M.A. Economics (Semester-II)
Macroeconomics-II: ECON4007

NEW CLASSICAL ECONOMICS

(Part – A)

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The classical economists maintained that the economy possesses self-correcting properties in the form of price flexibility. It would automatically correct any tendency for real aggregate demand to be too high or too low.

This idea dominated macroeconomics prior to the 1930s.

The Great Depression of 1930s discredited the old classical approach based on flexible prices and self-correction.

The Keynesian theory based on rigid nominal wages dominated macroeconomics until the late 1960s.

The Great Inflation of the 1970s undermined its dominance. It provided increasing credibility and influence to those who warned that Keynesian activism was both over-ambitious and fundamentally flawed.

Milton Friedman launched a monetarist ‘counter-revolution’ against Keynesian policy activism.

Friedman challenged the orthodox Keynesian insistence that relatively low levels of unemployment are achievable via the use of expansionary aggregate demand policy.

During the 1970s another group of economists argued that the Keynesians had failed to explore the full implications of endogenously formed expectations on the behaviour of economic agents.

Since the early 1970s, macroeconomics has been split between two basic explanations of business cycles.

First to emerge as a challenge to the old Keynesian orthodoxy was the **new classical approach** originated by Milton Friedman.

It was subsequently more fully developed by Robert E. Lucas.

The first strand of new classical macroeconomics was based on the idea that households and firms lack the full set of information needed to make their economic decisions.

The second strand was based not on imperfect information but on shocks to technology and supply conditions. This second approach the **real business cycle** model was developed by Edward Prescott.

New Classical Policy Ineffectiveness Proposition

The central policy tenet of the new classical economics is that stabilization of real variables, such as output and employment, cannot be achieved by aggregate demand management. The values of such variables in both the short run and the long run are insensitive to systematic aggregate demand management policies.

The fact that systematic monetary and fiscal policy actions that change aggregate demand fails to affect output and employment, even in the short run, is termed as the new classical policy ineffectiveness proposition.

The Structure of New Classical Models

The new classical approach as it evolved in the early 1970s exhibited several important features:

i. a strong emphasis on underpinning **macroeconomic theorizing with neo-classical microfoundations** within a Walrasian general equilibrium framework.

ii. the adoption of the key neoclassical assumption that **all economic agents are rational and are continuous optimizers** subjects to the constraints they face. Firms maximize profits and labour and households maximize utility.

iii. agents do **not suffer from money illusion** and therefore only real magnitudes (relative prices) matter for optimizing decisions.

iv. **complete and continuous wage and price flexibility** ensure that markets continuously clear .

Given these assumptions, changes in the quantity of money should be neutral and real magnitudes will be independent of nominal magnitudes.

The **main elements of the early new classical approach** to macroeconomics may be summed up as the joint acceptance of three main sub-hypotheses involving

i. the **rational expectations hypothesis** of Muth;
ii. the assumption of **continuous market clearing**; and
iii. the Lucas **'surprise' aggregate supply hypothesis**.

(These hypotheses will be discussed in detail in subsequent PPTs)

Reference:

Snowdon, B. & Vane, H. R. (2005), Modern Macroeconomics: Its Origins, Development and Current State, Edward Elgar, Massachusetts, USA.