LECTURE SIX - PART TWO

New Classical Economics

- Rooted in the Classical Economics tradition.
- A strong influence on macroeconomic theory.
- Played a pivotal role in the 1992 defeat of George Bush by Bill Clinton.

New Classical Economics

- Based on the controversial theory of "*rational expectations*."
- Provides a sharp contrast to the notion of "*adaptive expectations*."

Robert Lucas

Thomas Sargent

Robert Barro

Adaptive Expectations

- People assume inflation will continue to be what it already is.
- If inflation was 3% <u>last</u> year, adaptive expectations predict inflation will be 3% <u>next</u> year.

Rational Expectations

- People take into account ALL available information.
- This includes any future effects from activist fiscal and monetary policies such as more demand pull inflation.

Key Point
You can fool the people with activist Keynesian policies for a while but not over the longer term.

Rational Expectations Neutralize Keynesian Activism!

- Because people learn from their experiences, you can't fool them.
- Policy implication: Rational expectations render activist Keynesian policies completely ineffective so they should be abandoned!!!

An Example: Activist Monetary Policy

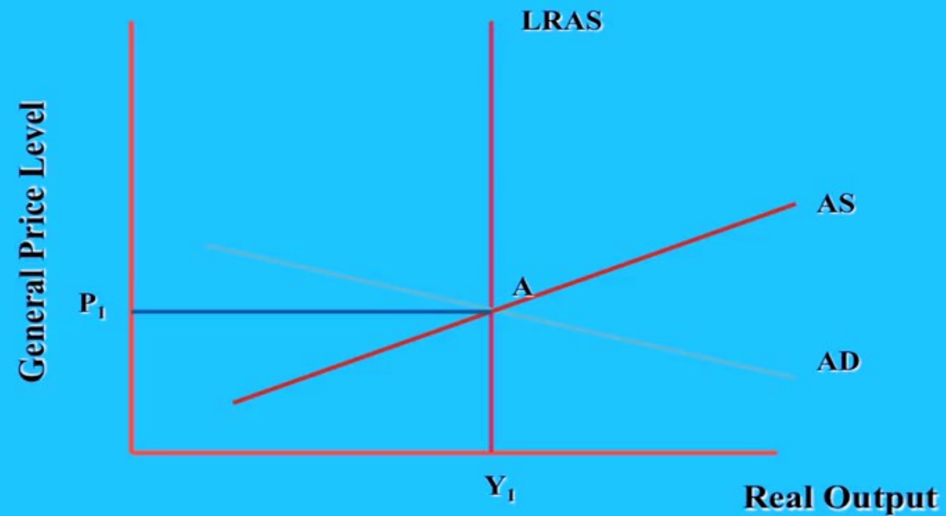
- Suppose the Fed expands the money supply to close a recessionary gap.
- Repeated experiences with such “easy money” have taught people to rationally expect more inflation.
- Businesses immediately respond by raising prices and workers demand higher wages.

Key Point
The attempted expansionary monetary stimulus is completely offset by inflation’s contractionary effects!

Example: Activist Fiscal Policy

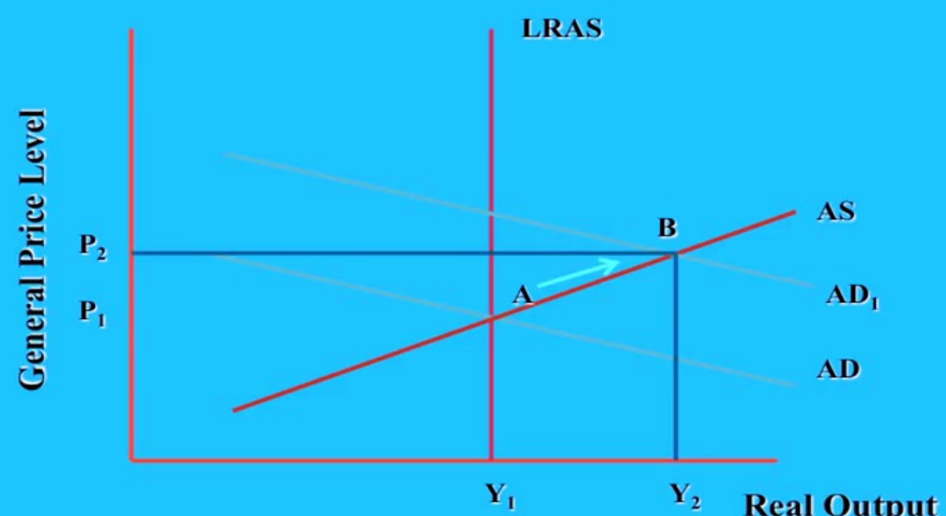
- Suppose the government increases spending to close a recessionary gap.
- People will anticipate a future tax hike to pay for the resultant budget deficit so they will save more and consume less.
- Reduced consumption will thereby offset the Keynesian government spending stimulus!
- Or so the New Classical argument goes

Example: We Start At Full Employment

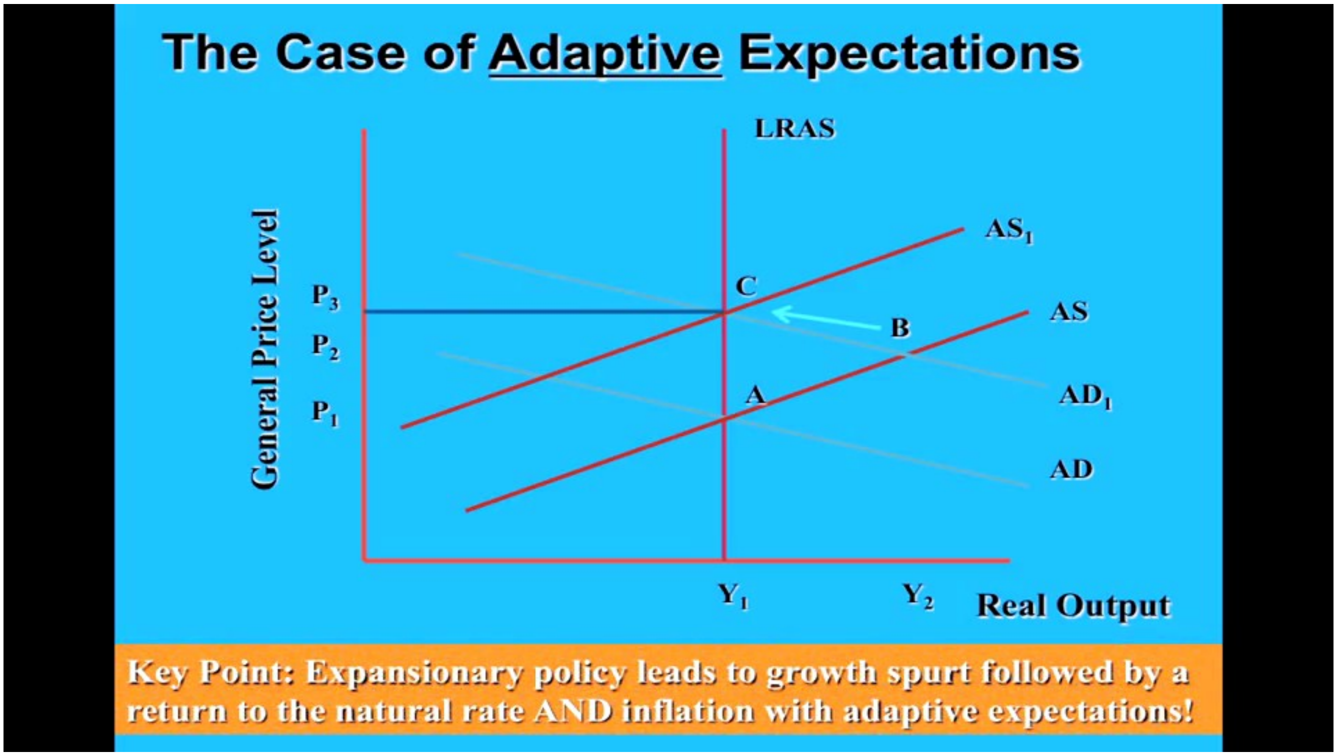


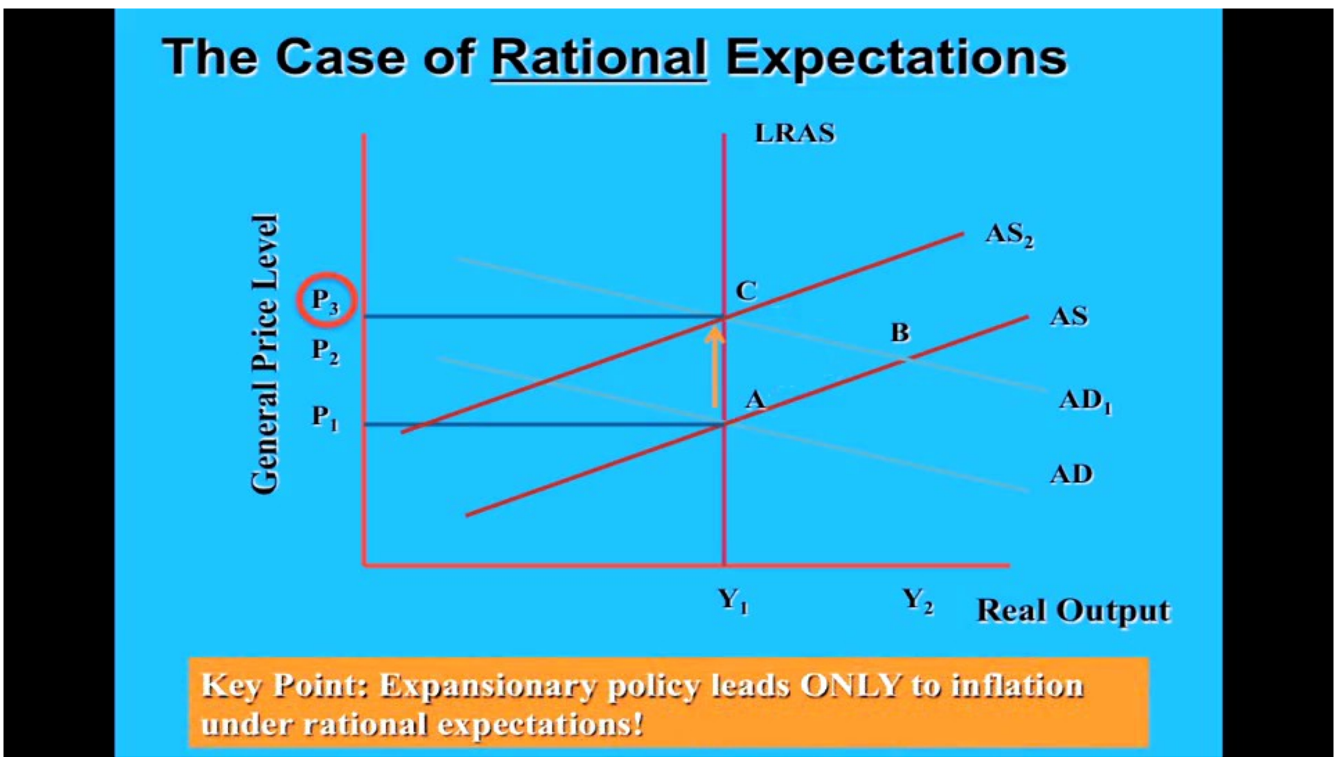
Suppose the government undertakes expansionary fiscal policy to increase output above the full employment rate.

The Case of Adaptive Expectations



Key Point: Expansionary policy leads to a growth spurt under adaptive expectations!


The Case of Adaptive Expectations
LRAS
AS1
AS
AD1
AD
C
B
A
P3
P2
P1
General Price Level
Y1
Y2
Real Output
Key Point: Expansionary policy leads to growth spurt followed by a return to the natural rate AND inflation with adaptive expectations!


The Case of Rational Expectations
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Real Output
Key Point: Expansionary policy leads ONLY to inflation under rational expectations!

A Critique of Rational Expectations

The Economics and Politics of the Theory

A Critique of Rational Expectations

- Critics say people are not as economically literate as the theory requires.
- Therefore, adjustments will not take place with the speed they are supposed to.
- This criticism should not detract from the central point of rational expectations:

Central Point
People's behavior may partially, or completely, counteract the goals of activist fiscal and monetary policies.

Good Economics is Bad Politics

- President George H.W. Bush learned a harsh political lesson relying on his New Classical advisors.
- His advisors flatly rejected any Keynesian "quick fix" to a deepening recession.

Bush's New Classical Advice

- More "stable and systematic" policies based on long term goals.
- No Keynesian "short-sighted discretionary reactions."

Bush Loses the 1992 Election

- Bush took the New Classical advice.
- The economy limped into the 1992 election.
- Bush lost to a Democrat in much the same way as Nixon lost to JFK.

Clinton Restores Confidence

- Bill Clinton actually did very little to stimulate the economy.
- However, his promise of more activism restored business and consumer confidence!

Congress Passes Deficit Reduction Bill

- This legislation sent Wall Street a clear signal Clinton was serious about budget balance.
- Restored business, consumer, and Wall Street confidence accelerated a recovery already begun by the end of Bush's term.
- A booming economy set the stage for Clinton's remarkably easy 1996 re-election.