal policy, with its multiplier effect on income and spending, as the only game in town.

Their policy differences notwithstanding, Fisher and Keynes remained united both in their opposition to "do-nothing" and austerity measures and in their dedication to eliminating the depression through activist intervention. In this connection, Nasar correctly emphasizes that although Keynes is sometimes accused of being a socialist or a socialist sympathizer, in actuality he was anything but. He detested socialism and admired capitalism as the economic system most conducive to individual liberty, personal initiative, and intellectual and artistic creativity. He sought to save capitalism by restoring it to its full-employment potential where those qualities could flourish.

Nasar's book is full of surprises. We learn, for example, (1) that Hayek and philosopher Ludwig Wittgenstein were cousins, (2) that Schumpeter's pioneering *The Theory of Economic Development* was ignored by most economists and critiqued with extreme hostility by others upon its publication, (3) that libertarian Hayek, the darling of American conservatives, in the 1950s "despised Republican politicians, all cars, and practically everything else about life in America, including the absence of universal health insurance and government-sponsored pensions," (4) that Irving Fisher was perhaps the first U.S. employer to make automatic cost

of living adjustments to the wages of his employees, (5) that Marx in *Das Kapital* condemned the squalor of factory workers without ever setting foot in an actual factory, (6) that philosopher Frank Ramsey wrote at age 19 a criticism of Keynes' *Treatise on Probability* "so devastating that Keynes gave up any notion of a mathematical career," and (7) that the Bretton Woods conference was crawling with Soviet spies, including Treasury economist Harry Dexter White, FDR adviser Lauchlin Currie, and the University of Chicago's Oskar Lange. But perhaps Nasar's biggest surprise is the cordial personal and professional relationship she finds existing between Keynes and Hayek, the two main rival macroeconomists in the 1920s and '30s, and bitter foes on the causes of the trade cycle and mass unemployment and of the need for stabilization policy. Although both economists ordinarily were extremely critical of each other's work, it was Keynes who congratulated Hayek on the excellence of his *Road to Serfdom* and who nominated him for membership in the British Academy. And it was Hayek who wrote to Keynes' widow in 1946 that Keynes was "the one great man I ever knew, and for whom I had unbounded admiration."

In sum, Nasar's is a fascinating and accessible work, one that will reward all readers, economists and noneconomists alike. True, the book is not perfect: Rather it is a somewhat awkward amalgam of three smaller books pressed into one. It is an economic history, largely of England and Vienna, of

the period circa 1850-1950. It is a series of scintillating intimate portraits of a too small subset of great economists. And it is a partial catalog of their theories and policy analyses. One wishes Nasar had chosen to expand the third book to include additional great economists and their theories. And one wishes she had given that expanded third book pride of place. But she did not choose to do so.

Nasar wrote the bulk of her book before the appearance of the recent financial crisis and the Great Recession. She opines that these disturbances neither invalidate her thesis of the long-run persistence of shared prosperity under capitalism, nor do they necessitate revision of her book. Maybe so, but this reviewer's preference is that she extend her coverage to include at least some of the economic and policy debates sparked by these recent episodes. Given the need to reassess mainstream macroeconomic thinking in the light of its failure to predict the crisis, these debates seem bound to impact the current and future evolution of economic thought.

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motorists from using local roads to bypass tolls while allowing local drivers to make some short trips for free. But for longer trips, North Carolina's entire I-95 corridor would become a toll road upon completion of phase one in 2019.

Under this scenario, the study estimates that each of the three toll zones in the first phase would charge \$3.84, while each of the six toll zones in the second phase would charge \$1.28. So the owner of a passenger car crossing the entire state would pay \$19.20. North Carolina expects to collect all fees electronically as cars move at full speed through the toll zones using a transponder system that would be compatible with E-ZPass and other toll programs along the I-95 corridor. Owners of cars lacking toll transponders would receive bills in the mail. The study projects that the tolls would raise nearly \$30 billion over 40 years.

Virginia's plan to charge tolls on I-95 is less ambitious and detailed than North Carolina's proposal. But the Old Dominion expects to place tolls on I-95 that would raise \$250 million in the first five years and more than \$50 million per year after that. The tolls would help fund comprehensive improvements outlined in Virginia's "I-95 Corridor Vision Plan." The Virginia Department of Transportation estimates that it would cost \$12.1 billion to fully execute the plan along its 179-mile stretch of I-95, so additional funding would have to come from other sources.

Critics of toll roads claim they discriminate against poor people. But tolls connect the cost of highways to the people who use them, says Brian Taylor, director of the Institute of Transportation Studies at the University of California, Los Angeles. Federal and state fuel taxes made that connection in the early days of driving, but increases in fuel efficiency and reluctance to raise fuel taxes have created huge gaps in highway funding nationwide.

"A great deal of concern has been raised, some of it justified, about the equity of returning to tolls, but critics have been silent about the equity of using sales taxes to fund highways," Taylor says. Raising general sales taxes to pay for highways is "a doubly regressive approach," while tolls tend to raise a greater share of funding from wealthier motorists. Taylor argues that sales taxes are inherently regressive, and when their proceeds are used to fund highways, they become doubly regressive because wealthy people tend to use highways more than poor people.

Taylor attributes much of the recent interest in tolls to advances in technology. "We have eliminated the need for the traditional toll booth," he says. "Tolling is much more practical now." And the North Carolina and Virginia proposals should be more palatable to local drivers on I-95, he adds, because many out-of-state motorists travel this Maine-to-Florida thruway.

— KARL RHODES