Brief History of Macroeconomics

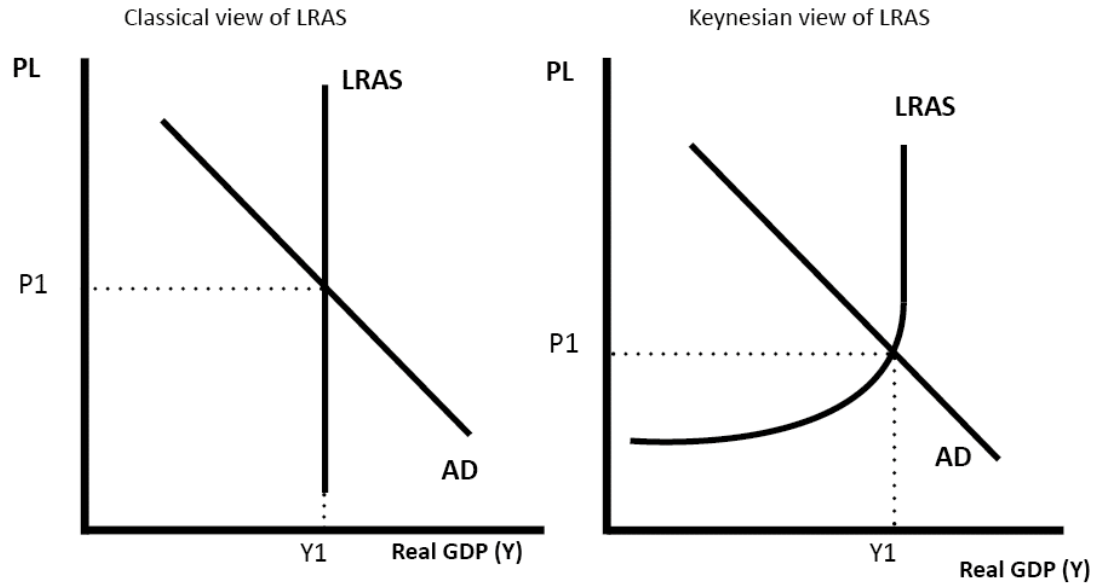
Keynesian vs Classical models and policies

- Classical economics emphasises the fact that free markets lead to an efficient outcome and are self-regulating.
- In macroeconomics, classical economics assumes the long run aggregate supply curve is inelastic; therefore any deviation from full employment will only be temporary.
- The Classical model stresses the importance of limiting government intervention and striving to keep markets free of potential barriers to their efficient operation.
- Keynesians argue that the economy can be below full capacity for a considerable time due to imperfect markets.
- Keynesians place a greater role for expansionary fiscal policy (government intervention) to overcome recession.

	Keynesian view	**Monetarist view**
Fiscal policy	In recession, expansionary fiscal policy can stimulate economic activity	Fiscal policy causes no long-term increase in real output
Wage rigidity	Wages can be sticky downwards causing unemployment	In absence of min wages/ trade unions wages flexible.
Unemployment	Demand-deficient unemployment big causes	Tend to emphasis supply-side unemployment (natural rate)
Phillips Curve	There is a trade off between unemployment and inflation	Only a trade-off in the short-term.
Government borrowing	In recession, governments should borrow more to offset fall in private spending	Government should seek to run balanced budget
Crowding out	No crowding out in recession	Government borrowing causes more crowding out

1. Shape of long-run aggregate supply

A distinction between the Keynesian and classical view of macroeconomics can be illustrated looking at the long run aggregate supply (LRAS).



Classical view of Long Run Aggregate Supply

The Classical view is that Long Run Aggregate Supply (LRAS) is inelastic. This has important implications. The classical view suggests that real GDP is determined by supply-side factors – the level of investment, the level of capital and the productivity of labour e.t.c. Classical economists suggest that in the long-term, an increase in aggregate demand (faster than growth in LRAS), will just cause inflation and will not increase real GDP>

Keynesian view of Long Run Aggregate Supply

The Keynesian view of long-run aggregate supply is different. They argue that the economy can be below full capacity in the long term. Keynesians argue output can be below full capacity for various reasons:

- Wages are sticky downwards (labour markets don't clear)
- Negative multiplier effect. Once there is a fall in aggregate demand, this causes others to have less income and reduce their spending creating a negative knock-on effect.
- A paradox of thrift. In a recession, people lose confidence and therefore save more. By spending less this causes a further fall in demand.

Keynesians argue greater emphasis on the role of aggregate demand in causing and overcoming a recession.

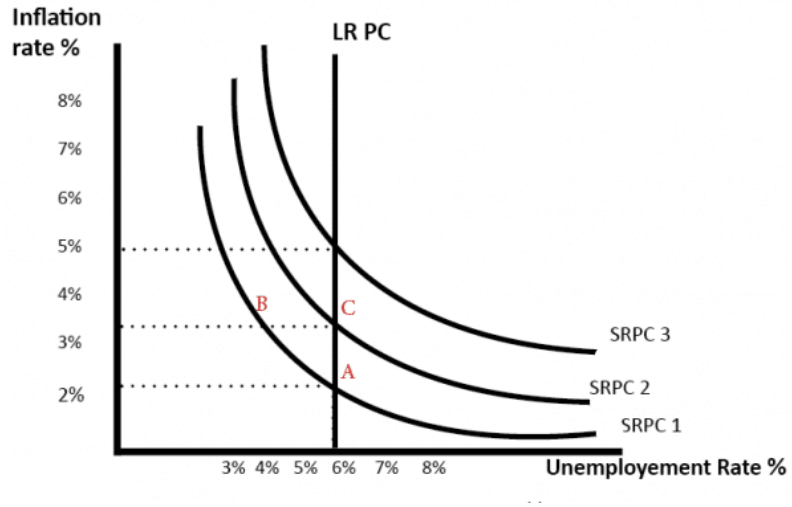
2. Demand deficient unemployment

Because of the different opinions about the shape of the aggregate supply and the role of aggregate demand in influencing economic growth, there are different views about the cause of unemployment

- Classical economists argue that unemployment is caused by supply side factors – real wage unemployment, frictional unemployment and structural factors. They downplay the role of demand deficient unemployment.
- Keynesians place a greater emphasis on demand deficient unemployment. For example the current situation in Europe (2014), a Keynesian would say that this unemployment is partly due to insufficient economic growth and low growth of aggregate demand (AD)

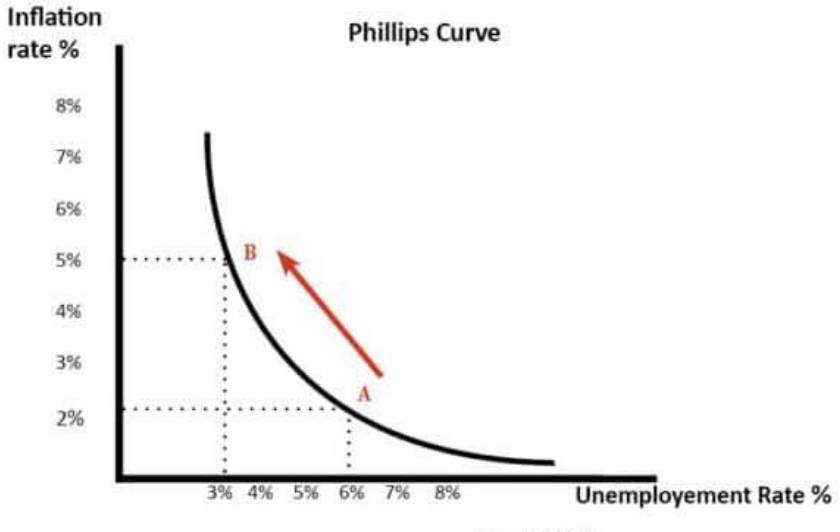
3. Phillips Curve trade-off

A classical view would reject the long-run trade-off between unemployment, suggested by the Phillips Curve.



Classical economists say that in the short term, you might be able to reduce unemployment below the natural rate by increasing AD. But, in the long-term, when wages adjust, unemployment will return to the natural rate, and there will be higher inflation. Therefore, there is no trade-off in the long-run

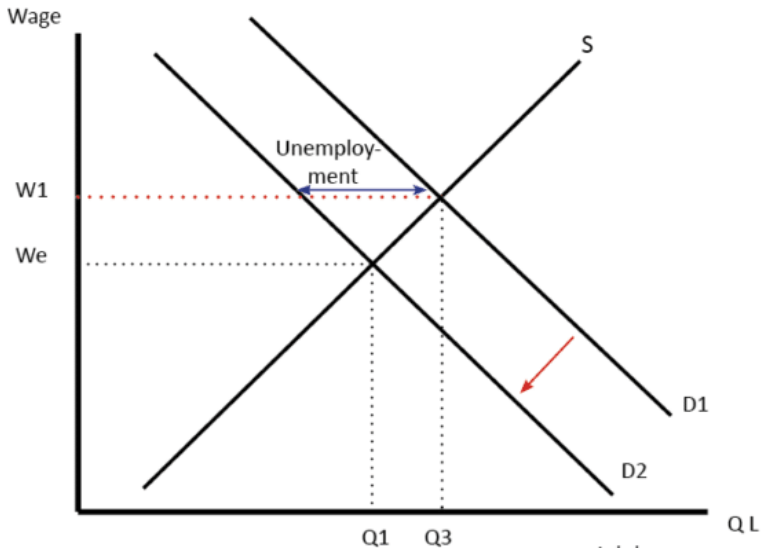
Keynesians support the idea that there can be a trade-off between unemployment and inflation. See: Phillips curve



In a recession, increasing AD will lead to a fall in unemployment, though it may be at the cost of higher inflation rate.

4. Flexibility of prices and wages

In the classical model, there is an assumption that prices and wages are flexible, and in the long-term markets will be efficient and clear. For example, suppose there was a fall in aggregate demand, in the classical model this fall in demand for labour would cause a fall in wages. This decline in wages would ensure that full employment was maintained and markets 'clear'.



A fall in demand for labour would cause wages to fall from W1 to We

However, Keynesians argue that in the real world, wages are often inflexible. In particular, wages are 'sticky downwards'. Workers resist nominal wage cuts. For example, if there were a fall in demand for labour, trade unions would reject nominal wage cuts; therefore, in the Keynesian model, it is easier for labour markets to have disequilibrium.Wages would stay at W1, and unemployment would result.

A Keynesian would argue in this situation the best solution is to increase aggregate demand. In a recession, if the government did force lower wages, this might be counter-productive because lower wages would lead to lower spending and a further fall in aggregate demand.

5. Rationality and confidence

Another difference behind the theories is different beliefs about the rationality of people.

- Classical economics assumes that people are rational and not subject to large swings in confidence. (see: Rational economic man)
- Keynesian economics suggests that in difficult times, the confidence of businessmen and consumers can collapse – causing a much larger fall in demand and investment. This fall in confidence can cause a rapid rise in saving and fall in investment, and it can last a long time – without some change in policy.

Differences in policy recommendations

1. Government spending
   - The classical model is often termed 'laissez-faire' because there is little need for the government to intervene in managing the economy.
   - The Keynesian model makes a case for greater levels of government intervention, especially in a recession when there is a need for government spending to offset the fall in private sector investment. (Keynesian economics is a justification for the 'New Deal' programmes of the 1930s.)

2. Fiscal Policy
   - Classical economics places little emphasis on the use of fiscal policy to manage aggregate demand. Classical theory is the basis for Monetarism, which only concentrates on managing the money supply, through monetary policy.
   - Keynesian economics suggests governments need to use fiscal policy, especially in a recession. (This is an argument to reject austerity policies of the 2008-13 recession.

3. Government borrowing
   - A classical view will stress the importance of reducing government borrowing and balancing the budget because there is no benefit from higher government spending. Lower taxes will increase economic efficiency. (e.g. at the start of the 1930s, the 'Treasury View' argued the UK needed to balance its budget by cutting unemployment benefits.

- The Keynesian view suggests that government borrowing may be necessary because it helps to increase overall aggregate demand.

4. Supply side policies
   - The classical view suggests the most important thing is enabling the free market to operate. This may involve reducing the power of trade unions to prevent wage inflexibility. Classical economics is the parent of 'supply side economics' – which emphasises the role of supply-side policies in promoting long-term economic growth.
   - Keynesian don't reject supply side policies. They just say they may not always be enough. e.g. in a deep recession, supply side policies can't deal with the fundamental problem of a lack of demand.

Keynesian

It is the 1930s. Many people have begun to wonder if the United States will ever escape the Great Depression's cruel grip. Forecasts that prosperity lies just around the corner take on a hollow ring. The collapse seems to defy the logic of the dominant economic view—that economies should be able to reach full employment through a process of self-correction. The old ideas of macroeconomics do not seem to work, and it is not clear what new ideas should replace them.

In Britain, Cambridge University economist John Maynard Keynes is struggling with ideas that he thinks will stand the conventional wisdom on its head. He is confident that he has found the key not only to understanding the Great Depression but also to correcting it.

From the 1950s onwards, Keynesian macroeconomics established itself as a new sub-discipline of economics. It was taken up both in universities and in public institutions such as central banks. Modified by Franco Modigliani (1944) and popularised by Alvin Hansen (1953), the IS-LM model becomes its baseline tool. One shortcoming of the elementary IS-LM model was its fixed prices assumption. The Phillips curve, drawn from Bill Phillips's study of the relationship between changes in wages and unemployment in the UK from 1861 to 1957 (Phillips 1958), did the job. It quickly found its place in the macroeconomic corpus. The fact that it was based on a solid empirical relationship, valid over a long period, was viewed as an advantage. Moreover, it had a Keynesian flavour since it incorporated the idea of a wage floor. An additional step taken by Paul Samuelson and Robert Solow (1960) was to suggest that the Phillips curve pointed to the possibility of a trade off between inflation and unemployment — that is, government could 'buy' a decrease in the level of unemployment by accepting an increase in the inflation rate.

The success of the IS-LM model cannot be due to mere luck. It has two main virtues. The first is its ability to model economic interdependence in a simple and intuitive way. In this respect the IS-LM approach is unrivalled. Even in its most elementary form, it lends itself to drawing cogent real-world inferences. The second main virtue of the IS-LM model is its plasticity. It constitutes an architecture that is general enough to allow a more-or-less unlimited diversity of specifications. This plasticity also extends to policy implications, since friends and foes of Keynesian policy alike can use it to promote or refute policy prescriptions. For some twenty-five years after the end of the Second World War, the IS-LM model dominated macroeconomics.

It is the 1960s. Most economists believe that Keynes's ideas best explain fluctuations in economic activity. The tools Keynes suggested have won widespread acceptance among governments all over the world; the application of expansionary fiscal policy in the United States appears to have been a spectacular success. But economist Milton Friedman of the University of Chicago continues to fight a lonely battle against what has become the Keynesian orthodoxy. He argues that money, not fiscal policy, is what affects aggregate demand. He insists not only that fiscal policy cannot work, but that monetary policy should not be used to move the economy back to its potential output. He counsels a policy of steady money growth, leaving the economy to adjust to long-run equilibrium on its own.

It is 1970. The economy has just taken a startling turn: Real GDP has fallen, but inflation has remained high. A young economist at Carnegie–Mellon University, Robert E. Lucas, Jr., finds this

a paradox, one that he thinks cannot be explained by Keynes's theory. Along with several other economists, he begins work on a radically new approach to macroeconomic thought, one that will challenge Keynes's view head-on. Lucas and his colleagues suggest a world in which self-correction is swift, rational choices by individuals generally cancel the impact of fiscal and monetary policies, and stabilization efforts are likely to slow economic growth.

John Maynard Keynes, Milton Friedman, and Robert E. Lucas, Jr., each helped to establish a major school of macroeconomic thought. Although their ideas clashed sharply, and although there remains considerable disagreement among economists about a variety of issues, a broad consensus among economists concerning macroeconomic policy seemed to emerge in the 1980s, 1990s, and early 2000s. The Great Recession and the financial crisis in the late 2000s, though, set off another round of controversy.

With the advent of new classical macroeconomics in the early 1970s that dominance was at first challenged and then broken. Yet the IS-LM model still lives on. While no longer central to the graduate training of most macroeconomists or to cutting- edge macroeconomic research, it continues to be a mainstay of undergraduate textbooks, finds wide application in areas of applied macroeconomics away from the front lines of macroeconomic theory, and, until the last decade, remained at the conceptual core of most government and central banks macroeconometric models.

The new classical all-out attack on Keynesian macroeconomics

As just seen, Friedman had few qualms about the Marshallian–Keynesian conceptual apparatus. His anti-Keynesian offensive was mainly a matter of policy. This was no longer true for the next wave of attack against Keynesian theory led by Lucas and others, and inaugurated 'new classical macroeconomics'. While the new approach was evidently collective, we shall focus our attention on the work of one individual, Lucas. He was the leading character in the movement, and commandingly assumed the role of its methodological spokesperson.

The transition from Keynesian to new classical macroeconomics deserves to be viewed as a Kuhnian scientific revolution. This expression refers to an episode in the history of a discipline where a period of normal development is disturbed because of the persistence of unsolved puzzles which trigger a drive to change the agenda, the conceptual toolbox and the research methods in radical ways. This is often accompanied by thundering declarations of war (e.g. Keynesian theory is dead), a confrontation between younger and older generations of researchers, the rise of new stars in the profession, and the eclipse of the previous stars.

New classical macroeconomics: a different research programme

The 'new classical macroeconomics' term applies only to the works of Lucas and his allies. The paradigm that they had inaugurated soon underwent an inner evolution that led to the emergence of real business cycle modelling under Kydland and Prescott's lead. A second transformation, leading to the emergence of dynamic stochastic general equilibrium (DSGE) modelling, followed.

These three modelling strategies should be considered as phases within the same research programme the main features of which were present from the first instalment onwards (see note 1). Therefore the comparison between Keynesian and new classical macroeconomics that we shall now undertake has a more general bearing.

Drawing a contrast between two paradigms is a matter of selecting criteria against which they can be compared and assessing how they measure up to them. Table 1 summarises the results:

Table 1. Contrasting Keynesian and new classical macroeconomics

	Keynesian macroeconomics	**New classical macroeconomics**
1. The overarching aim of macroeconomics	explaining unemployment	explaining the business cycle
2. Basic model	the IS-LM model	the Lucas-Rapping supply function
3. Relative role of supply and demand	emphasis on demand	emphasis on supply
4. The wage-employment relationship	stable Phillips curve allowing the policy exploitation of the inflation/ unemployment inverse relation	no possibility of a policy exploitation of the inflation/ unemployment inverse relation
5. Micro/macro relationship	under the mantle of the neoclassical synthesis; macroeconomics is concerned with its disequilibrium short-period leg	rejection of the neoclassical synthesis; its equilibrium long-period leg can provide all the explanation necessary
6. Expectations	adaptive expectations	rational expectations
7. Econometric modelling	Keynesian macroeconometric models are complex systems of equations, whose parameters are fixed by economically-estimated coefficients	Models are simplified general equilibrium models which ought to be based on 'deep structural' parameters based on the calibration method
8. Methodology	Marshallian	Walrasian
9. The nature of the business cycle and policy conclusions	the business cycle is viewed as a market failure — the policy aim is to bring the economy towards full employment through demand activation	fluctuations express agents' optimising reaction to exogenous shocks — no activation policy should be undertaken

The impact of the 2008-9 financial crisis on macroeconomic theory

How did macroeconomics stand in the wake of the so-called Great Recession (an analogy with the Great Depression of the 1930s)? These events brought out at least two blind spots in the dynamic stochastic approach to macroeconomics (that is, DSGE modelling in general). The first is the limited attention that had been given to the financial sector in these models, a dramatic blank once the Great Recession broke out in 2008. The second pertains to the limits of what can be done with models premised on the view that, whatever the situation in which economic agents find themselves, they ought to be considered as having achieved their first best optimising plan. In other

words, DSGE models exclude in advance the possibility of any pathology in the working of the market system, and certainly of any collapse in the trading system to the extent that we have recently encountered.

This marks a clear analogy with the situation faced by Keynes in the 1930s. Equilibrium models convey a Panglossian view (all is for the best in this best of all possible worlds) of the working of the economy as they rule out the possibility that markets can fail and that agents may find themselves in a state where they are unable to achieve their optimising plan. When the economy is in a state of plain sailing, this neglect is admissible, but it is no longer justifiable when the economy shows signs of collapse. Whatever the virtues of the newclassical real business-cycle methodology, its limits are clear. To 'old' Keynesians, this has the sweet smell of revenge. New voices have arisen proclaiming the need to return to Keynes's General Theory. Lord Skidelsky, Keynes's biographer and the author of The Return of the Master (Skidelsky 2009), and Paul Krugman, the 2008 Nobel-prize laureate (see for example Krugman 2010) are two prominent figures in this movement (not to mention Posner's rediscovery of Keynes's book (Posner 2009)). In Krugman's words, "Keynesian economics remains the best framework we have for making sense of recessions and depressions" (2010, p. 8). We disagree with these economists. We prefer to draw a distinction between two meanings of the Keynesian modifier. The first point to a general vision that can be labelled 'ideological' without giving this terms a pejorative meaning and which views the market economy as likely to fall prey to market failures upon which governments are able to remedy. The second designates the conceptual apparatus proper to the Keynesian tradition in its heydays, i.e. the IS-LM model. Against the background of this distinction, our view is that the Keynesian vision might well ride high again, but we doubt that any return to the Keynesian conceptual apparatus will occur. Be that as it may, what is certain is that Krugman's and Skidelsky's injunctions were badly received by the profession.

The Great Recession will certainly have an impact on the course of macroeconomics. The clearest sign of this is the widespread admission that the loose integration of finance into macroeconomic models was a serious mistake (Eichenbaum 2010), and the ensuing surge of work aiming to fill this gap. At this juncture, it is, however, still difficult to gauge whether a mere integration of the financial sector within the existing framework will suffice, or whether the Great Recession will trigger a more radical reorientation of macroeconomics.