A Short History of Neoclassical Business Cycles: Part II

Author : James Annable

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The conclusion of last week's post deserves emphasis: "It should be made clear that, unlike the New Keynesians, Lucas – ever the rigorous theorist – has never been embarrassed about his rejection of forced joblessness. He correctly argues that the concept cannot exist in general-market-equilibrium modeling. His advice is to accept that fact, stop obsessing about unemployment, and continue to perfect [general-market-equilibrium] analysis absent involuntary job loss." The great architect of market-centric continuous-equilibrium macroeconomics that changed the course of the discipline insists that the proper conduct of research must often be divorced from recognizable cyclical behavior.

Given that state of the art, it cannot be sensibly argued, as many do today, that the modern friction-augmented general-market-equilibrium (FGME) model class is fundamentally finished theory. In particular, it is asserted that microfoundations research is no longer needed. Lucas's neoclassical market-centric program, restoring the importance of optimization and equilibrium, was a necessary step; but we surely cannot ignore that it never produced adequate stabilization-relevant theory. Insightful macroeconomists understand that we must get serious, even if only quietly, about replacing the FGME paradigm.

The fatal assumption of Lucas and dominant FGME theorists is badly misunderstood, treated as clearly wrong but innocuous, in the academy: All rational price-mediated exchange occurs in the marketplace. Nearly a half century after the neoclassical macro revolution upended the established Early Keynesian order, the GEM Project has worked through the implications of the generalization optimizing exchange from the marketplace to workplaces restricted by asymmetric employer-employee information. That research program has demonstrated that optimization and equilibrium in information-challenged workplaces require (i) more careful understanding of worker preferences and (ii) nominal labor pricing that both chronically exceeds market opportunity costs and is downward rigid over stationary business cycles. Fifty years after Lucas's organization of some cyclical behavior to be consistent with general market equilibrium, an alternative "equilibrium model of the business cycle" generally consistent with actual instability has emerged. While Lucas eliminates market disequilibrium, GEM Project analysis relies on general decision-rule equilibrium that easily accommodates cyclical and trend market disequilibrium and supports the derivation of much more useful stabilization theorems.

Moreover, close attention should be paid to capacity of generalized-exchange modeling to revive important parts of Keynes and Early Keynesian macroeconomics that Lucas unhappily pushed to the sidelines. From Lucas and Sargent (1979): "After freeing himself of the straightjacket (or discipline) imposed by the classical postulates, Keynes described a model in which rules of thumb, such as the consumption function and liquidity preference schedule, took the place of decision functions that a classical economist would insist be derived from the theory of choice." The Project has derived most of the derided Keynesian rule-of-thumb models from a rigorous theory of choice.

The bookend continuous-equilibrium macro models, featured in Parts I and II respectively, share two guiding principles. Both adhere to the fundamental neoclassical tenets of optimization and equilibrium. Both restrict expectations to be rational, i.e., rooted in the efficient use of available information. A critical difference is Lucas's rejection of the GEM principle that assumptions used in stabilization-relevant modeling should be aligned with the evidence. The great theorist most famously violates this principle when assuming, as he frequently has, that involuntary unemployment has no place in rigorous macroeconomics. His argument is valid only in special-case, artificial circumstances that restrict rational exchange to the marketplace.

The construction of the generalized-exchange model class has been more properly guided by four rules of engagement, offered here as necessary principles for doing macroeconomics in the context of highly specialized economies. First, agents should optimize well-specified objective functions. Second, the pursuit of those objectives is best organized around general decision-rule equilibrium. Lucas's criticism of Keynes for abandoning the "equilibrium discipline" has met the test of time. Third, trading arrangements that provide the framework for rational price-mediated exchange should be clearly specified. Fourth, the model can be used to advise stabilization authorities only if its important assumptions sufficiently correspond to relevant evidence. If not, the model may still be admitted to active debate and research but cannot be used for policy guidance. My argument is not that Lucasian macroeconomics should be banned for providing damaging advice. We made that mistake with the Early Keynesians with disastrous results for the profession. The realistic-assumption aphorism is much more limited: Do not use FGME theory to advise stabilization policymakers. It has proven itself much too unreliable for such serious purpose.

Despite my belief that work on FGME should continue, I must confess to frustration at its dominant – near exclusionary – position in the modern academic practice of macroeconomics. It would greatly improve the quality of today's analysis if theorists paid more attention to the evidence produced by actual behavior. My own professional career at the Fed, CBO, and legacy banks of JP Morgan taught me the value of an accurate reading of the economy and its prospects. Respect for actual behavior greatly enhanced my own model-building. That respect continues in the GEM Project. The second bookend of the history of neoclassical business cycles described above was constructed by business and government – not academic – theorists working on the generalization of exchange. Success in business economics especially requires useful real-world insights; stubbornly Lucasian chief economists would be fired for irrelevancy. Next week's third essay in this series elaborates on the general uselessness of modern mainstream macro theory when confronted with important real-world issues.

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