M.A ECONOMICS PROGRAMME-SEM. 2-COURSE COAD -CC8

TOPIC:-THE NEW CLASSICAL MACRO ECONOMIC APPROACH-POLICY IMPLICATIONS

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The New Classical Macroeconomics was developed by Robert Lucas,Thomas Sargent,Robert Barro,Neil Wallace and Patrick Minford.

The new Classical Macroeconomics is an attempt to repudiate and modify Keynesian and monetarist views about the role of macroeconomic stabilization policy in the light of the classical school of thoughts. The Keynesians advocate demand management policies both fiscal and monetary to stabilize the economy .They favour active interventionist fiscal and monetary policies. In contrast monetarists are highly critical of discretionary fiscal and monetary policies. Friedman advocated government to follow a sound monetary policy in which there is maximum freedom for individual initiative and enterprise. During the late 1970s when the debate between Keynesians and monetarists stalemated, the new classical macroeconomics emerged based on classical microeconomics.

Principles/Hypotheses

1 Markets Continuously Clear
2 Rational Expectations
3 Aggregate Supply Hypothesis
The New Classical Macroeconomics is based on these three hypothesizes in which hypothesis no. 1 and no.3 are classical but their analysis is new whereas hypothesis no.2 is totally new.

1. Markets Continuously Clear-- The New Classical Macroeconomics assumes that the economy is in a state of continuous equilibrium both in the short-run and long-run where all markets continuously clear in the economy. Prices and wages adjust instantaneously to clear markets.

   The new classicals differ from Keynesians and monetarists. Keynesians assume that the economy may remain in a state of disequilibrium due to slow price adjustments. Monetarists assume that the economy may be in disequilibrium in the short-run and attain equilibrium in the long-run as prices and wages are fairly flexible and markets have a tendency to clear.

2 Rational Expectations—is called Ratex hypothesis. The Ratex hypothesis holds that economic agents like individuals, firms ,etc. form expectations of the future values of economic variables like prices ,incomes, etc.by using all the economic information available to them. The new classical economists use Ratex to explain the Phillips curve in the inflation theory and conclude that rational expectations are not based on past rates of inflation but on the current state of the economy and policies being followed by the government.

Fig. 1 shows short-run vertical Phillip curve at the natural unemployment rate

.Fig.2 shows downward sloping short-run Phillip curve which is vertical at the natural rate of unemployment.

3 Aggregate supply hypothesis—is based on two assumptions

(a) Rational decisions taken by workers and firms reflect their optimizing behavior.

(b) The supply of labour by workers and output by firms depend upon relative prices.

The aggregate supply hypothesis is derived from optimizing behavior of workers and firms about supply of labour and goods which depend on relative prices only.

POLICY IMPLICATIONS OF NEW CLASSICAL MACROECONOMICS

1 Policy Ineffectiveness Proposition—This analysis holds that monetary policy ,if anticipated in advance will have no effect on output and employment in the short-run, only an unanticipated increase in the money supply will affect output and employment. It is due to rational expectations and flexible prices and wages.

Fig. 3 shows policy ineffectiveness proposition .

2 Impotency of systematic monetary policy—As systematic monetary policy can be fully predicted, private buyers and sellers adjust their purchases and sales through flexible wages and prices. only a non-systematic monetary policy will bring changes in output and employment around there natural levels.

3 Policy credibility –This analysis is based on the presumption that rational economic agents have expectations about what the monetary authority is going to announce and this influences their behavior .The economic agents form expectations on the credibility of monetary authority's policy

announcements. Anticipated or announced changes will have no effect on output and employment even in the short-run.

4. The Lucas critique—Robert Lucas criticized the building of econometric macroeconomic models of the economy for policy evaluation, which were based on parameters derived from past data collected under particular policies. The use of such models to predict the consequences of alternative policies may be wrong as their parameters may change as economic agents adjust their expectations and behavior to the new policy.
5. Policies to increase aggregate supply—In new classical analysis changes in output and employment are based on the equilibrium supply decisions of firms and workers given their perceptions of relative prices. It recommends measures to increase output and reduce unemployment that indirectly increase aggregate supply of output and labour.They relate to reduction in the power of trade unions, reduction in unemployment benefits, tax reforms to remove poverty and raise incomes of the unprivileged, measures to increase geographical and occupational mobility of labour, etc.

CRITICISMS

1. Rational Expectations Hypothesis unrealistic
   (a) Majority of economic agents cannot act on the basis of Ratex as to acquire, process and disseminate information is expensive .
   (b) Information available to government differs from that available to economic agents.
   (c) There is no guarantee that expectations formed on the basis of available information is rational.
   (d) Economic agents may form expectations which are systematically wrong.
2. Markets do not continuously clear -prices and wages are not flexible as collective bargaining in the labour market leads to wage contracts and stickiness of money wages. Similarly prices are also not flexible and both labour market and goods market are unable to clear continuously.
3. Aggregate supply hypothesis unacceptable-critics say that changes in aggregate demand influence output and employment both in the short-run and long-run.

4 The policy implications of new classical macroeconomics become unacceptable due to unrealistic hypothesizes.

QUESTIONS

1. **Critically** examine the New Classical Macroeconomics.—10 marks
2. **Describe** policy implications of New Classical Macroeconomics-5 marks

DIAGRAMS-Fig 1, Fig. 2,Fig. 3 annexed

ANNEXTURE
THE NEW CLASSICAL MACROECONOMICS

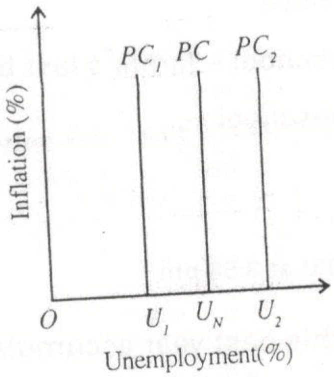

Fig. 1

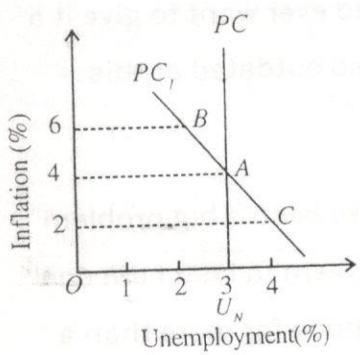

Fig. 2

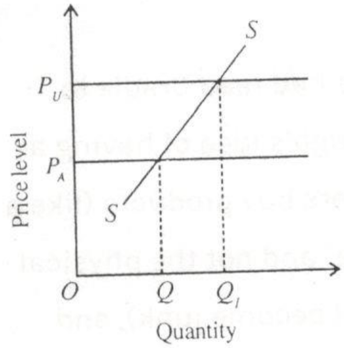

Fig. 3