

NEW KEYNESIAN AND NEW CLASSICAL DEBATE ON CONTEMPORARY MACROECONOMIC DEVELOPMENT: REVIEW

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Abstract

This paper analyzes the extended debate between two schools of economic thought – Keynes and Classics with recently updated ideas noted as New Keynesianism (NK) and New Classicism (NC). Here, ideas on Keynesian and classical economics, their similarities, differences, successes, applicability and criticisms has been studied comparatively through descriptive analysis of previous articles from researchers and renowned economists since decades before. The paper suggests that the nomenclature issue between these macroeconomic developments is more than a terminological debate that points out what should be the current issue between Keynesians and Classical. There are both similarities and differences within the schools of thoughts. The analysis shows the assumptions, criticisms and successes of two of these schools of economic thought viz. NC and NK and explains which of them is appropriate to be applied for assessing policy, monetarism and business cycle theory. Nevertheless, no matter how much they criticize and compete with one another or how many theories and explanations are added, their core remains the same while their applicability always differs in accordance to time and place.

Keywords: Extended debate, Schools of economic thought, Nomenclature.

JEL Classification: E12, E13

1. Background

Economic knowledge is historically determined . . . what we know today about the economic system is not something we discovered this morning but is the sum of all our insights, discoveries and false starts in the past. Without Pigou there would be no Keynes; without Keynes no Friedman; without Friedman no Lucas; without Lucas no . . .’ (Blaug, 1991a, pp. x–xi, as cited in Snowdon, 2005). And this is how different schools of thought takes place. Among which, New Classical Economics (NCE) and New Keynesian Economics (NKE) are two of the recent schools of economic thought.

After the existing Keynesian macro econometric models were deemed incapable of providing reliable guidance in formulating monetary, fiscal and other types of policy

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based in part on the spectacular recent failure of these models, and in part on their lack of a sound theoretical or econometric basis ... on the latter ground, there is no hope that minor or even major modification of these models will lead to significant improvement in their reliability (Lucas & Sargent, 1978, as cited in Snowden, 2005). Hence, NCE originated in the early 1970s in the work of economists centered at the Universities of Chicago and Minnesota—particularly, Robert Lucas (recipient of the Nobel Prize in 1995), Thomas Sargent, Neil Wallace, and Edward Prescott (co-recipient of the Nobel Prize in 2004).

While the development of a New Keynesian terminology was inevitable after the New Classical terminology came into being - for every Classical variation there exists a Keynesian counterpart (Colander & College, n.d.). Justifiably, the label “new Keynesian” was introduced describing economists Alan S. Blinder, N. Gregory Mankiw, John Taylor, David Romer, who, in the 1980s, responded to this new classical critique with adjustments to the original Keynesian tenets.

These opposing views of the capitalist economy have been existing for more than two centuries. (Greenwald & Stiglitz, 1987) ‘Classicism stresses its virtues, and the efficiency with which prices carry information between consumers and producers, and allocate resources. The other neo-classicism spotlights the shortcomings of the market system, and particularly its episodes of massive unemployment of capital and labor. Adherents of the first group usually treat unemployment as a temporary aberration that market forces will cure if left to themselves.’ The NCE went further and interpreted changes in employment levels as rational agents’ responses to perceived changes in relative prices and unemployment capital as spare capacity held for those few times when it is really needed, unemployment. Keynes reconciled these conflicting views of capitalism. He confronted the unemployment problem, and argued that limited government intervention could solve it. Once unemployment was removed, the classical vision of the efficient market could be restored. Two sub-disciplines were developed- Macroeconomic courses introduced to Adam Smith’s invisible hand, and the fundamental theorems of welfare economics; were followed by macroeconomic courses. Samuelson dubbed this the Neoclassical Synthesis.

The two sub-disciplines could be reconnected into two ways- macrotheory adapted to microtheory (NCE) and microtheory adapted to macrotheory (NKE). NCE aimed to derive the dynamic, aggregative behavior of the economy from the basic principles of rational, maximizing firms and individuals for understanding macro-behaviour. On the other hand, NKE aimed to develop a microtheory that can account for the phenomena of unemployment, credit rationing and business cycles that are inconsistent with standard macroeconomic theory.

Mankiw (1991) sees the history of macroeconomic thought as a pendulum

swinging between two views of the economy. On the right is the classical view of a well-functioning economy; on the left is the Keynesian view of an economy fraught with market failure. The Great Depression of the 1930s swung the pendulum decisively from the right to the left, and Keynes could plausibly call classical economics “misleading and disastrous.” The new classical economics of the 1970s swung the pendulum back to the right, and Robert Lucas could plausibly proclaim the “death of Keynesian economics.” The new Keynesian economics of the 1980s swung the pendulum back toward the left (at least somewhat) and thus reincarnated Keynesian economics. According to the research (Mankiw, 1990), the macro econometric models and the macroeconomic consensus views till 1970s failed both empirically and theoretically. So, he divided recent developments in macroeconomics into three categories of research based on - axioms of rational expectations; new classical models in which the assumption that prices continually adjust to equilibrate supply and demand is maintained; new Keynesian models that combines the IS—LM model with a modern Phillips curve. Hence, though the nomenclature is similar, all of these schools of thought are different in their own way.

In any way, recent developments in macroeconomic theory will ultimately be judged by whether they prove to be useful to applied macroeconomists. ‘The passage of time will make efficiency wages, real business cycles, and the other “breakthroughs” of the past decade less novel. The attention of academic researchers will surely turn to other topics. Yet it is likely that some of these recent developments will permanently change the way in which economists of all sorts think about and discuss economic behavior and economic policy’ (Mankiw, 1990). So, only time will tell which of these developments has the power to survive the initial debate and to permeate economists’ conceptions of how the world works.

2. Statement of Problem

The Fairy Tale History of Macroeconomics is, like all such stories, a tale of triumph. Once upon a time, there were the Dark Days of Macroeconomics when Keynesian IS-LM curves roamed the land. Then come the Troubled Times when the Keynesian models floundered in the Great Stagflation of the 1970s. But, along came an intrepid set of warriors, bearing new and better models, sorting through the wreckage of the Great Destruction of the Keynesian model. After Keynesian Economics came the Promised Land. And so, macro economists now live in a better country, where New Classical and New Keynesian economists live in harmony (Hartley, 2014). The only debate being whether there are sufficient frictions in the economy to prevent Pareto Optimality from prevailing all the time.

The school of economic thought classifies the different economic models from different economists. The ideas that are similar come under the same school while the

idea that criticizes them and make different assumptions from different school. Such events have given birth to many economists and theories but, due to the same reason, there arises an unanswerable question whether the theories will have a positive or a negative impact till it crosses the judge of time considering economic theories need to be applied to justify it and if there is any wrong with the theory, it may greatly affect the economy of a country.

The theories that work for the present may not work for the later date or the past theories that solved an economic crisis may not be the answer to all crises. New theories are introduced with every new economic problem faced. In this regard, Classical and Keynesian theories were updated time and again. This could be further explored through following points: (i) Is the nomenclature issue more than a terminological debate? (ii) What similarities are there in these schools of thought? Likewise, what differences causes the school of thoughts to differ? (iii) How the Classics vs. Keynes debate fare during the modern macroeconomics development?

The objective of this study is to search the area of knowledge under the topic “New Keynes and New Classics - Updated ideas on the extended debate of Macroeconomics Development”. General Objective are (a) To analyze the recent macroeconomic developments viz. NCE and NKE comparatively, (b). To observe the extent of use of similar taxonomy. Specific Objectives are (a) To study on Classics and Keynes relatively. (b) To study the similarity and differences between Classical and Keynesians.

This study is conducted in order to study the updated ideas on Classicism and Keynesianism i.e., NCE and NKE. In this regard, following are some of its significances. (i) This paper could be used as a reference for students for general understanding of Keynes and Classics. (ii) It may serve as a good reference for acknowledging the recent development in macroeconomics. (iii) Some may also find it as a summary report of various studies carried so far in modern macroeconomics.

3. Reviews on Classical and Keynesian School of Thoughts

This chapter contains various relevant literature that justifies the topic and objective of the study. Major literature from different times and different countries is reviewed to understand the updated views on macroeconomics development i.e., NKE and NCE.

Caraman (2015) studied on ‘Classical, Neoclassical and New Classical Theories and Their Impact on Macroeconomic Modeling’ representing an incursion into the history of classical economic thought, outlining existing similarities reflected by common reference points as well as divergences manifested in compliance with the new realities of the time of the issued theory. The researcher concluded that even though correlated at various levels, both from the perspective of the theoretical research and in the modeling

area, the classical, neoclassical and new classical theories have differentiated from one another by clearly outlined elements. The ideas of pure classicism, based on state non-intervention, and therefore on markets self-adjustment, as result of the absence of price, wage and interest rate rigidity, are taken over by neoclassicism, however with a new vision on the value of goods, seen by the latter as depending on the provided utility. Neoclassicism, also distinguished by promoting the idea of rationality of economic agents, issue supported and improved thereafter, while considering the economic agents' expectations, by the new classical theory, which aimed at surprising the dynamic evolution of economies.

Hic. O (2019) researched on 'Evolution of New Keynesian Economics' with the objective of discussing the developments in NKE and the properties of KE in terms of their assumptions and models. Researcher mentioned that NKE provides consistency between micro and macro analysis and explains facts or at least parts of empirical observations for economic models. He thinks NC has fallen out of favor and NK has prominence in the academic world as always is wide-spread and widely used.

Colander (1992) in his paper provided his definition of NK, what its relation is with other schools of macro and why its emergence is an important development in macro theory under the topic 'New Keynesian Economics in Perspective'. He believed that the nomenclature issue is more than a terminological debate that points out what should be the current issue between Keynesians and Classicals. He saw not Keynesian adding ad hoc assumptions to NC models but NC adding such to NK models and concluded that NK is not tacking on macro foundations to the existing Neo Keynesian models but searching for appropriate macro foundations for microeconomics: this may change how economists think about macro as well as micro.

Mankiw (1991) in his paper discussed the reemergence of Keynesian economics on the topic 'The Reincarnation of Keynesian Economics' presented the differences between new Keynesianism and the convictions of early Keynesians. Researcher pointed out that new Keynesians adopted many views that were once considered monetarist or classical; concluding that the term Keynesian may have outlived its usefulness.

Mankiw (1990) presented a nontechnical discussion of some of the important developments in macroeconomics under three broad categories of research. First, discussing how the notion of rational expectations has affected economists' views on the role of economic policy, the debate over rules versus discretion, and empirical work in macroeconomics. Second, it discussed on various new classical approaches to the business cycle including imperfect information theories, real business cycle theories, and sectoral shift theories. Third, it discussed various new Keynesian approaches to the business cycle, including theories based on general disequilibrium, labor contracting, and menu costs. The discussion on the first category showed a firm standing. To explain

economic fluctuations, new classical theorists emphasized technological disturbances, intertemporal substitution of leisure, and real business cycles and frictionless markets, while the Keynesians believed that market failures of various sorts are necessary.

4. Methodology

Research method deals with the systematic theoretical analysis of the methods applied to the field of study. It is the specific techniques used to identify, select, process, and analyze information about a topic. In a research paper, this section allows the reader to critically evaluate a study's overall validity and reliability.

In this paper, the data used are secondary in nature. The data and articles required for this research are collected from various search engines such as Google Scholar, JSTOR, etc.

The major portion of this study comprises descriptive analysis of all those data so collected variously. There are various tables used as per need as a statistical tool to present the data of this study in "Discussion and Analysis" Section. Figures have been presented so as to meet the objectives of the report.

This study has potential limitations. Although the efforts are made to present and analyze the facts clearly, truly and within the boundary, some errors may arise due to techniques of data collection and analysis, reliability of tools, infancy age in research experience, lack of time, availability of adequate data, and so on. Some of the major limitations could be concluded through following points:

- i. This paper has very limited scope of study and the materials provided here are secondary in nature.
- ii. This paper is more of a descriptive in nature rather than analytical one.
- iii. The results and findings of this study cannot be used as re-commendatory to any official uses.
- iv. It poses the possibility to be sighted as "How the research design should be?" for the academicians and mostly students only.
- v. This study is subject to the personal biases on the ground of what should be included and what not.

5. Analysis and Discussion

This section is the analytical part of this paper. Here, I have presented the data so collected variously and tried to explain and analyze those data according to methodology prescribed that could fulfill the objectives proposed.



Source : Author's own visualization

Figure 2 : Macroeconomic Schools

	No Prefix	Keynesian	Neo	Keynesian	New	Keynesian
Modelling Techniques	Classical Informal; based on Quantity Theory and Say's Law	Keynesian Informal; based on simple income expenditures model	Classical Semiformal; focused on IS/LM model	Keynesian Semiformal; focused on IS/LM model	Classical Formal; based on general equilibrium, Say's Law, Quantity Theory, rational expectations and market clearing	Keynesian Formal; based on general equilibrium with macro externalities; rational expectations and multiple equilibria
Institutional Backdrop	Informal; contextual	Informal; contextual	Semiformal; semi contextual	Semiformal; semi contextual	Noncontextually; analytic	Noncontextually; analytic; although it employed the importance of context in deciding at which equilibria will be arrived at
Monetary Theory	Quantity Theory; dichotomy between real and nominal sectors	Unclear how monetary sector is integrated into real sector	Formal money market analysis with LM curve rather inelastic; Quantity Theory dichotomy broken by Pigou effect	LM curve rather elastic; dichotomy broken by Keynes effect	Quantity Theory; dichotomy between real and nominal sectors; no formal analysis of money	Money is part of production function; dichotomy inherently broken
Explanation of Unemployment	Wage rigidities	Cyclical fluctuations; short fall of demand	Wage rigidities	Wage rigidities combined with shortfall of demand	Model precludes unemployment; wage rigidities would cause unemployment	Initial model focuses on aggregate inefficiency not unemployment
Source: (Colander, 1992)						

On Policy : According to Greenwald & Stiglitz (1987), ‘There has been a long-standing controversy over what governments should do in the face of unemployment: (a) nothing; (b) encourage wage reductions; (c) use monetary policy; or (d) increase government expenditures. The success of Keynesian theory has much to do with the fact that it provided a theoretical justification for those who wished to take the fourth course. The success of the New Classical theory has much to do with the fact that it has provided a theoretical justification for those who wished the government to do nothing. According to researchers, Keynes’ policy conclusions were basically correct. Government policy can affect the outcome; in recessionary periods, monetary policy is likely to be of limited efficacy; and wage cuts may not be effective.’

Palley (2012) For the debate over the impact of fiscal policy on economic activity, it is explained that in the classical and new Keynesian models’ workers are always on the labor supply schedule. In the new classical model, they can be off it due to price expectation errors. In the classical and new classical models’ discretionary fiscal policy has no effect on output and employment. The new Keynesian model sees the economy as returning to full employment once prices can reset so that fiscal policy is only temporarily effective and only if it is conditioned on unexpected demand shocks. That partially explains why new Keynesians want to close the budget deficit relatively quickly compared to Keynesians, showing again how theory implicates policy debate.

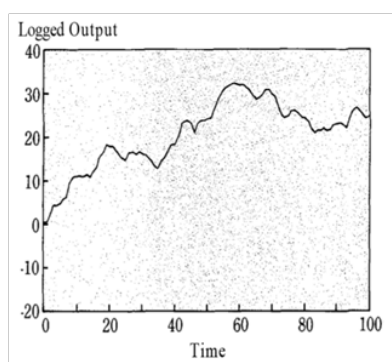
On Monetarism :Regarding NCE, Snowdon (2005) views, ‘monetarism is a school of thought that says fluctuations in the money supply are the primary cause of fluctuations in aggregate demand and income, whereas new classicism is a particular theory as to why fluctuations in aggregate demand might matter through an unanticipated price surprise. This price surprise view proposed by Lucas is the next step after monetarism. More recently, new classical economists have turned their attention to real business cycle theory, which is the antithesis of monetarism.’

Regarding NKE, (Snowdon & Vane, 1995) ‘The challenge raised by the real business cycle school is the question of whether money is neutral and, if not, why not? Twenty years ago, when Friedman and Tobin were debating, there were some things they agreed on. They agreed on the proposition that the Federal Reserve was an important player in the economy, that what it did really mattered. The real business cycle school has challenged that by writing down models without any real effects of monetary policy. What the new Keynesian models have tried to do is establish why money is not neutral, what microeconomic imperfections are necessary to explain monetary non-neutrality at the macro level. In this sense, these models are trying to support both traditional Keynesian and monetarist views.’

On Business Cycle : Both NC and NK economists are searching for the central cause or causes of business fluctuations. In Keynesian models, the imperfect market

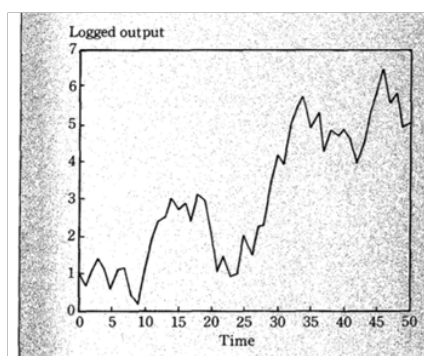
structure causes business cycles, quantities adjust faster than prices and prices do not clear markets. The essence of New Classical business cycles lies in agents' intertemporal substitution of consumption and labor in response to technology (supply) or other shocks. Both schools of thought, then, have constructed models that explain business cycles in that they reproduce the basic empirical regularities of observed fluctuations. Transacted quantities of all goods exhibit high positive correlation over time, and quantity movements tend to persist in the same direction for many periods. Further, both generate pro-cyclical real wages. These are the most basic features of observed business cycles.

Figure 3: Procyclical movement of real wage in simulated Equilibrium model



SOURCE: Long and Plosser (1983, p. 65).

Figure 4: General movement of Price in simulated Disequilibrium model



SOURCE: Robinson Crusoe and Friday disequilibrium economy

The Long & Plosser's equilibrium model to explain NCE and Robinson Crusoe & Friday's disequilibrium economy model to explain NKE mimic the basic behavior of real business cycles: strong co-movement among quantities of different goods, persistence of quantity movements in the same direction for many periods, and pro-cyclical real wages. But existing NC models cannot explain other aspects of observed business cycles, such as pro-cyclical productivity or other observed characteristics of the labor market. Further, evidence exists that capital markets are not clear and reject the NC utility function exhibiting strong intertemporal substitutions. Without such a utility function, the model has not been shown to produce persistent output cycles. The NK model is robust to most of these criticisms. It requires no specific utility function to generate cycles, it fits the observed regularities of business cycles more fully, and it employs a more general model of price movements over time. However, like the NC model, it provides no convincing explanation of the Great Depression. Since equilibrium models: (1) Comprise a subset of disequilibrium models; (2) employ identifying restrictions that are not empirically validated; and (3) require nonstandard dynamical adjustments; it appears that, at present, despite this shortcoming, New Keynesian theories provide a better paradigm of the business cycle. (Kades, n.d.)

6. Conclusion

After the analysis of data presented in this study as per the methodology prescribed, and the comparison between the results of these literature following are some finding of this study. The review suggests that the nomenclature issue is more than a terminological debate that points out what should be the current issue between Keynesians and Classicals. There are both similarities and differences within the schools of thoughts. The analysis shows the assumptions, criticisms and successes of two of these school of economic thought viz. NC and NK and explains which of them is appropriate to be applied for assessing policy, monetarism and business cycle theory. Also, no matter the taxonomy, the core ideas have been comprehended and, the debate over little to no government intervention for policy formulation, neutrality of money, causes of business fluctuations and microeconomic foundations continues even during the era of prefix 'new' added with Keynes and Classics and may persist.

To sum up, there are various schools of thoughts including those that are not mentioned in this paper. Each of them has their own assumptions, conclusions, criticisms and successes. They have their own purposes and assist during different economic situations. One may invite problem to the economy of a region while that very theory may relieve another region off its problems. Same is the case with these theories that has kept the debate between Classics and Keynes for such a long period. In any way, no matter how much they criticize and compete with one another, one thing is common for both of them- time and tide determines their very existence and applicability. The new NC or NK economists may add many new theories and explanations of policy, employment, business cycle, income and output, prices, and so on but their core has always remained the same for such an extended period of time and no doubt, will remain the same beyond the race of time.

However, 'One might be tempted to conclude from these developments that macroeconomics does not make progress, that it is destined to oscillate between two irreconcilable extremes' (Mankiw, 1991). But, we should not forget that 'it is undoubtedly easier to criticize the state of the art than to improve it' (Mankiw, 1990). 'The passage of time will make efficiency wages, real business cycles, and the other "breakthroughs" of the past decade less novel. Yet it is likely that some of these recent developments will permanently change the way in which economists of all sorts think about and discuss economic behavior and economic policy' (Mankiw, 1990).

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