The return of schools of thought in macroeconomics

Simon Wren-Lewis

University of Oxford
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Just five years ago, macroeconomists talked about a new synthesis, bringing together Keynesian and Classical ideas in a unified, microfounded theoretical framework. Following the Great Recession, it appears that mainstream macroeconomics has once again split into schools of thought. This column explains why macroeconomics, unlike microeconomics, periodically fragments in this way.

In the 1970s and 1980s, macroeconomics was all about ‘schools of thought’. A popular textbook (Snowdon et al 1994) had the title *A Modern Guide to Macroeconomics: An Introduction to Competing Schools of Thought*. Macroeconomists tended to take sides, and different schools had clear ideological associations. Antagonists often talked across each other, and anyone not already on one side just got totally confused. Schools of thought fragmented mainstream macroeconomics in a way that had no parallel in mainstream microeconomics.

But then things began to change. The discipline appeared to become much more unified. It would be going much too far to suggest that there was a general consensus, but to use a tired cliché, most macroeconomists started talking the same language, even if they were not saying the same thing. Goodfriend and King (1997) coined the term ‘New Neoclassical Synthesis’. Other authors wrote along similar lines (eg Woodford 2009 and Arestis 2007). This synthesis did only apply to what is generally described as mainstream economics. Heterodox economists continued to organise in schools (for example neo-Marxists, post-Keynesians, and Austrians).

The synthesis was reflected in master’s-level textbooks (eg Romer 1996), which would typically begin by setting out a Ramsey-style model, then discuss ‘real business cycle’ models, and finally move on to add sticky prices to get New Keynesian theory.

There were two main factors behind this synthesis. The first was microfoundations, ie deriving the components of macro models from standard optimisation applied to representative agents. This gave macroeconomics the potential to achieve the same degree of unity as microeconomics. The second was the development of New Keynesian theory, which allowed an analysis of aggregate demand within a microfounded framework, and which integrated ideas like rational expectations and consumption-smoothing into Keynesian analysis. All models were now ‘dynamic stochastic general equilibrium’ models.

Following the Great Recession, things seem rather different. In popular discussion of macroeconomics, schools of thought in macro are definitely back. Bitter disputes have broken out between those advocating fiscal stimulus (‘Keynesians’) and those against. (For just one example of such quarrelling, see DeLong 2012.) For those in freshwater departments like Chicago, the idea of an effective fiscal stimulus was something they thought had died with the rational expectations and New Classical revolutions. It must therefore have been something of a shock to see it being resurrected, and it is understandable that they might dismiss it as invoking long-discredited ‘fairy tales’. It looked as if 30 years of progress in the discipline was being ignored. Those advocating stimulus and deflating premature austerity, on the other hand, were understandably taken aback to find their analysis dismissed in this way. They thought they were using mainstream macroeconomic theory, not the partisan analysis of a Keynesian school of thought. In a recent Vox column, Jonathan Portes (Portes 2012) describes his puzzlement at being labelled Keynesian, when he thought he was following synthesis macroeconomics.
So why have schools of thought within mainstream macroeconomics returned? One simple story is that schools of thought are associated with macroeconomic crises, and macro synthesis follows periods of calm. Keynesian theory itself was born out of the Great Depression. The first Neoclassical Synthesis arose from the period of strong growth and low inflation in the postwar period. Monetarism gained strength from the rapid inflation of the 1970s. The more recent synthesis may be a child of the Great Moderation, and now we have the Great Recession, schools of thought have returned. Because these crises are macroeconomic, and there are no equivalent crises involving microeconomic behaviour or policy, then fragmentation of the mainstream into schools will be a macro, not micro, phenomenon.

However I think this is too simplistic a view of what is happening today. One interesting feature of the current divide is that the label ‘Keynesian’ appears to be used more by those opposed to certain policies – and in particular fiscal stimulus – than those on the other side. Typically Keynesians see themselves as putting forward synthesis analysis, without the need for branding. What has become clear is that the New Neoclassical Synthesis was in many ways a celebration of New Keynesian theory which was not shared by many freshwater departments in the US.

There may be good reasons why New Keynesian economists might have imagined that their analysis was now an uncontested part of the mainstream. In particular, it is used in nearly all central banks as their main tool in carrying out monetary policy. With monetary policy somewhat depoliticised through central bank independence, the successful implementation of New Keynesian theory during the Great Moderation allowed divisions among academic departments to remain dormant.

On the other side, there was a belief that New Classical economics had been revolutionary, ie a successful counter-revolution against Keynesian ideas. Once again there were good reasons supporting this belief. On consumption, rational expectations, the Lucas critique and more, traditional Keynesians had unsuccessfully opposed New Classical ideas. Furthermore, many of the leaders of New Classical thought did not want to update Keynesian thinking; they wanted to destroy it. The label ‘Keynesian’ was associated with much more than a belief that prices were sticky and that therefore aggregate demand mattered. Instead it became associated with state intervention. Wikipedia, in its third paragraph on ‘Keynesian economics’, says: “Keynesian economics advocates a mixed economy – predominantly private sector, but with a significant role of government and public sector…”.

The New Classical counter-revolution failed in one respect. While Keynesian analysis may have suffered a near-death experience, it survived and subsequently prospered. New Classical critiques led to fundamental and largely progressive changes. Yet, for many reasons including ideological ones, the would-be counter-revolutionaries did not want to give up their counter-revolution. Partly as a result, the degree to which New Keynesian theory was taught to graduate students differed widely among academic departments, at least in the US.

So, perhaps unlike the first (postwar) neoclassical synthesis, the New Neoclassical Synthesis was partial in terms of its coverage among academics. This incompleteness was not apparent during the Great Moderation, because in central banks the synthesis was uncontested. The fault lines only became evident when monetary policy became relatively impotent at the zero bound after the Great Recession, and fiscal stimulus was used both in the US and UK. Once that happened, what might be called the Anti-Keynesian school re-emerged.

Using this account, it is perhaps possible to view the current emergence of schools of thought as a historical aberration. The microfoundation of macroeconomics would seem to imply that mainstream macro should be as free from fragmentation into schools as microeconomics. As it becomes clear that the New Classical counter-revolution was not successful, the New Neoclassical Synthesis may yet become complete. (For an argument along these lines, see Economist 2012) After all, New Keynesian models are essentially real business cycle models
plus sticky prices, and the addition of price rigidity seems both empirically plausible and inoffensive in itself. Both sides could agree that for economies with a floating exchange-rate monetary policy is the stabilisation tool of choice, with fiscal policy only being used if monetary policy is constrained (Kirsanova et al 2009). When interest rates are stuck at the zero lower bound, synthesis models clearly show fiscal policy can be highly effective at stimulating output (Woodford 2011). What has been called ‘demand denial’ appears not to make academic sense, particularly at a zero lower bound (Wren-Lewis 2011).

This outcome may, however, represent wishful thinking by New Keynesians. An alternative reading is that the Keynesian/Anti-Keynesian division is always going to be with us, because it reflects an ideological divide about state intervention. That divide occurs all the time in microeconomics, but because it involves arguing about many different externalities or imperfections it does not lend itself to fragmentation into schools. In macro, however, there is one critical externality to do with price rigidity, and so disagreements about policy can easily be mapped into differences about theory. Demand denial is attractive because it gives a non-ideological justification for what is essentially an ideological position about economic policy. Unfortunately, there is a danger that dividing mainstream analysis this way makes macroeconomics look more like a belief system than a science.

Author’s Note: This column combines a number of recent posts from my blog, mainly macro.

References


