Module 4

Lecture 30

Topics

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4.5 New Classical and New Keynesian Macroeconomics

4.5.1 Overview

- $\mathrm{IS}-\mathrm{LM}$ model as the flagship of Keynesian macroeconomics ruled the macroeconomics for 30 years after the second world war for a long time.

- The consensus view consisting of IS-LM model and Philips curve predicted negative relationship between inflation and unemployment.

- This view was seriously challenged in the 1970s on both empirical and theoretical grounds.

- The theoretical objection came from Milton Friedman and Edmund Phelps in late sixties who argued that unemployment should depend on labor supply, labor demand and search cost and other microeconomic considerations and not on average growth of money supply.

- Their arguments were supported by macro-economy of the U.S. in the 1970s which was characterized by high inflation and high unemployment -- popularly known as stagflation.

- A more forceful attack against the macro-methodology of that time came from Robert Lucas in 1970.

- His critique, famously known as Lucas critique, argued that the policies themselves change the way people form expectation. Hence, models should incorporate the interactions between expectation formation of public and the policies.

- Let us elaborate his point using a simple example. Suppose Ravi (government) decides to drop by his colleague Amit's (public) place during dinner time (policy). He goes there on Monday and finds Amit joyfully receiving him and asking to have dinner with him (public's response to policy).

- So Ravi decides that Amit is happy whenever he drops by for dinner and drops by for dinner every day.

- Ravi fails to recognize that policy decision affects people's expectation and their consecutive responses to policies. Amit welcomes Ravi (response to policy) when he expects it to be once in a while phenomenon. However, if he realizes that it is a regular phenomenon he may not receive Ravi with that much warmth.

- This shows that people's expectation about a policy plays an important role in determining their responses to the policy (and therefore the effectiveness of the policy). Hence, policymakers have to exploit the formation of expectation to design effective policies.

4.5.2 The breakdown of the consensus

- The consensus characterized by $IS - LM$ and Philips curve broke down in 1970s following two major objections: one empirical and one theoretical.

- The empirical objection emerged from the inability of Philips curve paradigm to explain stagflation that was prevalent in 1970s U.S. The theoretical objection came from the lack of micro-foundation in these models.

- Which one of these objections was the key in the breakdown of the consensus view?

- To see this let's ask the following questions:
    1. Would the breakdown happen if macroeconomics had a theoretically sound model which failed to explain the events of the1970s?
    2. Would it happen if the existing model could explain what was happening in 1970s?

    The answers to both the questions are in negative

- If the model was otherwise good, the events could have been explained by OPEC oil shock and a few large residuals.

- If the existing model could explain the events of 1970s a new set of models need not be called for.

    [This was the take of Greg Mankiw in explaining the emergence new paradigm. However, new research paradigms often emerge with the changing political scenario. Hence, the one way of looking at the emergence of new paradigm is to relate it with the changing global politics and its effect on academic thinking. From 1980s onwards we see a surge of neo-liberal policies which finally culminates in the decade of 1990. The revival of new classical research paradigm is quite consistent with the change in global politics]]

4.5.3 Current research

- Research in macroeconomics took three paths after the breakdown of the consensus view.

- **Modeling Expectation**: One large category of research explored the importance of expectation in determining macro outcomes. The people involved in this group used different variants of rational expectation.

- **New Classical**: A second category attempts to explain macro phenomenon by using new classical models which are characterized by the assumption of market clearing. Recent research has shown that economic fluctuations can be explained by models that uses market clearing assumption.

- **New Keynesian** The third strand of research reconstructs models in Keynesian traditions: incorporates market imperfection in models with micro foundation.