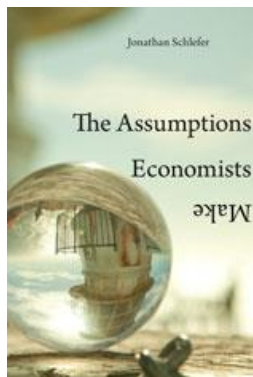


The Central Bank of Barbados Book Review Series seek to highlight publications which offer useful insights and analysis on topics related to finance, economic development, and other issues relevant to small island developing economies. The views expressed are those of the author(s) and do not necessarily represent those of the Central Bank of Barbados.



THE ASSUMPTIONS ECONOMISTS MAKE, BY JONATHAN SCHLEFER, CAMBRIDGE, MASSACHUSETTS, AND LONDON ENGLAND THE BELKNAP PRESS OF HARVARD UNIVERSITY PRESS, 2012

Authors: Jonathan Schlefer

Publisher: Belknap Press; First Edition (US) First Printing edition (March 20, 2012)

ISBN: 978-0674052260

Book Review contributed by Christopher Kinch.

The book, ‘The Assumptions Economists Make’ by Jonathan Schlefer, is a welcomed and thought provoking addition to the existing body of economic literature, as it dissects the role of economists and the often ‘invisible’ assumptions which drive their policy recommendations. Dr. Schlefer achieves this by using both historical and current economic theories, data driven examples and other supporting evidence from both primary and secondary sources.

The book begins with a discussion of the impact of the concept ‘the invisible hand’, which is the ideological thinking of classical economists, and in the author’s view was the main catalyst behind market deregulation. He states that financial deregulation is a component of the set of other sector deregulations established in the 1970s for the airlines, communications, and energy sectors. The first chapter discusses the themes developed in the remaining fourteen chapters, the most interesting being what do economists actually do, how models are constructed, the social and political influence of older economic thinking on the state, and the nature and causes of economic crises on economies.

In the second chapter, ‘What Economists Do?’, the writer discusses the design of economic models. He believes models do not sufficiently represent reality and notes that part of the problem is that economics has moonlighted as a physical science, and has provided a false sense of reality as to what economists do, but also what economics is capable of doing. The chapter

motivates the question: do assumptions, models and ideas of pioneering economists able to explain today's economic questions in the light of the occurrence of the Great Recession?

The third chapter provides a historical overview of Adam Smith's classical economic theory. The author highlights that Smith's classical theory can be seen as an answer to both the social and political issues that Britain experienced during the eighteenth century. According to Smith, "the greatest part of capital invested should be directed firstly to agriculture, then manufacturing, and lastly trade." Smith believes this is the most efficient method to allocate capital within an economy. Within the context of Britain, Smith thought that agriculture would have contributed the greatest economic value to the country's wellbeing, given the large number of jobs available in the industry. Following agriculture, capital should be invested in manufacturing because it contributed the next greatest economic value. As the author progresses, he shows the reader that Smith's theory leaves room for criticism from both classical and neoclassical economists.

In chapter 4, the author investigates both the defense and improvement of Adam Smith's classical economy by David Ricardo. According to Dr. Schlefer, Ricardo opposed the laws which favoured the landlord, because workers were placed at a disadvantage. He proposes that Ricardo's assumption of the determination of wages by society indicates that both society and markets are interconnected into one economy. However, neoclassical economic thought does not hold the belief that wages are determined by society, but rather as a result of the interactions between firms and households.

Schlefer also highlights that Ricardo believed firms have essentially one technique for producing goods at a given state of technology. Using the example that even though accounting firms might utilise different computer software for their work, the differences are minimal and can be ignored by the model. Similarly, neoclassical models assume firms have access to a wide range of techniques. The writer concludes that Ricardo's models depart from the neoclassical model in two important ways. First, the assumption that in the long run, wages cannot be determined by market interactions but by society. Secondly, only one technique is known for producing goods.

In chapters five through seven, Schlefer details the continued advancement of not only classical economics but also neoclassical economics throughout history. The author highlights the assumptions and conclusions proposed by Ricardo, Marx and Jevons. Ricardo's view that wages could be determined by social interactions did leave room for his model to be critiqued. According to Schlefer, the neoclassical theory that emerged did reject the assumption that social interactions should determine the division of income between capital and labour. Dr. Schlefer also shows that not all models are built on perfection but rather imperfection. He mentions that Nobel Prize winning economist Paul Krugman, was able to demonstrate that when competition

within a market was imperfect and firms have access to market dominance, governments would intervene to promote development.

In chapters eight and nine, the author explores the world of production, but also investigates the causes of income inequality since the 1970s. He highlights that neoclassical economists believed that wages were seen as payments to workers for services rendered, while in terms of payments of capital, it is the interest rate. The author argues that the Reagan revolution during the 1970s drove the wages of all workers further behind the economy wide-productivity growth, and the mediocre education system contributed to greater income inequality. According to the OECD report on Inequality and Growth , the richest 10 percent earns about 9.5 times more than the poorest 10 percent, while compared to the 1980s, the ratio was 7:1.

In chapters ten to thirteen, the author discusses Keynes's General Theory, economies both in the long run and short run, and also the Golden Age of Capitalism. This section of the book begins with Keynes' creation of the General Theory, which was a response to the economic destruction caused by the First World War and Great Depression. Jonathan Schlefer presses on through out the book, where he compares both the Neoclassical Growth Theory and Keynesian Growth Theory in explaining long-term growth. The author mentions that Samuelson was one of the neoclassical economists who disagreed with the Keynesian theory that was utilised to combat the Depression. In spite of his opposition, Samuelson agreed that the theory did provide good recommendations such as public spending during a recession in order to stimulate employment. Dr. Schlefer concludes that the uniqueness of equilibrium is just really an assumption. He goes on further to highlight that no model has ever demonstrated that an economy with a diverse group of firms and individuals, while producing and trading various goods, could possibly be lead to equilibrium by an invisible hand.

In chapters fourteen and fifteen, Dr. Schlefer discusses the issues and causes surrounding the 2008 financial crisis. He argues that central banks which utilised both dynamic stochastic general equilibrium (D.S.G.E) and financial models were unable to predict the crisis in 2008. His opinion is that they created this panglossian view that an economy would always return to equilibrium and avoid going to a recession.

After his assessment, Schlefer (2012, page 279) ends the book by giving five recommendations for economists: (1) they should be realistic about their assumptions and consistent to the reality of a particular situation; (2) the structure of the models must be explained thoroughly, in order for policy makers to make informed decisions; (3) they should seek to encompass all of the crucial features of an economy; (4) economists should always weigh conflicting models that explain facets of an economy; and (5) they should always be transparent and forthcoming about things they do not know.