

Module 4

Lecture 32

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4.7 New Classical and New Keynesian Macroeconomics

4.7.1 New Classical Macroeconomics

- In the initial days of new classical macroeconomics there was a general optimism that mere incorporation of rational expectation will fix the problems of existing macro models.
- With more research it turned out that there are much more work to be done to rebuild macroeconomics with micro foundation with technology and preferences as given parameters.
- New Classical economists pursued this goal with two fundamental assumptions -
-market always clear and individuals always optimize.

- New classical research can be classified under three major areas: Imperfect information, Real business cycle models, Sectoral shift models.

4.7.1.1 Imperfect Information

- The earliest new classical models had the aim of generating monetary business cycle models.
- To do this they assumed imperfect information paradigm regarding prices.
- Main assumption: Individuals are more aware of the prices of the goods they produce than they are of the prices of the goods they purchase.
- So people confuse movements in overall price level with movements in relative prices.
- In face of unanticipated inflation people infer that prices of the goods they produce are high and therefore they increase supply of their produce.
- This way the assumption of imperfect information generates negative relation between inflation and unemployment -- expectation augmented Phillips curve as proposed by Friedman and Phelps.
- This approach however lost its popularity in recent times.

4.7.1.2 Real Business Cycles

- The new classical tradition of 1980s mostly centered around the school of thought known as Real Business Cycle (RBC) theories.
- Rigorously founded on micro principles, RBC theory proposed to explain business cycles in terms of `real' shocks such as technological and preference based shocks.
- RBC theory makes three main assumptions which remain controversial. **First**, it assumes that the economy experiences large and sudden changes in technology. RBC aims to explain recession in terms of negative technological shocks.

- **Second**, RBC assumes that employment fluctuations reflect the changes in the amount people want to work. According to RBC, people revise their labor supply decision in face of big technological shocks. However, for this explanation to be true the value of elasticity of substitution between labor and leisure has to be quite high.
- **Third**, Monetary policy is irrelevant for economic fluctuations. They maintained the position that money supply is endogenous. Hence, what is seen as the co-movement in money supply and real variables is mere correlation -- causality running in the opposite direction.
- RBC was heavily criticized on the ground of the first two assumptions as they could not be sustained empirically.

4.7.1.3 Sectoral Shift

- This body of literature explains unemployment by sectoral shift theory.
- According to their view when one worker moves from one sector to another sector period of unemployment prevails because of costly job search.
- During the period of recession there are more sectoral shocks leading to more sectoral adjustments -- workers changing jobs.
- However, empirical findings do not seem to support this theory a lot.
- If this theory is true we should see high unemployment coinciding with high job vacancy. This is usually not observed.
- It seems unlikely that sectoral shift theory can plausibly explain fluctuations in general employment level.

4.7.2 New Keynesian Macroeconomics

- While New Classical paradigm was trying to explain fluctuation within the Walrasian (i.e. market clearing) paradigm.

- New Keynesian macroeconomics is more like an umbrella term comprising of different types of scholarly work.
- One general characteristic of this school is the belief that economic fluctuations are the result of some grand market failure -- not a Pareto efficient response of the economy to some changes in tastes and technology.
- New Keynesian economics can be summarized in three main sub categories.

4.7.2.1 Fixed Prices and General Disequilibrium

- Following the seminal paper by Barro and Grossman (1971), much research in this area examined how markets interact when prices are fixed at a non market clearing level.
- These models find that the behavior of the economy crucially depends on which markets are in excess supply and which are in excess demand.
- Unemployment in these models arises in two regimes: **Classical unemployment** -- firms can sell all they want in the goods market. But real wage is too high to employ the entire labor force and **Keynesian employment**-- firms are unable to sell goods in the market; unemployment arise because of the quantity constraint.
- These findings raise some important questions regarding the role of goods market vis a vis labor market in determining the degree of recession.
- These general disequilibrium models emerged before the breakdown of the consensus view and so they did not aim to remedy the problems of IS – LM based models.
- However, with the emergence of new classical models, American Keynesians were less concerned with the details of quantity adjustment under fixed prices. They put more effort for understanding price adjustment process.
- When one turns to the question of price adjustment, it is necessary to admit that some economic actors have control over prices and go beyond the price taking assumption of general equilibrium theory.

- With price adjustment becoming the priority, general disequilibrium models stemming from Barro-Grossman paper may not be the best framework to deal with the questions at hand.

4.7.2.2 Labor Contracts and Sticky Wages

- A big portion of New Keynesian macro models attempt to explain unemployment by labor market imperfection.
- Labor market is unable to adjust in face of excess supply condition because of formal contracts.
- In presence of wage stickiness, policy irrelevance suggested by Sargent-Wallace does not hold.
- These models based on nominal wage contracts are criticized on three grounds:
 - 1.** The existence of such contracts is never explained from microeconomic principles.
 - 2.** In the context of long term employment relation, a wage paid in any given period need not be equal to marginal productivity. For example, in the U.S. some universities pay the annual salary of some professors equally over nine months while some universities pay it equally over twelve months. But surely this difference does not have any effect on work effort (marginal productivity) of the professors over the course of the year.
 - 3.** Real wage in these models are countercyclical. But in data there is no consistent relation of wage with economic activity.

4.7.3 Monopolistic Competition and Sticky Price

- Dis-satisfaction with models of sticky wage models shifted the focus to goods market.
- Much effort devoted to examining the behavior of monopolistically competitive firms in presence of small "menu cost" when they change prices.
- Menu costs are costs of informing price changes. Menu costs include the cost of updating price lists, time taken to inform the customers, the customer annoyance

caused by price changes and the effort required even to think about a price change.

- In presence of small menu cost firms may not have much incentive to change their price when faced with a cut in demand.
- Even though the losses from not adjusting price to individual firms are low, total social loss is substantial.
- Sticky price models are important because unlike nominal wages, many of the rigid prices have important function in allocating resources.
- Menu cost models do not imply counter cyclical real wage -- it can be a cyclical or procyclical.
- This shift of focus to goods market does not imply that New Keynesians now embrace equilibrium in the labor market. Rather they explain unemployment by *real* rigidities.