

K. Christ / History of Economic Thought

12: The Keynesian crisis and modern macroeconomics

Outline

I. The crisis in macroeconomic policy (1960s to 1970s)

- The “neoclassical synthesis”: A view that combines Keynesian and classical ideas to explain how an economy can deviate in the short-run from its equilibrium levels of output and employment, and which argues that fiscal and monetary policy each can have important effects on real economic activity. The “orthodox” macroeconomic view for much of the 1950s and 1960s.
- *Stagflation* and Friedman’s warnings:
 - For much of the 1960s, the Phillip’s curve summarized most economists’ understanding of output-inflation tradeoffs.
 - Milton Friedman (the “Chicago” school) warned of the difficulties ahead for policy makers who continuously sought to exploit Phillip’s curve tradeoffs:
 - “The present situation cannot last ... it will either degenerate into hyper-inflation and radical change; or institutions will adjust to a situation of chronic inflation; or government will adopt policies that will produce a low rate of inflation and less government intervention into the fixing of prices.” Stagflation of the 1970s spelled doom for orthodox Keynesianism.
 - Monetary policy “experiment” from 1979 to 1982.
- Competing schools of thought: Keynesians vs. Monetarists

<u>Orthodox Keynesianism</u>	<u>Orthodox Monetarism</u>
<ul style="list-style-type: none">▪ Economy is inherently unstable▪ Output determined by Aggregate Demand▪ Phillip’s curve tradeoff▪ Policy focus on fiscal stimulus	<ul style="list-style-type: none">▪ Economy is inherently stable▪ Inflation is a monetary phenomenon▪ No Phillips curve tradeoff in the short run▪ Policy focus on monetary rules

II. New classical macroeconomics

- In the mid-1980s an updated classical view of the macroeconomy evolved out of monetarist and free-market thinking. This “new classical” *view* is closely associated with the Chicago school and Robert Lucas, Thomas Sargent, Edward Prescott, and others.
- The Lucas Critique – a theoretical blow to structural equation models of the macroeconomy.
- Key operational assumptions: rational expectations and continuous market clearing.
- Focus on aggregate supply, not aggregate demand – shift in emphasis from short-run stabilization to long-run economic growth.
- Equilibrium business cycle theories – monetary misperceptions (late 70s to early 80s) and real business cycles (mid to late 80s).
- Policy implications:
 - (1) Output costs of disinflation (relevant to the key policy debate during the 70s).
 - (2) The “policy ineffectiveness proposition” – extremely diminished role for government in the management of the economy.
 - (3) Focus on microeconomic policies to increase aggregate supply – lower taxes on labor, labor market flexibility, and deregulation.

III. Disequilibrium and New Keynesianism

- New Keynesianism is a term that is sometimes applied to an extremely diverse set of economists who generally take issue with the continuous market clearing assumption of the new classical approach. It is an updating of the “neoclassical synthesis”.
- Focus on market imperfections that give rise to Keynesian interpretations of business cycle facts. For some, New Keynesianism is an attempt to re-establish a significant role for government in the management of the economy.