Modern Paradigm in Macroeconomic Monetary Theories

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Abstract

In this paper we tried to present an objective perspective over modern monetary theories and their impact on economic activity. In the end, our research stressed some specific actions that influence the macroeconomic equilibrium.

Neoclassical and New Keynesian trends supported modern macroeconomic stabilization policies.

New Keynesian paradigm assumed that, in general, agents have rational expectations. This controversial subject points out that although the expectations can be wrong on average they are actually correct.

Neoclassical economists will have a different approach towards the theory of expectations, saying that decisions were based on the expectations that people have and not on what really happen.

We appreciated that in order to achieve macroeconomic stability a mix between monetary and fiscal policies is needed, fixed rules should be applied in interdependence with discretionary government measures and acting upon incomes is the best way to fight against inflation.

Key words: neoclassical, New Keynesian, rational expectations
J.E.L. classification: E13, E12, D84

1. Introduction

Monetarists have been seriously criticized by neoclassical and Keynesian followers. Rational expectations theory developed by supporters of the New Classical School stated that, in general, traders take into consideration not only the past events, but the future events, too. If Keynesian followers campaigned for boosting the demand, neoclassical supporters focused on macroeconomic stabilization policies.

The essence of macroeconomic activity, according to neoclassical approach is based on two ground rules: prices and salaries are flexible and in general, people are using all the available information before acting or making a decision.

Knowing how important the impact that monetary theories have over macroeconomic stability is, we appreciate that our research theme is relevant to be analyzed. In addition to this, the research highlights how these economists updated their predecessors' ideas in terms of economic development.

We analyzed works of some of the most known representatives of the new paradigm: Robert Lucas Jr. (Chicago), Thomas Sargent (Stanford) and Neil Wallace (Minnesota).

Our research is focused on two main objectives. First of all, to present an overall perspective over Neoclassical and New Keynesian paradigm and to see how these two modern monetary theories influence the economic activity and second of all, to highlight in the end the core measures from these theories that support macroeconomic stability.

2. Neoclassical vs. New Keynesian perspectives: points of view

The two trends therefore supported modern macroeconomic stabilization policies. If the neoclassical approach shifts from macroeconomic to micro level, New Keynesians will address the same subject, but in reverse order.

Similar to New Classical adepts, New Keynesian paradigm assumed that, in general, agents have rational expectations. This controversial subject points out that although the expectations can be wrong – meaning that you cannot predict 100% the future – on average they are actually correct.

Best known for being designed by Robert Lucas Jr., the expectations theory was firstly introduced in 1961, by John F. Muth and is the foundation of every model where persons and organizations have to make different types of choices under the umbrella of uncertainty. This theory believes that every person or firm take into account all the information needed in order to achieve optimal predictions (Muth, 1961, pp. 315 – 335).

Robert Lucas Jr. wrote about it in *Expectations and the Neutrality of Money (1972)* and in *Econometric Policy Evaluation: A Critique (1976).*

Neoclassical economists went beyond the monetarists ideas. They will have a different approach towards the theory of expectations, saying that decisions were based on the expectations that people have and not on what really happens. They will also agree with the idea of flexible prices which are established by the supply and demand ratio. Regarding the salary adjustment, neoclassical economics doesn't see no difference between wage and price adjustment. In contrast to their thinking, this gap was slightly larger in Keynesianism and smaller in monetarism. If monetarist supporters took decisions aiming monetary policy especially, neoclassical economists were the promoters of fiscal policy.

Based on the people's anticipatory behavior, neoclassical thinkers weren't encouraging an early "announcement" of macroeconomic policy decisions because, in this way, people could model their behavior by anticipating the effects of these decisions, creating the chance that these policies could not fix the problem for which they were adopted.

National Bank of Romania, as most of the central banks throughout the world use in their forecasts neoclassical and New Keynesians ideas.

Nobel Prize winner for Economics in 1995, Robert Lucas Jr., explains – using the model of Paul Samuelson (Samuelson, 1958, pp. 467 – 482) – that we can talk only about a long term neutrality of money (Lucas, 1972, p. 103). So, we can conclude that on the short term, money is not neutral.

Debates regarding money neutrality – meaning no change in variables such as output, real wages and real interest rates when there is a currency fluctuation – were subject of research for the past three centuries. David Hume wrote about money neutrality in his paper *Of Money* (Hume, 1752).

Samuelson's model included two generations: young producing persons and old consuming people that don't produce anything to offer young people something in return. The solution would be to give them money, which they will use when they grow old to pay the new generation of young people who will produce the goods. But will the new youth accept this money? After all, when they grow old they will be in the exact situation. There's how this model does not use the money for consumption or production.

Lucas concludes that the most effective monetary policy approach will include some tax regulations apart from the establishment of a constant growth rate of money supply. It is once again observed the necessity to combine the two policies to achieve economic stability.

The economic activity may be altered only if fluctuations in the money supply are not anticipated or known, otherwise, are ineffective. The solution would be the adoption of a strong and restrictive monetary policy. Currency has therefore no active function in the economic life.

Big contributor to what rational expectations theory means for macroeconomics, Thomas Sargent – who also received Nobel Prize award in Economic Sciences in 2011 – together with Neil Wallace – economist from University of Minnesota – discussed about expectations in a strong dependency with monetary and fiscal policies. They claimed that a good fiscal policy is compulsory when a good monetary policy already exists (Sargent *et al*, 1981, p. 1). Moreover, by studying four countries with hyperinflation in 1920 (Austria, Germany, Hungary and Poland), Sargent showed how a government can use inflation in order to finance their deficits (Sargent, 1983, pp. 41 – 97). All these countries had to reduce the budgetary deficits, so that the expectations of people were affected. The measures were successful, so that inflation was eliminated.

Using an ad hoc macroeconomic model where people have rational expectations about prices, Sargent and Wallace analyzed alternative monetary policies (Sargent *et al*, 1975, p. 241).

Rational expectations theory has limitations too. The most important of them concerned a problem of credibility in supported models. The theory is based on the idea that the market is in a permanent balance, which is contrary to reality, knowing the difficulty of prices and wages to adapt to market changes.

Big supporters of bank loans, New Keynesians, consider them as being more important for overall demand than bank deposits. Developing their theory under the key word uncertainty, they considered that unemployment and inflation are macroeconomic phenomena, not related to microeconomic theory, so they have therefore developed their own theory.

Followers of Keynes can be categorized as monetarists, since the origins of their ideas can be seen in Friedman's paradigms. De Long stated that the reverse is also true (De Long, 2000, pp. 83 – 94). For having a critic attitude towards laissez-faire, which didn't ensure macroeconomic stability, and also by claiming a limitation of state action in the economy, they can be called as Keynesians.

Their theory stressed that on short term, prices are being influenced to a very limited extent by demand changes. Therefore, in order to fight inflation, the solution was not reducing global demand, but the differences between incomes. Under inflation, the monetary authorities should interfere by reducing the interest rate, so that the unemployment will be also diminished as a consequence.

New Keynesians tried to answer Keynesian uncertainty and distrust in terms of establishing monetary decisions. For the representatives of this trend, prices have on short term a minimum influence over the prices, which are set by companies. In other words, to combat inflation by reducing demand is not a winning solution. What should be the best solution? According to New Keynesians the escape solution is found in the income policy, so by acting upon inequities in income distribution. And they will do so through cyclical monetary policy.

In this regard, during inflation, the central bank will not raise interest rates, in order to reduce unemployment and therefore inequities in income distribution. If New Keynesians admitted the presence of incomplete and imperfect information – see Bruce Greenwald and Joseph Stiglitz (1987) – neoclassical followers were not considering them when they wanted to demonstrate the changes in economic activity. New Keynesian has four fundamental features according to Bruce Greenwald and Joseph Stiglitz in *Keynesian, New Keynesian and New Classical Economics* (Greenwald *et al*, 1987, pp. 19 – 24):

- *„Efficiency wages" models*: that shows the interdependence between salaries paid by a company and all other salaries in the market. These models try to solve the issue of wage rigidities from the labor market, of interest rate from the capital market and of prices from goods and services market, highlighting how big their impact is on economic activity. Because of this interdependence, any incomplete information has consequences for all markets. The effect of propagation of this information is very high;
- *Credit limiting*: determines traders to take risks to get money, which could reduce earnings that have been expected by the capital owners;
- *Capital market imperfections*: refers to incorrect information that traders have and because of which investments are negatively impacted. This negative impact on investments leads traders to seek for bank loans, being in this way forced to take risks;
- *A new vision of the role of monetary policy*: banks can be determined to lend money through specific actions of the monetary authorities.

3. Conclusions

After analyzing the core characteristics of these two paradigms, we can highlight the main measures that in our opinion are key contributor to macroeconomic stability.

By rejecting Keynesian dirigisme for not achieving long term prosperity and stability, rational expectations theory followers agreed that decisions are taken individually.

In order to achieve macroeconomic equilibrium, we believe that a mix between monetary and fiscal policies is necessary. In the same time, we appreciate that fixed rules should be applied in a permanent interdependence with discretionary government measures. In our opinion, contrary to rational expectations adepts, these measures does not create confusion, if their solely aim is to have an impact over macroeconomic activity. Otherwise, the discretionary treatment can indeed shape the overall behavior in an unwanted way.

We also emphasize that a concrete measure from the New Keynesian perspective for fighting against inflation is looking at the incomes distribution, and not on reducing demand. Therefore, we agree that a specific action in the incomes policy is diminishing the gap between the salaries paid by firms and the market level.

Neoclassical economists went beyond the monetarist's ideas and had a different approach towards the theory of expectations, saying that decisions were based on the expectations that people have and not on what really happens.

Of course that the actions listed above are not the only measures that have an important impact over macroeconomic equilibrium so, the list can be updated anytime. What is relevant is that both Neoclassical and New Keynesian theories offer plenty of ideas that influence the macroeconomic development.

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