NEW IDEAS FROM DEAD ECONOMISTS

AN INTRODUCTION TO MODERN ECONOMIC THOUGHT

COMPLETELY REVISED AND UPDATED

Todd G. Buchholz

With a Foreword by Martin Feldstein

A PLUME BOOK

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NEW IDEAS FROM DEAD ECONOMISTS

TODD G. BUCHHOLZ is an internationally acclaimed economist who advises some of the world's leading investment funds. He has served as a director of economic policy at the White House and as a managing director of the legendary Tiger hedge fund. Buchholz holds advanced degrees from Cambridge University and from Harvard, where he was awarded the Allyn Young Teaching Prize by the Department of Economics. His other books include New Ideas from Dead CEOs, From Here to Economy, Market Shock, Bringing the Jobs Home, and a novel, The Castro Gene. He lives in Solana Beach, California.

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Foreword

All of us are affected by government economic policies and by private economic decisions. No one can be an informed voter or even an understanding reader of the daily newspaper without a knowledge of economics. And who can plan for the future in which we and our children will live and work without a sense of the forces that shape our economic life?

The economic policy issues that we debate today—trade policy, inflation, the proper role of government, the eradication of poverty, and the means of raising the rate of economic growth—have been discussed by economists for more than two centuries. Many of today's economic policies—both the good ones and the bad—are the result of the ideas of those past economists. And many of today's debates about economic policy can be understood only by those who have at least some familiarity with the ideas of earlier economists.

The giants of economic science during the past two hundred years have been men concerned with the critical policy issues of their time. They studied the working of the economy in order to advocate better economic policies. But despite their concern with policy, they were not polemicists or politicians but men who sought to persuade their contemporaries in government and in the broader public by analysis and evidence that would meet the standards of professional debate.

Like any scientific discipline, economics advances by discovering the limitations of earlier ideas. Although economics does not have the opportunities for experimentation that characterizes the natural sciences, economists can use systematic observation and the analysis of experience to reject old theories and develop new ones.

The changes in technology and in the political and institutional environment impede the process of drawing firm conclusions about the likely effects of alternative economic policies. It can take decades before issues are settled, and new generations of economists and policy officials may have to learn that the conclusions of the past continue to be valid in the changing environment of today.

Adam Smith, the eighteenth-century founder of modern economics, rejected the conventional wisdom of his day by arguing that government interference in the economy is generally harmful and that the public's interest is best served by competition among private buyers and sellers. In recent years, governments around the world have recognized the virtues of a market economy based on private enterprise rather than on government planning and public ownership. The reduction of tax rates in the United States, the privatization of nationalized industries in England and France, the resurrection of family farms in China, and the Soviet economic restructuring that has been labeled "perestroika" are the direct descendants of the early ideas of Adam Smith.

The theories of John Maynard Keynes, developed in England during the depression of the 1930s, have helped governments to avoid a return to mass unemployment. But the

Keynesian arguments against saving and in favor of increased consumer spending are being gradually abandoned as inappropriate for the very different conditions of today’s economy. Now we understand that increased saving can in general be the basis for increased investment in new plant and equipment and therefore for faster economic growth and a higher standard of living.

When Federal Reserve officials make decisions about monetary policy and interest rates they are relying on ideas and evidence that can be traced back to nineteenth-century economists like John Stuart Mill as well as on the latest data being developed in Washington. When Treasury officials debate appropriate tax rules for businesses and individuals, they may make use of analytic arguments that date back more than a century to David Ricardo and Alfred Marshall. Similarly, the analysis of trade policy, energy and environmental regulation, and antitrust legislation are based on ideas that have developed through the centuries. A familiarity with these economic ideas is important for anyone who wants to understand how new policies are likely to affect the economy and why certain policies are chosen.

In this book, Todd Buchholz provides a lively and intelligible introduction to the key ideas of economics through the study of the great economists who have shaped the discipline. Instead of the formal models and complex diagrams that are the focus of standard economics textbooks, Buchholz provides clear, nontechnical explanations and timely examples.

I first met Todd Buchholz when he was teaching a section of the introductory economics course at Harvard. Buchholz was an excellent teacher who was selected from among the thirty other teachers in the course to receive the annual prize for outstanding teaching of introductory economics. His skills in the classroom are well displayed in this very readable book.

—Martin Feldstein

Cambridge, Mass.

June 1989

Preface to the Revised Edition

Vincent van Gogh painted twenty-eight portraits of himself in just two years! I have avoided such introspection and have managed to keep both ears attached to my head. I had not read New Ideas from Dead Economists since early 1989, when I delivered a manuscript to the offices of E.P. Dutton, for its hardcover debut. I suppose some authors reread their works often, reminiscing about a skillful turn of phrase or prescient thought. Rather than reread my work, I continually watched the world economy over the subsequent ten years to see how the book's ideas and the great economists' ideas held up. This revised edition benefits from a careful study of economic trends and crises from my perch as a White House economist, Wall Street adviser, investment fund manager—and father. I was none of those when I drafted the first edition.

The world has changed in staggering ways. Mostly for the good. New medicines, new technologies, more jobs, less inflation, and less crime have blessed the United States. In 1989, we had no Internet, no anti-baldness drugs, few automobile airbags, and no hope that the jobless rate could plunge below 5 percent or that U.S. stock prices would more than triple during the 1990s. In the years since the first edition we have also seen demonstrated a phenomenon I call the "scissors economy." Technology has permitted Americans to cut out the middleman from many purchases. Who needs a stock-broker or an insurance agent if the Internet allows people to comparison shop? You can buy a sockeye salmon direct from Alaska within seconds or an airplane ticket to Timbuktu. Consumers have more control than they have ever had before. Even the old monopolistic utilities have broken down, as cable, satellites, fiber optic, and wireless technologies compete for your television, telephone, and computer business. A striking advertisement appeared in the Washington, D.C., area, touting a new telecommunications company. Posters displayed a statue of Lenin with a rope around his neck and the headline: "No Empire Lasts Forever—Especially One That Keeps You Waiting 5 hours for a Repairman."

Three sweeping changes command our attention. The first element is mostly a positive story for world peace: The Berlin Wall came tumbling down, freeing hundreds of millions of Eastern Europeans from Soviet drudgery and pushing them into competitive markets, where many have thrived and others have struggled. Within a few years of the Berlin Wall's crumbling, Czech and Bulgarian versions of New Ideas from Dead Economists appeared, as newly freed minds searched to understand a market economy. Second, the Japanese economy transformed itself from a threatening giant in the late 1980s into a humbled midget in the 1990s. The key Tokyo stock market, which climbed to 39,000 in 1989, collapsed and stood at just 17,000 in 2007. What happened to all of those stories of superior Japanese management techniques? Third, China emerged as a powerhouse in world trade, its factories churning out more goods than any other country except the U.S. and Japan. This from a nation whose GDP barely showed up on a chart in the 1970s.

The Berlin Wall

As the Soviet Union and the U.S. waged the Cold War, intercontinental ballistic missiles were poised and aimed at each other, ready to destroy humanity. Most geopolitical strategists believed that a standoff, that is, a “stable Cold War” was a good outcome that could, hopefully, be extended well into the twenty-first century. Not even Ronald Reagan, surely the most optimistic Cold Warrior, thought that the Soviet empire would crumble as swiftly and peacefully as it did after 1989. Many of his advisers and almost all of his opponents urged caution. When Reagan implored then Soviet leader Mikhail Gorbachev to “tear down this Wall!” State Department “experts” objected to the forceful yet fanciful dare. Why rile the Soviet bear and ask for an impossible task? It turned out that the bear was not so strong and the task not so far-fetched. Only a few years later, East Berliners and West Berliners took picks and hammers to the Wall in all-night celebrations while their radios blared the youthful, uplifting tunes of American rock and roll. Similar rejoicing took place in Warsaw, Prague, and Budapest.

Under German Chancellor Helmut Kohl’s bold leadership, West Germany adopted East Germany, supporting its population with generous financial gifts. Today, residents of eastern Germany still earn less money than their countryman cousins, but they are surely adapting to Western capitalist ways. The Polish, Czech, and Hungarian economies have also struggled to transform themselves. Despite economic turbulence, democratic elections have continued to reinforce a pro-market approach and bury Soviet ideology. Even when former communist officials win parliamentary seats, they generally support market reforms. During a recent visit to Gdansk—home of the Solidarity movement that brought down communism in Poland—I was impressed by the entrepreneurial energy of young Poles, who had opened up shops throughout the medieval Baltic port city. Prague and Budapest and Tallinn, Estonia, also bustle in living color, rather than the drab grays of the communist era.

In Russia, the path has been very bumpy. In 1998, Russia looked economically defunct, as the ruble lost most of its value and panicked sellers hammered the Russian stock market into rubble. Foreign investors who held Russian bonds could use them for wallpaper. Why did Russia’s capitalist experiment fail? A not-so-funny thing happened on the way to the free market: the country took a dangerous detour into “crony” capitalism, in which former communist bosses exploited their connections, twisting former state monopolies into private monopolies that they continued to control. Managers of mines made themselves fortunes by smuggling precious metals out of the country by rail, truck, and even tucked in the pockets of trenchcoats. The iron hand of the Soviet police lost its grip, and the new democratic Russia had only a flimsy legal system to deal with crime and settle business disputes. Moscow’s fancy clubs, populated by newly rich racketeers, more closely resembled Chicago under Al Capone than a developing country. Billionaire barons set up their own private security forces. Moreover, President Boris Yeltsin’s government could not figure out how to force these barons to pay taxes. Thus, the Russian government ran up a huge budget deficit, forcing it to borrow money from foreigners by selling them bonds. After a frenzied bubble of stock market gains in 1996-97, the country looked corrupt, bankrupt, and ready to erupt. So Russians and foreigners snuck their money out of the country, erasing the modest wealth built up by a new middle class.

Is there a lesson here, or just a depressing tale? Russia's 1998 debacle teaches us that a market economy must rest on a dependable legal system. A free market does not mean utter chaos; it requires ground rules. Without courts to enforce contracts, police to punish mafiosos, and agencies to collect taxes, Russia's detour into crony capitalism was a voyage of the doomed. In the West, they say that justice is blind. Russia's problem was that she was blind to justice. Of course, Russia has failed before. The entire twentieth century was an economic failure. Visiting regal old cities like St. Petersburg and Odessa (in Ukraine) and witnessing breathtaking nineteenth-century architecture and stunning opera houses teaches one that the problem with communism was not that it couldn't keep up with capitalism; the problem was it couldn't even keep up with the standards of 1917. Let's hope for a new Russian revolution in the twenty-first century, a revolution that finds a place both for economic liberty and for the rule of law.

Japan: Land of the Setting Sun?

When I wrote the first edition of New Ideas from Dead Economists, scholars and journalists were crowning Japan as the king of the world economy. Books with titles such as Yen! Japan's New Financial Empire and Its Threat to America and Trading Places: How We Are Giving Our Future to Japan painted a picture in which Japan would take over the world and Americans would be reduced to flipping hamburgers in order to make ends meet. Japanese speculators collected Van Goghs, Monets, and golf course memberships as if they were souvenir tokens. They bought up downtown Los Angeles and the best properties in Hawaii. Their banks dominated the financial industry, and analysts calculated that the land beneath the Imperial Palace in Tokyo was worth more than all the land in California. A prominent Japanese politician wrote a best-selling book condemning U.S. hegemony, called The Japan That Can Say No. How the mighty have fallen! Japanese investors turned out to have a reverse Midas touch, turning precious assets into worthless trinkets. Along with a devastating slide in the Tokyo stock market, the price of Impressionist paintings sank along with Hawaiian real estate. Their investments in movie studios left them with staggering losses, as slick Hollywood producers ripped them off. Back in Japan, arrogance turned to humility and fear, as property prices and incomes dropped. In 1998, interest rates fell to zero, meaning that you could borrow money from the government for free! The only thing that rose was the jobless rate.

What happened? The quick answer is that in 1989 the Japanese central bank jacked up interest rates to deliberately pop a bubble in the stock market. But that does not explain a nearly ten-year plunge. Two culprits come to mind. First, the Japanese government encouraged its premier corporations to dominate the manufacturing sector, while the

United States was shifting toward service industries like finance and health care. Though Japanese banks dominated the world in size, they lagged way behind in profitability and sophistication. Most of the new financial products, from stock index funds to complex derivatives, were made in the United States or England. Why didn't Japan develop these ideas? They faced little competitive pressure at home. The Ministry of Finance protected the insurance companies from the savings banks and the savings banks from the corporate banks. Whereas in the United States these industries faced ferocious competition from each other, the Japanese government created fiefdoms, safe behind bureaucratic walls. The ministry basically forced households to pour their money into pitifully low-yielding bank accounts, giving firms a captive audience. Adam Smith would have seen it coming. By keeping their home turf sedate, they imperiled their ability to fight in the real world.

Japan looked feeble in information technologies, too. When a Japanese friend of mine first encountered the Internet and noticed that almost all websites were in English, he shook his head and said, "We're toast." Although Japan successfully won market share in manufactured goods like electronics, they found their prices undercut by South Korean and Malaysian factories. Soon they gave up the fight and closed down Japanese factories and opened up cheaper ones in China. The concept of "lifetime employment" died, deflating the confidence of working men and women. Japanese commentators called the phenomenon the "doughnut" economy, as the economy turned hollow.

These structural flaws came along with incompetent fiscal and monetary policy. Essentially, the Bank of Japan waited too long before cutting interest rates, and the Ministry of Finance actually pushed up tax rates in the middle of a recession. John Maynard Keynes (see chapter IX) taught the world during the Great Depression that you shouldn't punish consumers when the economy is going down the drain. The message apparently did not make it into Japanese until recently, though New Ideas from Dead Economists has been available there since 1991!

China Awakens and Roars

China's emergence since 1990 looks awesome and a little frightening as it gallops along at a pace of 10 percent GDP growth each year. If you read the financial press, you will hear that nearly every hiccup in the world economy may be blamed on China. High oil prices? China must be hoarding. Low interest rates? China must be snapping up too many U.S. Treasury notes. Fewer manufacturing jobs? China must be stealing them. True, China is a mammoth force in the global economy today, especially considering that the country was an economic invalid just twenty-five years ago. In chapter VI on Karl Marx, we will see how Deng Xiaoping dismissed Maoism and sent his people scurrying not for copies of Mao's Little Red Book of communist quotations, but for copies of Harvard's crimson MBA manual. Despite China's current triumphs in world trade, the next ten years will pose extreme challenges. China will hit a demographic wall when it has to support more senior citizens with fewer young workers. Its quick-rising middle class will spend more abroad on tourism, health care, and luxury goods. When countries move from poverty to middle-class status, they desire three things: cars, protein (meat and grains), and health care. This will provide enormous opportunities for foreigners to sell goods there. The switch to cars has already taken off, and you can see Beijing choked with automobiles that spew out fumes and trample over traditional bicycles. China’s future will be rocky, fascinating, and hopefully a force for global prosperity.

Attitude Over Latitude

Most people, including many professional economists, think about a country’s economy like a potential homebuyer thinks about a model home. It’s awfully hot in Costa Rica! How lucky that Venezuela has oil! Too bad Australia is so far away from the action! The cliché “location, location, location” might work well for buying a three-bedroom colonial in Peoria, but it’s hardly worth a hill of beans when analyzing a country. Take Mexico, please. Mexico has enjoyed a great location, right on the U.S. border. It hasn’t moved. Yet America’s wealth and technology have not rubbed off much. Now look at prosperous Australia—a twelve-hour flight even after you change planes at LAX! And settled by criminals who sailed on leaky boats!

Economic textbooks spend a lot of time focusing on “factor endowments,” telling us that a country blessed with lots of minerals and natural resources has a big advantage. Really? Hong Kong is a pile of rocks. The Netherlands was a sinking Venice but without the charming bridges or the spumoni, and yet in the seventeenth century she leapfrogged her better endowed neighbors. And then there’s Israel today. She may be settled by God’s chosen people, but He chose not to give them a drop of oil, while gushers spout across Arabia. Read Mark Twain’s description of the arid and empty land. Israel’s terrain doesn’t naturally grow enough green for a sprig of parsley on your dinner plate, and yet there she blooms. In the race for economic development, would you rather bet on a country with a million tons of endowed zinc or one with a couple extra IQ points and a free flow of ideas?

A big endowment of riches may even be a curse. The earth under many parts of Africa bulges with metals. And yet the economies are retarded, as oligarchs hang on to power, preventing capital from diffusing through society. Think back to the schoolbook atlases that displayed the natural resources of each country. As a kid, I always thought it unfair that the evil Soviet Union seemed to have all the great stuff, even bauxite, which sounded like a mysterious, earthly version of krytonite, a bad thing in an enemy’s arsenal. But the Soviet system had a reverse Midas touch, too. It turned precious metals and rich soil into famine and poverty. Way back in 1500, when Yuan dynasty vases were being baked, the Chinese had all the technology they needed to beat England to the Industrial Revolution. But the mandarins of the time stomped on trade and financial flows. Because leftists refused to believe that “attitude beats latitude,” they felt sorry for and made excuses for the Soviet

Union's seventy years of bad weather. As Ronald Reagan put it, there are just four things wrong with communist farming: "spring, summer, winter and fall."

What counts most, then? Attitude, not latitude. And the best indication of a country's attitude may be the wisdom it gleans from the great economists.

The history of economic thought teaches us that success often goes to the hungry, the humble, and the limber. And that is what you will learn in the pages ahead.

The 1990s gave us plenty of new opportunities to test the wisdom and assess the musings of the great economists. And now the twenty-first century is delivering its own challenges—and the ideas of the dead economists will be there to help.

San Diego, Calif.
January 2007

Acknowledgments

This book explains modern economic theories by exploring the lives and ideas of the greatest economists. Because many of the economic problems of our day also challenged our forefathers, the echoes of Adam Smith and his descendants still speak to us today. To provide a better understanding of their theories, I have used contemporary examples that I hope the reader will find entertaining as well as illuminating.

As any economics student learns the first day, economics is about scarcity and choice. I have chosen to omit many brilliant economists and to focus on the Anglo-American tradition. Thus, Walras, Jevons, Menger, and others receive less attention than they would in a lengthier book. I can only hope that the reader is inspired to pursue these individuals in other texts. To paraphrase Bacon, I aim not to inform ad tedium, but to stimulate the mind briefly yet fruitfully.

I want to apologize to those economists mentioned in this book who are living today. The title, New Ideas from Dead Economists, is not meant to refer to them, their personalities, or their public speaking abilities—although I cannot be held responsible for resemblances. They should take comfort in the honor of being mentioned alongside Smith, Ricardo, Keynes, and others.

I would like to thank a number of individuals and institutions for stimulating my mind and energies. Martin Feldstein and Lawrence Lindsey encouraged this project and asked Harvard students to read a first draft. My students at Harvard listened to numerous digressions on the history of economic thought. Ronald Coase and Milton Friedman provided helpful comments on Alfred Marshall. Not only was Friedman one of the century's greatest economists but he was extraordinarily generous with his time. Geoffrey Meeks of Cambridge University and Sir Harry Hinsley, past master of St. John's College, Cambridge, allowed me to wander and ponder the same cloisters of Cambridge, frequented by so many of the heroes in this book. Before writing chapters on Malthus, Marshall, and Keynes, I searched among the medieval courts and halls for memories and mementos of these individuals, and their legacy spurred me onward. I also thank Michael Moohr and Douglas Sturm of Bucknell University, who sparked my interest in economic history and the history of intellectual thought.

Of course the views expressed in this book are my own and not those of any employer, past or present.

Finally, I thank my family, whose support and good humor gave me hope that I would find a few lessons and a few laughs among the "dismal" scientists. And perhaps the economists wouldn't have been so dismal had they known my cheerful and loving wife, Debby, to whom I dedicate this book.

CHAPTER I

Introduction: The Plight of the Economist

It's not easy being an economist. Corporate executives attack them for not calculating costs and benefits with enough precision. Altruists accuse them of being too fussy about costs and benefits. To politicians, economists are party poopers who won't let them promise prosperity without sacrifice. Some of the wittiest writers have taken time out to insult them, including George Bernard Shaw and Thomas Carlyle. Indeed, it's been open season on economists ever since Carlyle called economics the "dismal science."

Economists feel wrongly accused, however, for they are usually not the cause of bad news but simply the messengers. And the message is simple: Human beings must make difficult choices. We are no longer in Eden. The world does not flow with milk and honey. We have to choose among cleaner air and faster cars, bigger houses and bigger parks, more work and more play. Economists do not tell us that any of these is bad. They only tell us that we cannot necessarily have them all—all at once. Economics is the study of choice. It does not tell us what to choose. It only helps us understand the consequences of our choices.

The great economists, of course, were not content to be merely messengers. Though they have been ridiculed with irreverent epithets—Smith the bumbler, Mill the egghead, Keynes the bon vivant, and so on—they cannot be disparaged for their motives. It is ironic that economists themselves receive so much virulent criticism in our day, for as Keynes noted, most of the eminent practitioners started as do-gooders, searching for ways to improve the world. Alfred Marshall in particular saw economics as a profession that should blend shrewd science with a devotion to people. Whereas the medieval world saw three grand professions—medicine aimed at physical health, law aimed at political health, and theology aimed at spiritual health—Marshall hoped to make economics the fourth noble vocation, aimed at better material health not just for the rich but for all. Marshall tried valiantly to mediate between two powerful, regrettable strands: a trend toward arid mathematical economics without practical application and a trend toward sheer emotional radicalism without careful theoretical reflection. The curriculum he fought to establish at Cambridge drew together the most scientific minds with the most passionate. Keynes was, of course, the most stellar result.

The strongest link between economics and the real world has always been politics. Indeed, until this century economics was called "political economy." Almost all of the stellar economists served at some level of government. Two of them, David Ricardo and John Stuart Mill, won election to the British Parliament. Among the greatest economists we consistently see not just a spark of scientific interest, but a surge of passion. Among the numerous symbols of calculus and statistics we see bold exclamation points.

Throughout the history of economic thought we see confrontations and sometimes cooperation between government and economists. Modern economics received its initial push when Adam Smith denounced the incestuous marriage between the monarchies and the merchants of Europe. One of the few things Adam Smith, Karl Marx, and Thorstein Veblen had in common was their realization that businessmen love to use politics in order to help themselves. In a famous statement, Smith warned that businessmen seldom meet without plotting against the consumer. You can be sure that even today, the orator at the local Chamber of Commerce meeting who exalts the free market would jump at the chance of securing a monopoly, an exclusive government contract, or a regulation that guarantees his profits. Thankfully politicians have not always been obliging. After World War II, Great Britain's socialist leaders promised prosperity and near paradise through unionism and nationalization, but instead the British economy only got worse and worse. One of Winston Churchill's biographers tells the story of Churchill meeting the leader of the Labour Party in the men's room outside the House of Commons. The Labour leader entered first and took up a standing position. Churchill entered a moment later on the same mission and, seeing his opponent, stood all the way at the other end of the row. "Feeling standoffish today, are we, Winston?" the Labour leader asked. "That's right," barked Churchill. "Why, every time you see something big, you want to nationalize it!"[1]

Most of our presidents have shown little grasp of economic principles. John F. Kennedy once admitted that the only way he could remember that the Federal Reserve Board controlled monetary policy, not fiscal policy, was that Chairman William McChesny Martin's name began with the letter "M." Apparently, Kennedy couldn't have appointed a Volcker or Greenspan to the post.

Election campaigns are the most trying time for economists. Whenever a politician promises his or her constituents more margarine and more munitions, economists must warn of the calamitous consequences. Any progress that economists make in raising economic literacy can be wiped out in a second by the pie-in-the sky ravings of a candidate. An election-year speech is the political equivalent of prime-time television. When a presidential candidate appears on television, he cannot allow himself to appear any more sophisticated than Jed Clampett of "The Beverly Hillbillies." Of course, for some politicians, this is not a great challenge.

It is not hard to see why politicians misunderstand their economic advisers. Economists speak a different language to each other than they do to the public. They speak the language of models. In their attempt to explain a complex world, they must first simplify out those few factors at any given time that are most important, for every economic phenomenon may be affected by thousands of events. For example, the level of a consumer's spending in the United States may depend on some of the following: weather, musical tastes, weight, income, inflation, political campaigns, and the performance of U.S. Olympic teams. To isolate and rank which are most important, economists must design models that exempt some of the infinite number of possible causes. The best economists are those who design the most durable, robust models.

Of course, all scientists must construct models. For years physics rested on a Newtonian model of gravity. Astronomers still use a Copernican paradigm. Thomas Kuhn's classic and controversial The Structure of Scientific Revolutions traces the development of these models.[2] So why is economics more difficult than these "hard" sciences? An example may help here. Imagine a surgeon operating on a kidney. After inspecting an X-ray report, the surgeon knows that the patient's right kidney lies one inch below the colon. Imagine, however, that as the surgeon makes an incision, the kidney changes position. In just this way, as an economist isolates causes and estimates their influence, the degree of influence changes. As human relationships and social institutions change, so does the subject of our scientific inquiry. Economics may not be a "hard" science. But that does not mean it is an easy science. Because it is so fluid, it is hard to hold in place and to study.[3] No wonder Lord Keynes insisted that the master economist fulfill a set of attributes more extraordinary than those needed for knighthood or even sainthood:

He must be mathematician, historian, statesman, philosopher. . . . He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present in the light of the past for the purposes of the future. No part of man's nature or his institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician.[4]

The Genesis of Economics

Where shall we start in studying the history of economic thought? We could start with the Bible, which contains many statements on land, labor, and capital. But the Bible presents more commandments than careful analyses.[5] Although Adam Smith got his name and his moral posture from the Bible, it provided little inspiration for his economic theorizing.

We could also explore Aristotle's articulate remarks praising private property and denouncing the accumulation of wealth for wealth's sake. But Aristotle knew just enough about economics to know that time was a scarce resource. Therefore, he devoted more of his time to philosophy and to educating Alexander the Great than he did to economic theory. It shows. Aristotle remains one of the giants of philosophy, but at the risk of insulting ardent fans of college courses on Western civilization, we must admit that Aristotle left few marks in the annals of economic discipline.

In the Middle Ages theologians debated economic issues. The Catholic Schoolmen struggled over questions of justice and morality in the marketplace. In particular, they devised the doctrine of the “just price” and refined the Church view of usury. Whereas the Old Testament specifically forbade lending at interest to members of the same community, medieval theologians tried to separate the different components of interest such as risk, opportunity cost, inflation, and inconvenience in order to perforate the solid prohibition and permit loopholes. The theologians faced excruciating choices. If they continued to deliver orthodox Biblical interpretations that challenged commercial activities, the Schoolmen would lose their relevance, because many people were willing to take their chances with divine retribution. On the other hand, if the theologians simply condoned commercialism in all its forms, they would lose credibility as Church leaders. They devised most of their economic theories while straddling the secular and the sacred. This is neither a comfortable position nor one terribly conducive to studying economics. They spoke on economics because it was a duty to their flock. But the duty was to guide the flock to Heaven, not to a higher standard of living. When Protestants split the flock, the task grew even less manageable.[6]

We cannot sprint so swiftly past the mercantilists. Generally speaking, they were a group of writers and courtly advisers to European monarchs during the sixteenth through the eighteenth centuries. They did not share a common “good book,” and they certainly had different interests. As royal families of England, France, Spain, Portugal, and Holland consolidated their boundaries and battled for colonies across the seas, lawyers and merchants began advising kings and queens on how to manage their economies.

In retrospect, we can list several tenets often found in their recommendations: First, a nation should keep its house in order by awarding monopolies, patents, subsidies, and privileges to loyal subjects of the crown. Second, a nation should pursue colonies for the purpose of extracting precious metals and raw materials, which were good measures of national wealth, for they could pay for wars of conquest. Third, a nation should restrict its foreign trade so that it exported more finished goods than it imported. A consistently positive balance of trade would bring in gold (wealth) from debtor nations.

Thus under mercantilism, we see nations expanding their borders. At the same time, however, we see a tightened control over the internal economy, as guilds, monopolies, and tariffs distribute economic power to political favorites. In some nations the control extended further than in others. Finance Minister Jean-Baptiste Colbert thoroughly regulated the manufacture of many goods during the reign of Louis XIV and bestowed great authority to the guilds. In a stunning display of imperial power, he once announced that fabric from Dijon would contain 1,408 threads!

The mercantilists provided the perfect target for Adam Smith, with whom it seems reasonable to start our study of modern economic thought. He excoriated their theories on several levels. First, they measured wealth on the basis of coin and precious metals, while Smith believed that real wealth should be gauged by the standard of living of households. Bags of gold do not necessarily translate into bags of food. Second, he said that wealth must be measured from the viewpoint of a nation's consumers. Tactics that placed money in the hands of prime ministers or sycophantic merchants did not necessarily help the citizens of a nation. Third, Smith knew that individual motivation, invention, and innovation inspire an economy to greater prosperity. By bestowing gifts of monopoly and protection, mercantilist policies paralyzed the body politic. Thus began modern economics.

Should We Ignore the Economist?

Since the days of Adam Smith, we have produced few master economists. Mainstream economic theory does not explain everything. In particular, economists today have a difficult time explaining the labor market and the drop in productivity growth from the early 1970s through the early 1990s. Yet economists agree on enough to say that countries and individuals take foolish risks in ignoring the basic tenets of economic theory. The nation that raises trade barriers in an atavistic yearning for stable, mercantile times hurts its own consumers. The nation that keeps farm prices high hurts its own consumers and finds itself with a surplus of grain rotting in silos. On these two points few economists would disagree. Yet too few politicians in the world will listen.

Even if governments do not always take the advice of economists, we can look to economists to tell us where our standard of living has been and where it may be going. Ever since the Industrial Revolution sparked England, Americans have always looked forward to getting bigger and better. We see the present as the minimum. Yet history provides no precedent for continual progress. Every year that the industrialized nations avoid a new dark age, we set a record for humankind. Listen to the words of Georges Duby as he describes Europe in the eleventh century. It is frightening to think that these horrible decades came after and not before the relative affluence of ancient Greece, Rome, Babylon, and Egypt:

. . . the Western world in the year 1000. A wild world, ringed round by hunger. Its meager population is in fact too large. The people struggle almost bare-handed, slaves to intractable nature and to a soil that is unproductive because it is poorly worked. No peasant, when he sows one grain of wheat, expects to harvest more than three—if it is not too bad a year; that means bread to eat until Easter time. Then he will have to manage on herbs, roots, the makeshift food that can be gleaned from forest and riverbank and, on an empty belly, he will do the heavy summer tasks and wither with fatigue while he awaits the harvest . . . Sometimes, when too heavy rains have soaked into the ground and hampered the autumn ploughing, when storms have pummeled and spoiled the crops, the customary food shortage becomes a famine, a great death-dealing wave of starvation. The chroniclers of the times all described such famines, not without a certain satisfaction. "People pursued one another in order to eat each other up, and many cut the throats of their fellow men so as to feed on human flesh, just like wolves."[7]

Will the developed world ever know such horrors? Will it ever slip back into the frightening state of some of its Third World neighbors? Not even the master economist of

Keynes' most fantastic dreams would know. We do know that the goal of the great economists was to teach us to avoid such a dark abyss.

It is striking that so many of the lessons of the great economists still speak to us. Each of their wisest theories has a practical point or analogy today. This book seeks their wisdom by looking at mainstream economics and asking, Who first had these insights and built these durable models? We can learn from the masters. Some of the contemporary examples in this book are meant to be humorous. David Ricardo did not have access to the cast of "Gilligan's Island" to explain the Theory of Comparative Advantage. But to do so, I hope, does no disrespect and provides some help in understanding the difficult paradigm. Economics need not be dull. Why not have the last laugh on Carlyle by using the dead economists themselves to reverse their bad reputations and to teach the lessons they left to us? Better the ghosts of economists past roll over in their graves in laughter than toss and turn, disappointed that we forgot their work and fearful that we will drive ourselves back to the eleventh century.

CHAPTER II

The Second Coming of Adam Smith

When Ronald Reagan won the 1980 presidential election, conservative supporters in Washington rejoiced. At cocktail parties and meetings they congratulated one another and looked so forward to prosperity under "Reaganomics." They also noticed that they were wearing the same neckties, which featured the profile of Adam Smith.

Why were politicians and activists who prided themselves on patriotism parading the profile of an eighteenth-century Scotsman? Why not Theodore Roosevelt, Thomas Jefferson, or even Barry Goldwater? Could Adam Smith really be more relevant to contemporary economic crises than the thousands of economists and political leaders who had followed?

Adam Smith believed that his ideas would be relevant forever. This was a common trait of intellectuals in the eighteenth century, a truly revolutionary age. Political ferment began to bubble in France and America. By the time Smith wrote his greatest work, The Wealth of Nations, merchants were trading within the British Isles and across the seven seas, population was expanding, merchants were organizing small factories, and banking systems were spreading throughout Britain and the Continent. But the most powerful and profound revolution of the Enlightenment was caused by thinkers probing for new explanations of the world around them. No wonder Smith once proclaimed in his lectures: "Man is an anxious animal."[1]

From the Middle Ages until roughly the time of Columbus, theologians had dominated European intellectual thought. Church elders interpreted natural phenomena in accordance with religious doctrine. But in the century leading to Smith's birth, more and more people began following the bold paths of Francis Bacon and Nicolaus Copernicus in searching for rational explanations for natural events. Eventually, scientists emerged independent of ruling churches, applying the "scientific method" for laws of nature regardless of controversial conclusions.

Galileo Galilei attacked the religious cliché that God gave man only two books, the Bible and nature. Claiming that the language of the book of nature was mathematics, Galileo proved by mathematics and experiment, without the help of holy scriptures, his law of falling bodies. Galileo knew he was treading on treacherous ground and tried to avoid condemnation. Fearful when, in 1632, his telescope experiments confirmed Copernicus' heresy that the earth revolved around the sun, he dedicated his findings to the pope. He was right about the earth. And he was right to fear the Church's wrath, for a tribunal consequently condemned him.

Toward the end of his Discourse on Method (1637), René Descartes foreshadowed the explosion of thought in the eighteenth century by arguing that through practical science men can be the “masters and possessors of nature.”

The shining figure in the Enlightenment, though, was Isaac Newton. He pursued Galileo’s scientific quests, searching beyond religious texts for answers, which he revealed in his theory of gravity, laws of physical motion, and discovery of calculus. Newton seemed to portray God as a key player only at the beginning of time, as responsible for the world today as a pawnshop owner is after a pawned watch leaves the shop. The German philosopher Leibniz thought that Newton compounded the blasphemy by depicting God as a clumsy watch-maker.

Adam Smith was born into this movement. Like Galileo and Newton, Smith sought out cause-and-effect relationships. But instead of focusing his view on planets, he focused on people.

Born in 1723, Smith grew up with his mother in Kircaldy, a small port located across the Firth of Forth from Edinburgh. His father, a comptroller of customs, had died months before his birth. Smith himself never married.

Although it was not apparent from the Adam Smith neckties worn in Washington, Smith was an odd-looking Scotsman. He had a large nose, bulging eyes, a protruding lower lip, a nervous twitch, and a speech impediment. Smith once acknowledged his unusual features, saying: “I am a beau in nothing but my books.”

A good student, Smith entered the University of Glasgow at the age of fourteen and later accepted a scholarship to Balliol College, Oxford. Like most other college students of his day, Smith intended to study theology and enter the clergy. Like many college students of any day Smith complained about his teachers. He denounced the lecturers: “In the University of Oxford, the greater part of the public professors have, for these many years, given up altogether even the pretence of teaching.”[2] More important, Smith lashed out at academic censorship and complained to friends that college officials had confiscated his copy of David Hume’s heralded Treatise on Human Nature. Although he was permitted to read all of the ancient Greek and Latin classics, Smith was forbidden from reading one of the most potent works of his own time.

Despite academic restrictions, Smith was so influenced by David Hume’s skepticism (A Theory of Human Nature is subtitled, “An Attempt to introduce the experimental method of Reasoning into moral subjects”) that he refused to continue preparing for the clergy. Instead, he returned to Kircaldy, where he later delivered popular public lectures on rhetoric and law.

In 1748, Smith returned to the University of Glasgow to teach logic. The next year he filled the chair in moral philosophy vacated by his former teacher Francis Hutcheson. A “campus