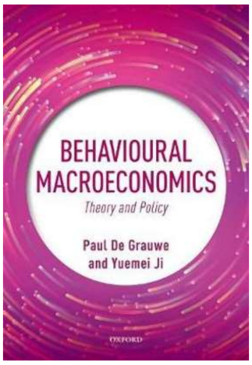
Book Review: "Behavioural Macroeconomics. Theory and Policy" / Paul De Grauwe & Yuemei Ji

OXFORD UNIVERSITY PRESS, 2019, ISBN 9780198832324, 272 p.



This is a very interesting book. It is very much a book about mathematical models, yet it is also an intelligible description of the models and how they work.

The basic Idea is that the "Rational Agent using all available Information to decide about his (her) Optimal Consumption and Production Plan" in the reality does not exist and that this figure does not work. The crisis of the years 2007-2008 with excessive optimism before the outburst and pessimism afterwards illustrates that.

The authors develop a theoretical model assuming individuals experience cognitive limitations. Rationality is introduced in the model in that these individuals will learn from their mistakes. Moreover, individuals do not all use the same rules of behaviour, but they influence each other. As a result, collective movements in "animal spirits" – i.e. the market sentiments - can emerge endogenously, driving the business cycle. Complexity emerges even though individuals use simple rules. The interaction of different beliefs about the state of the economy drives complexity.

All this has policy implications, especially for the Central Banks, whose role becomes different in the behavioural model. But also, fiscal authorities face other realities. The waves of optimism and pessimism and the ensuing boom and bust have important implications for the development of government debt and on how fiscal authorities are constrained by these movements.

The book works out these ideas in a very structured manner.

What is interesting, among a lot of other points, is that the reader does not necessarily need to be an "expert" in modelling but can follow the reasoning of the authors through their comments and explanations of the model formulas. The precise and explicit modelling workouts are given in an appendix at the end of each chapter.

There are two big parts in the book: “The basics” and “Applications”.

The first part explains the ins and outs of the new model as opposed to the pre-existing macroeconomic models (the Microfoundations based on utility maximisation and the Rational Expectations). Further on, the authors successively treat the basic behavioural model, the inertia in macroeconomic variables, the non-normality in the output gap, how shocks are transmitted and the simple and complex rules.

In the second part, called “applications”, the authors illustrate the practical use of the model: in optimal monetary policy, in inflation targets and the zero lower bound, in the relation between monetary policy and structural reforms, in fiscal policy, output stabilisation and debt sustainability. There is also a chapter on how the model might change the relationship between banks and monetary policy. The book ends with a chapter on synchronisation of business cycles.

As I understood, the main issue of the new model is to have a better understanding of what is going on in the real economy. Most probably the Queen shouldn’t anymore have to ask “*why did nobody notice it*”[1]. But it is not quite clear in how far the model has a capacity to predict. For example, can it predict the macroeconomic effects of Brexit or the Coronavirus? According to what I understood, it will very much depend on variations in *’optimism* ‘and *’pessimism*‘. However, the use of these variables in a macroeconomic model is in and of itself very important.

Anyway, considering the new insights in macroeconomic modelling and the quality of the explanation, everyone who is interested in macroeconomics should read this book, even if they are not a model freak.

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[1] P.15.