New classical macro Economics

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MACRO ECONOMICS

- CLASSICALS -1776-1930
- NEO CLASSICAL - 19 TH CENTURY PREVAILED UP TO 1930
- (Marginal revelution carl menger,jevon,walras)
- KEYNESS - 1930 DEPRESSION
- POST KEYNESIAN
- MONETARISM - 1968 FRIEDMAN
- SUPPLY SIDE ECONOMICS
- NEW CLASSICAL- 1970
- NEW KEYNESIAN

NEW CLASSICAL MACRO ECONOMICS

- 1970 'S STAGFLATION
- Modification of classical
- Propounded by Robert Lucas, Thomas Sergent, Barrow, Edward presscot
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- To explain rational behavior
- To explain policy effectiveness
- To explain keyness and monetary failures
- To explain stagflation

Features of the new classical model

CLASSICAL (1775)

- Market clear (ss=dd) long process
- Wage price flexibility
- Perfect knowledge

NEW CLASSICAL (1970)

- Immediate market clearing
- Wage price flexibility
- Adjustments are quickly due to rational expectation
- Imperfect knowledge due to asymmetric information
- Anticipated policy changes do not affect output and employment
- Unanticipated policy changes affect aggregate demand output and employment

Features of the new classical model

NEW CLASSICAL (1970)

- Unanticipated policy changes cause business cycle
- They highly criticized Keynes's wage rigidity and price expectation
- Mostly criticized by keyness policy action .
- based on the adaptive expectation

New classical …

- During 1970 when there was a debate between keyness and monetarist
- It is an attempt to modify keyness and monetarist views about the role of macroeconomics
- They complained about deflationary fiscal and monetary policy to control inflation
- They are highly critical of discretionary fiscal and monetary policy
- They believed that fiscal and monetary policy are complementary to each other
- They are not at all favors of monetary and fiscal policy action.
- They favored the Rule policy
- They arrive at noninterventionist conclusions like that of classical

NEW CLASSICAL MACROECONOMICS HYPOTHESIS

- Market continuously clear
- Rational expectation
- Aggregate supply hypothesis

The new classical macroeconomics: hypothesis

❖ Market continuously clear

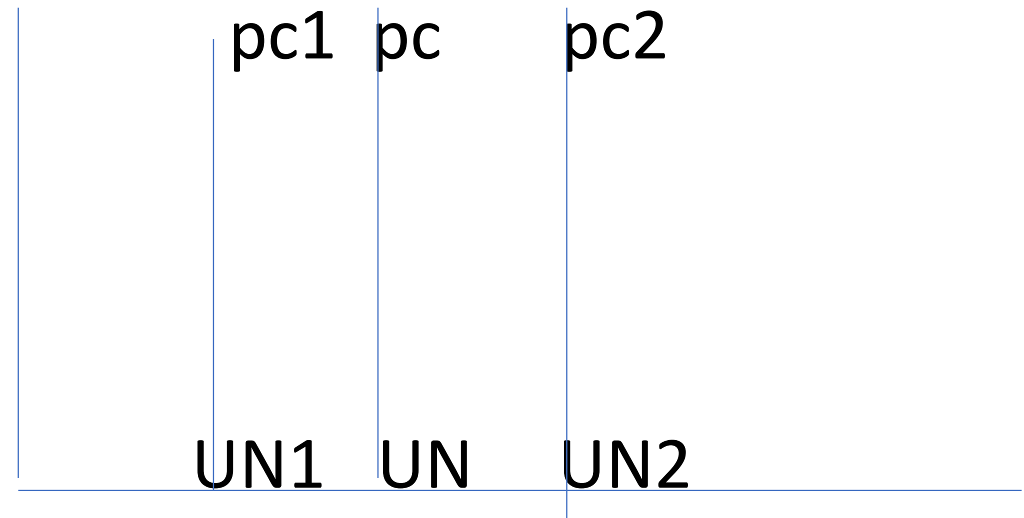
- All markets continuously clear
- Price and wage adjust instantly to clear the market
- The economy is in a state of equilibrium both in the short run and long run
- According to keyness market will not be clear. The economy is in a state of disequilibrium
- The new classical assumes all markets are clear instantly so that there is no disequilibrium in the short run.

Rational expectation

- Introduced by Muth
- Developed by Lucas
- Expectations are formed on the basis of all available information
- All the relevant past information the relevant present information +expected policy suggestions relating to that variable
- Expectations are formed rationally forecasting errors will be minimum.
- Actual rate =Expected rate
- Under rational expectation there is no trade-off between inflation and unemployment.

Philips curve under rational expectation

Y-INFLATION



X-UNEMPLOYMENT

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Adaptive expectation

- Expectations on future are based on what happened in the past only
- If they expect that inflation was higher in the past they expect inflation will be higher in the future
- Earlier Philip curve was based on the adaptive expectation
- Give importance to past events

Rational expectation

- Past present and future
- New classical predict Philip curve under the rational expectation
- Best guess for the future
- Un biased forecast based on available information

Aggregate supply hypothesis

- It is based on intertemporal substitution

- If the current real wage is above the normal real wage workers will have the incentive to work more

If the current real wage is below the normal wage rate workers will have the incentive to take more leisure.

Real business cycle theory-1980

- Out growth of the new classical theory
- Short run economic fluctuation based on classica model

- Second generation of the new classical model

- Real factors are responsible for changes in output and employment
- Real factors or supply side shocks

- Real factors-shocks,technology,variation in environmental condition ,changes in real price and tax
- Finn kydland ,Edward presscot,Barrow and King,Long and plosser,Prescott

Real business cycle theory

- Cyclical change in business activity is caused by real factors
- Real shock affect choice of economic agent which affect changes in aggragate demand,output employment ,consumption and saving
- **Assumption**
- All unempoyment are vuluntary
- Market will clear automatically
- Business cycle is an equilibrium phenominun

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- Nutrality of money
- Flexible price
- Money supply and pricelevel do not influence real variable such as output and employment
- Economic agent are rational,they make optimum decision
- single product
- Constant returns to scale , the economy is in a steady state

- Real factors or real shocks are responsible for business cycle
- Sources of short term fluctuation are due to supply side factors
- Monetary policy is ineffective ,they indirectly support fiscal policy

Central features of real business cycle model

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Agent optimise (Basic model of real business cycle)

Macro economic policy

Technological shock

1.Agent optimise (A simple business cycle model)

- Economy consist of identical individual
- Saving, cn,investment are alike
- Objective is to maximise utility,ulity can be derived from two sources cn and leisure $Ut= (Ct,Lt)$
- Ct= Consumption at time perod t
- Lt= Leisure at peroid t
- labour leisure tradeoff changes out put and production function
- $Yt= Ztf(Kt,Lt)$ Yt= output at time t
- kt= capital at time t
- Lt labour at time t
- zt=schock to the production function

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- Saving function
- Y=C+S H e faces a tradeoff between consumption and saving
- saving @ current period become Cn in the future period
- Capital stock of cruso   Capital stock t+1 perod causes depreciation
- shocks are exogenous ,schoks affect the choice of agent

2.Macro economic policy

- Monetary policy can not affect output and employment even in eliminating business cycle.
- the role of money is to determine price level only as that of classical
- when qty of money increases ,there will be change in price level ,but output and employment un changed
- They indirectly support fiscal policy
- Real factors are responsible for business cycle

3.Technological shock

- Technological schok means technological change
- sudden changes in the technoligy that affect economic ,social and political outcome, or the economy as a whole
- Technological shock-resource availability, investment,income, capital stock ,output,employment also get increased
- Schock increases productivity ,output and employment.