

ECONOMICS FORUM

The New Classical Counter-Revolution: A False Path for Macroeconomics

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In this article, I contend that the “new” classical counter-revolution that began in the 1970s has been a false path for macroeconomics [Seidman, 2003, ch. 11].

LUCAS AND SARGENT AND THE LAUNCHING OF THE NEW CLASSICAL COUNTER-REVOLUTION

In June 1978, Lucas and Sargent launched a dramatic attack at the annual conference of the Federal Reserve Bank of Boston that changed the direction of macroeconomics for many years to come. What led to the attack?

In the mid 1960s, Keynesian economic advisers (like Ackley and Okun) warned President Johnson that excess aggregate demand threatened to generate inflation and recommended a prompt stiff tax increase to damp down consumer demand. Johnson delayed and inflation came. When the Nixon Administration imposed wage and price controls in 1971-72, Keynesian economists predicted that once the controls were removed, inflation would resume if aggregate demand remained excessive. And so it did. From 1960 to 1973, U.S. economic history was well explained by Keynesian economics.

The 1973 oil shock, by contrast, was initially a problem for Keynesian economics. It was only in response to the oil shock that Keynesian economists recognized that they needed the same basic tool as microeconomics—the supply/demand diagram—with the price level plotted vertically and output horizontally. The AD/AS diagram, introduced into textbooks in the late 1970s by Keynesian economists (like Gordon), explained both the 1960s and the 1970s. In the 1960s, the aggregate demand curve shifted right, so we got more output and inflation. But in the mid-1970s, the OPEC oil producers raised the cost of U.S. production, shifted up the aggregate supply curve, so we got less output but more inflation.

Unfortunately, understanding something does not necessarily lead to a satisfactory policy solution. The new AD/AS diagram showed clearly that an upward supply shock was inescapably bad news. It caused inflation and recession simultaneously, and there was no magic way to get rid of both together. The public, however, was frustrated by the inability of Keynesian economists to find a way to reduce both inflation and recession simultaneously.

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As the conference convened in June 1978, at a moment of high public discontent, Lucas and Sargent decided to strike at the very foundation of Keynesian economics and the leadership of Keynesian economists. They entitled their presentation "After Keynesian Macroeconomics." After briefly conceding that Keynesians had won public relations points in the early 1960s, they continued:

We dwell on these halcyon days of Keynesian economics because, without conscious effort, they are difficult to recall today. In the present decade, the U.S. economy has undergone its first major depression since the 1930s, to the accompaniment of inflation rates in excess of 10 percent per annum...[Lucas and Sargent, 1978, 49].

Incredibly, Lucas and Sargent made *no* mention whatsoever of the oil price supply shock that simultaneously generated both "the first major depression since the 1930s" and inflation above 10 percent. I have searched their article in vain for the word "oil." Lucas and Sargent offered *no* explanation for the stagflation of the 1970s. Instead, they claimed that Keynesians had predicted a decade of economic success:

That these predictions were wildly incorrect, and that the doctrine on which they were based is fundamentally flawed, are now simple matters of fact, involving no novelties in economic theory. The task which faces contemporary students of the business cycle is that of sorting through the wreckage, determining which features of that remarkable intellectual event called the Keynesian Revolution can be salvaged and put to good use, and which others must be discarded [Lucas and Sargent, 1978, 49-50].

Lucas and Sargent denounced the use of Keynesian models to guide the design and implementation of countercyclical policy. Yet at the very same conference, Klein, a pioneer of Keynesian econometric models, showed how international disturbances such as oil supply shocks could be incorporated into Keynesian models, thereby providing a satisfactory explanation of the 1970s.

At the conference, Solow led the Keynesian counterattack:

The question is: what are the possible responses that economists and economics can make to those events [of the 1970s]? One possible response is that of Professors Lucas and Sargent. They describe what happened in the 1970s in a very strong way with a polemical vocabulary...Let me quote some phrases that I culled from their paper: "wildly incorrect," "fundamentally flawed," "wreckage," "failure," "fatal," "of no value," "dire implications," "failure on a grand scale," "spectacular recent failure," "no hope." Now if they were doing that just to attract attention, for effect, so that people don't say, "yes dear, yes, dear," then I would really be on their side. Every orthodoxy, including my own, needs to have a kick in the pants frequently, to prevent it from getting

self-indulgent, and applying very lax standards to itself. But I think that Professors Lucas and Sargent really seem to be serious in what they say, and in turn they have a proposal for constructive research that I find hard to talk about sympathetically. They call it equilibrium business cycle theory, and they say very firmly that it is based on two terribly important postulates—optimizing behavior and perpetual market clearing...[Solow 1978, 203-04].

Solow said that Klein, Fair, and others had introduced supply into their Keynesian models so that an upward supply shock from world oil prices generates both inflation and recession, nicely explaining the 1970s. He continued:

So fast does the economics profession move now that there are already textbooks that do the supply side quite adequately... [Solow 1978, 206].

But Solow opposed Lucas and Sargent's new classical agenda not only for its failure to mention the oil shock and its consequent inability to explain the 1970s. Solow strongly rejected their central pre-Keynesian postulate of perpetual market clearing. It reminded Solow of the claims during the Great Depression that the labor market was clearing nicely and any alleged "unemployment" was purely voluntary. Solow explained:

It is as plain as the nose on my face that the labor market and many markets for produced goods do not clear in any meaningful sense. Professors Lucas and Sargent say after all there is no evidence that labor markets do not clear, just the unemployment survey. That seems to me to be evidence. Suppose an unemployed worker says to you, "Yes, I would be glad to take a job like the one I have already proved I can do because I had it six months ago or three or four months ago. And I will be glad to work at exactly the same wage that is being paid to those exactly like myself who used to be working at that job and happen to be lucky enough still to be working at it." Then I'm inclined to label that a case of excess supply of labor and I'm not inclined to make up an elaborate story of search or misinformation or anything of the sort...The notion that excess supply is not there strikes me as utterly implausible [Solow 1978, 208].

Solow made one final comment in response to Lucas and Sargent's assertion that they will do macroeconomics using the assumption that all markets are always in competitive equilibrium:

Deep down I really wish I could believe that Lucas and Sargent are right, because the one thing I know how to do well is equilibrium economics. The trouble is I feel so embarrassed at saying things that I know are not true [Solow 1978, 206-207].

Two years later, Tobin [1980] emphasized that the most crucial assumption of the new classical economics is the continuous clearing of a competitive labor market. He wrote:

The market-clearing assumption is just that, an assumption. It is not justified by any new direct evidence...Indeed, the main practical controversy of the day is to what extent, if any, the ongoing inflation is inertial...Such inertia is a phenomenon of disequilibrium; markets are not always clearing at these wages and prices; therefore demand management policies, even though unsurprising, may be able to increase or decrease both quantities demanded and quantities supplied. This is the Keynesian message...[Tobin 1980, 788-89].

A few years later Blinder wrote:

The New Classical Economics (NCE) counterrevolution does not seem to me to mark a major step forward from the Keynesian tradition it supplanted. The attempted revival of market clearing was quixotic, in the worst sense of the word...Does that mean we had it all right in 1972? Hardly...I begin with a brief mention of an obvious flaw. Vintage 1972 macroeconomics—whether it was Keynesian or monetarist—was all about demand fluctuations, a term then thought to be synonymous with economic fluctuations. The 1970s and 1980s destroyed this narrow-minded focus forever. We now know that Marshall's celebrated scissors also comes in a giant economy size. Economic fluctuations can, and sometimes do, emanate from the supply side—from oil shocks, food shocks, and the like...[Blinder 1989, 108-111].

EMPIRICAL EVIDENCE AGAINST THE NEW CLASSICAL COUNTER-REVOLUTION: THE 1982 RECESSION

At the end of the 1970s, a sharp practical difference crystallized between Keynesians and new classicals concerning a specific prediction. Keynesians predicted that if the Federal Reserve applied a tight money policy to the economy, it would throw the economy into recession, and that the recession would eventually reduce inflation. Keynesians emphasized that tight money could not reduce inflation without generating a recession. The reason was inertia in setting wage and price increases. Having gotten used to large wage and price increases (following the oil price shocks of the 1970s), workers and managers would continue to set large increases unless a recession compelled them to moderate the increases. Only when workers feared layoffs would they agree to smaller wage increases; only when employers experienced falling demand and profits would they have the backbone to insist on smaller wage increases. Smaller cost increases would then permit smaller price increases.

By contrast, new classicals contended that the Federal Reserve could reduce inflation without generating a recession. The reason was their assumption that workers and employers possessed forward-looking rational expectations about wage and price

increases. If the Fed clearly signaled its intent to reduce inflation through a firm tight money policy, rational workers and employers would immediately expect lower inflation, and hence would immediately agree to smaller wage and price increases. Thus, disinflation would occur without the economy going through recession.

Then the experiment was run. At the beginning of the 1980s in the U.S., Britain, and most other economically advanced countries, the head of the central bank publicly pledged to reduce inflation and applied a tight money policy, evidenced by a very sharp rise in interest rates. In every case, the economy was thrown into a recession. In no case did inflation subside without a recession.

BARRO'S HYPOTHESIS

Another new classical economist, Barro (1974), propounded a hypothesis that has come to be known as “Ricardian equivalence”—a phrase that surely helped endear the hypothesis to economists who rightly admired Ricardo’s analysis of international trade. Because Ricardo rejected the hypothesis as unrealistic, I will call it “Barro equivalence.”

Barro contended that the average person would entirely save any income tax cut or cash transfer because he would actually engage in the following reasoning: “If the government leaves me with more cash today by either cutting my tax or sending me a cash transfer, it will have to borrow more today and will therefore have to tax me more tomorrow to pay back its debt; so I better set aside all of the cash today to get ready to pay the tax tomorrow.” Clearly, if people reasoned this way, temporary changes in taxes and transfers would have no effect on current consumption. According to Barro, Keynesian tax cuts or transfers to combat a recession would not raise aggregate demand and hence would not work.

It cannot be overemphasized that Barro has never provided any empirical evidence whatsoever that ordinary people think this way. Even worse, he and other economists who accepted the truth of his hypothesis have felt no need to discover whether ordinary people actually reason this way. In his macroeconomics textbook, Mankiw [2000] gave two reasons why Barro’s hypothesis is unrealistic: myopia and borrowing constraints. According to Mankiw, Ricardo considered the argument but rejected it as unrealistic. Mankiw writes:

Although Ricardo viewed these alternative methods of government finance as equivalent, he did not think other people would view them as such...Ricardo doubted that people were rational and farsighted enough to look ahead fully to their future tax liabilities...It is one of the great ironies in the history of economic thought that Ricardo rejected the theory that now bears his name! [Mankiw, 2000, 424].

There is overwhelming anecdotal evidence that people do not think Barro’s way when they get a tax cut or transfer—just ask any noneconomist. Barro’s hypothesis, therefore, does not deserve to be taken seriously as an empirical proposition about the actual economy. I suspect that even on a Barro island—an island populated only by Barro and other economists who accept his hypothesis—a tax cut or transfer might not be entirely saved.

PRESCOTT AND REAL BUSINESS CYCLES

Real business cycle theory is a branch of new classical economics not because it emphasizes technology shocks, but because it assumes all markets are competitive and clear instantaneously so that all fluctuations in output and employment are the consequence of voluntary choice of labor supply in response to technology shocks and are therefore socially optimal. Perhaps the leading pioneer of real business cycle theory is Prescott. When Prescott used the phrase “economic theory” in the following quote, he meant theory premised on the (dubious) assumption of continuous competitive equilibrium in the labor market:

Economic theory implies that, given the nature of shocks to technology and people’s willingness and ability to intertemporally and intratemporally substitute, the economy will display fluctuations like those the U.S. economy displays...In other words, theory predicts what is observed...The policy implication of this research is that costly efforts at stabilization are likely to be counterproductive. Economic fluctuations are optimal responses to uncertainty in the rate of technological change. [Prescott, 1986, 21].

Responding to Prescott, Summers wrote:

A more fundamental problem lies in Prescott’s assumption about the intertemporal elasticity of substitution in labor supply. He cites no direct microeconomic evidence on this parameter, which is central to his model of cyclical fluctuations. Nor does he refer to any aggregate evidence on it...My own reading is that essentially all the available evidence suggests only a minimal response of labor supply to transitory wage changes. Many studies...suggest that the intertemporal substitution model cannot account at either the micro or the macro level for fluctuations in labor supply. [Summers, 1986, 24].

Summers challenged real business cycle theorists to identify the source of each alleged negative technology shock that supposedly caused each recession:

My second fundamental objection to Prescott’s model is the absence of any independent corroborating evidence for the existence of what he calls *technological shocks*...Prescott assumes that technological changes are irregular, but is unable to suggest any specific technological shocks which presage the downturns that have actually taken place. A reasonable challenge to his model is to ask how it accounts for the 1982 recession, the most serious downturn of the postwar period [Summers, 1986, 25].

According to Summers, the attempt to explain the Great Depression as a consequence of a negative technology shock is “absurd,” and other postwar recessions have a more plausible demand-side explanation:

While it is hard to account for postwar business cycle history by pointing to technological shocks, the account offered by, for example, Otto Eckstein and Allen Sinai of how each of the major recessions was caused by a credit crunch in an effort to control inflation seems compelling to me. [Summers, 1986, 26].

THE NEW CLASSICAL COUNTER-REVOLUTION AND THE ROLE OF MATHEMATICS IN ECONOMICS

The new classical counter-revolution recruited many newly minted young economics Ph.D.'s, despite the empirical unrealism of its crucial assumptions. How was this possible? By the time of the launching of the new classical counter-revolution, many top-ranked universities had made mathematical skill the sole criterion for obtaining an economics Ph.D., ignoring the wisdom in this passage from Keynes' biographical sketch of his teacher Alfred Marshall:

The study of economics does not seem to require any specialised gifts of an unusually high order. Is it not, intellectually regarded, a very easy subject compared with the higher branches of philosophy and pure science? Yet good, or even competent, economists are the rarest of birds. An easy subject, at which very few excel! The paradox finds its explanation, perhaps, in that the master-economist must possess a rare *combination* of gifts. He must reach a high standard in several different directions and must combine talents not often found together. He must be mathematician, historian, statesman, philosopher...No part of man's nature or his institutions must lie entirely outside his regard [Keynes 1963, 140-141].

Here is an example from Keynes' *General Theory* of his skill at observing actual behavior:

Now ordinary experience tells us, beyond doubt, that a situation where labour stipulates (within limits) for a money-wage rather than a real wage, so far from being a mere possibility, is the normal case. Whilst workers will usually resist a reduction of money-wages, it is not their practice to withdraw their labor whenever there is a rise in the price of wage-goods. It is sometimes said that it would be illogical for labour to resist a reduction of money-wages but not to resist a reduction of real wages. For reasons given below, this might not be so illogical as it appears at first; and, as we shall see later, fortunately so. But whether

logical or illogical, experience shows that this is how labour in fact behaves. [Keynes, 1936, 9].

It is hard to imagine a new classical economist saying, "But whether rational or irrational, experience shows that this how labor in fact behaves."

The new classical substitution of mathematics for empirical realism is illuminated by contrasting the new classical approach to the labor market with the empirical work of Bewley in his book *Why Wages Don't Fall During a Recession* [2000] for which he interviewed over 300 businesspeople, union leaders, job recruiters, and unemployment counselors. Bewley found that employers resist pay cuts largely because the savings from lower wages were usually outweighed by the cost of lower worker morale. Managers prefer layoffs to pay cuts because they harmed morale less. It is hard to imagine new classical economists even thinking of interviewing labor market participants.

The driving force behind new classical economics in academia was the new set of mathematical models that it provided for new Ph.D. candidates and assistant professors. Instead of refining the Keynesian framework, which had been worked on continuously for several decades, the classical counter-revolution gave young economists of the late 1970s and 1980s new mathematical models to explore and extend. Just as Keynesians had spent several exciting decades using mathematics to develop the implications of Keynesian assumptions, new classical economists had the opportunity to use mathematics to explore the implications of new classical assumptions.

WHITHER NEW CLASSICAL ECONOMICS?

Now a question naturally arises to any economist: If new classical macroeconomics was really a defective product, how could it prevail in the market place? The answer is that it did *not* prevail. Customers in government and the business community never "bought" it. The Federal Reserve Board under Volcker and Greenspan has remained thoroughly Keynesian, continuously practicing countercyclical monetary policy to combat both inflation and recession. The business community takes it for granted that the Fed will practice such countercyclical policy, and there would be widespread alarm if a new classical economist became chairman of the Fed. The undergraduate textbooks that dominate the market continue to use a Keynesian framework based on the assumption of sticky wages and prices and give a sympathetic treatment of countercyclical monetary policy and automatic fiscal stabilizers. When recession hit the U.S. in 2001, the public expected the Fed to cut interest rates, and even expected Congress and the president to provide fiscal stimulus (like the \$600 rebate). The fact is that new classical economics failed in the marketplace.

The only place that the new classical counter-revolution succeeded was in academia. In academia, many "impractical," "unrealistic" subjects thrive, as they should, because academia welcomes flights of the imagination, virtuoso intellectual performances, and enjoyment of a subject as an end in itself, whatever its realism. In academia, new classical economics was at home with many other subjects. Undergraduates (and their tuition-paying parents) tolerated new classical economics professors just as they tolerate literature and mathematics professors.

New classical economics will last a long time in academia. At many universities, new classical economics professors now supervise economics Ph.D. theses, hire assistant professors, and make tenure decisions. With tolerant consumers, academia can exhibit substantial inertia. New classical economists are editors of several economics journals and will continue to publish new classical economics articles until they retire. Nevertheless, many young economists have begun to notice that if they want to influence actual macroeconomic policy, mathematics alone is not enough: they will have to pay attention to the empirical realism of their model's assumptions. A young economist practicing new classical economics may well succeed in academia, but will likely fail to have any impact on actual macroeconomic policy making.

In conclusion, I want to return to the provocative quote from Lucas and Sargent's launching of the new classical counter-revolution at the 1978 conference. From today's vantage point, I offer a revision of their quote [Lucas and Sargent, 1978, 49-50], substituting new classical counter-revolution for Keynesian revolution; my substitutions into the original quote are indicated by brackets below:

[I] dwell on these halcyon days of [new classical] economics because, without conscious effort, they are difficult to recall today...[At the end of the 1970s, new classical economists predicted that the Federal Reserve, and other central banks, would be able to engineer disinflation without recession because economic agents were rational and labor and product markets were perfectly competitive and cleared instantaneously]. That these predictions were wildly incorrect, and that the doctrine on which they were based is fundamentally flawed, are now simple matters of fact, involving no novelties in economic theory. The task which faces contemporary students of the business cycle is that of sorting through the wreckage, determining which features of that remarkable intellectual event called the [new classical counter-revolution] can be salvaged and put to good use, and which others must be discarded.

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