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Classical, Neoclassical and New Classical Theories and Their Impact on Macroeconomic Modelling

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Abstract

This study represents an incursion into the history of classical economic thought, aiming at capturing, from a personal perspective, the concatenation of the vision expressed by the partisans of the issued theories, outlining, on one hand, the existing similarities, reflected by common reference points such as the dichotomy between the nominal and the real factors of the economy or the self-adjustment of markets, as result of the absence of any rigidity at the level of price, wage and interest rate, and, on the other hand, the divergences manifested in compliance with the new realities of the time, like the microeconomic fundamentals-based macroeconomic analysis or the rationality of economic agents. The specific macroeconomic modelling is also briefly approached, focussing on the novelty elements launched and implemented during each stage of the studied period: the classical model of Smith, analysing the labour demand and supply, as fundamental equilibrium, the general equilibrium model of Walras, describing the economy by the aggregation of the individuals' behaviours, in the context of several interacting markets, or the real business cycle model, taking the attention away from the nominal interest rates, while orienting towards the real production factors of the basic classical model, and revealing the fluctuations caused by the real shocks to the business cycle.

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1. Introduction

In the humanity history, the economic thought has passed through various stages, marked by miscellaneous controversies. After a period of supremacy of the ancient and medieval conceptions, we assist to the emerging of modern theories: classical, neoclassical, Keynesian, neo-Keynesian, new classical and new Keynesian, to mention the most relevant.

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This paper is meant to follow the long way of classical thought, starting from the basic variant and going all along the new approaches, developed under the influence of the Keynesian thinking and of the real economy of the time, the economic classicism progressively acquiring new characteristics specific to certain theories totally unaccepted at its beginnings.

Classicism, unquestionably excluding the state intervention in economy and staking on the self-adjustment of markets, as result of the price, wage and interest rate flexibility, is followed by neoclassicism that generates a new vision regarding the perceived value of goods, launching the marginal utility concept, element with final impact on the decision of consumption or production of economic agents, respectively the new classical theory which, although having taken over the classical tradition regarding the equilibration of markets, contradictorily debates on the dichotomy between the real and nominal economic factors.

Such theories have left traces in the macroeconomic modelling area, so that, in 1776, we find the classical model of Smith, which, based on the results obtained at microeconomic level, analyses the labour demand and supply, as fundamental equilibrium, then, in 1870, the classical general equilibrium model of Walras, describing the economy by the aggregation of the individuals' behaviours. In 1970, we assist to the outlining of the new classical model, the real business cycle, which takes the attention away from the nominal interest rates, focussing on the real production factors of the basic classical model. Starting from the price flexibility hypothesis, it tries to reveal how the real shocks can cause fluctuations of the business cycle, the paper of Kydland and Prescott (1982) being deemed as a reference element of such theory.

2. Pure Classicism

The beginnings of economic classicism are marked by the conceptions of Adam Smith, who reorients the economy focus from the protection of one's own interest to the support of the entire nation's interest, starting from the premises that price, wage and interest rate flexibility creates the conditions necessary for equilibrating the markets, at full employment.

The market self-adjusts providing economic stability, the state intervention being necessary only to ensure the free operation of markets and a balanced budget. We assist to the progressive development of a thinking system in a context dominated by perfect competition, without protectionist restrictions and in the absence of any form of monopole or unfair competition. The economy succeeds in continuously reaching the natural level of GDP, its self-adjusting mechanisms laying the grounds for quick rebalance in case of steady state deviations.

Full employment, key element of pure classicism, is deemed to be characteristic to any freely functioning economy. Even in disequilibrium standings, with some unemployment level, the equilibrium is re-established by lowering the wages, naturally resulting in an increase of the labour demand and, therefore, in the reset of the initial equilibrium. Equilibrium is also obtained in case of inequalities between the level of savings and investments. The lowering of the investments weight in total available incomes diminishes the demand for money and leads, indirectly, given the intention to stimulate it, to a decrease of the interest rate, thus becoming attractive for any potential investors who would re-establish the market equilibrium.

Save for the free market theory, two other issues reflect the basic classical economic thinking, namely the law of Say and the Fisher's quantitative theory of money.

The Say's law suggests that, while reaching a certain level of real GDP, any economy tends to generate also the necessary incomes to procure it, therefore creating the premises of a demand high enough to equal the obtained production, covering in this way the natural level of it. Even if a part of the income is oriented towards other destinations than the acquisition of goods and services, therefore lowering the demand in relation to the supply level, followed by the supply adjustment and, as a consequence, by underemployment, the economy will be subsequently directed either to consumption or to investments, which, as components of gross domestic product, would help the market in regaining its equilibrium.

According to the classical economists, money does not exert influences on the real economy, it being neutral. Thus, the real factors of the economy, such as the production level, employment and consumption, are not concatenated with the nominal ones, like the level of price, wage or exchange rate, reflecting the well-known classical dichotomy in the matter. In this regard any increase of money supply, as reflected by Fisher, would be transposed into a generalised increase of prices, not into production surplus (Snowdon & Vane, 2005, pp.69-70).