

## New theoretical foundations for economic policy

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**Abstract.** *For four decades, economics has been confronted with two major flaws: the large theoretical gap between macroeconomic and microeconomic analysis, and the growing rates of both inflation and unemployment. Research seemed divided between two opposite approaches, searching for a new theory to solve the macro imbalances in modern economies.*

*In this context, we start with the analysis and evaluation of the main theoretical contributions during the past decades: rational expectations, market-clearing models and rigidities. Then we investigate how this considerable theoretical progress has managed to influence economic policies. The theoretical part of the paper uses formal analysis and synthesis, comparison and interpretation regarding recent progress in economics. In the second part, we bring empirical evidence from several countries to point out the impact of these developments at the policy level. We conclude that today the ideological division seems to have vanished; new theories don't follow a strict ideology. Theoretical research has integrated microeconomic principles into macro analysis and has addressed the macroeconomic implications of imperfections.*

*By contrast, policy-makers still use the outdated IS-LM model together with the modern Phillips curve, they still use complex macroeconomic models for forecasts, which suggests that theoretical progress has had little impact on applied macroeconomics.*

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During the '60s, the large macroeconomic models used by economists would describe the economy through a system of equations – one for consumption, one for investment, one for the money demand etc. – each of these being derived from the decisions of firms or individuals. This approach was attractive because the models were explicit and clear from a mathematical point of view, and the equations parameters could be estimated using the solid econometric tools constructed and perfected during the post war period. They were considered unanimously as fitting the US economy model and were used to solve economic policy problems, primarily the influence of monetary policy on production, inflation and unemployment. At the same time though, economic research had created a gap between macroeconomic analysis and microeconomic principles and economists needed to investigate the relationship between the micro and macro levels, in other words, to provide solid microeconomic foundations for macroeconomics.

This apparent consensus that dominated economic thinking until the 8<sup>th</sup> decade was much along the lines of the Keynesian doctrine. However, since the early '70s, a state of turmoil has characterized economics – and particularly macroeconomics – causing the consensus to break down. Essentially, this breakdown was due to two major flaws, one empirical and one theoretical. The empirical flaw was that the mainstream view could not adequately cope with the rising rates of inflation and unemployment experienced during the '70s. The theoretical flaw was that the mainstream view continued to preserve a chasm between macroeconomic practice and microeconomic principles. These theoretical and empirical failures led to a period of confusion and division in economics, which, in part, still continues today (Rogojanu, Badea, 2011). Consequently, much of the economic research of the past 20 years has attempted to build macroeconomics on a firm microeconomic foundation; economists have focused on formulating macroeconomic theories founded on sound microeconomic principles; the most important outcome of these attempts was, by far, the so-called "rational expectations revolution", one of the few hypotheses in recent economic research, almost unanimously accepted by economists. Unfortunately, the relevance of theoretical research to current economic issues is often neglected, if not completely ignored. (Enăchescu et al., 2012). Too many practitioners, the research endeavours appear esoteric, or even useless, and in many respects, research seems indeed futile for practical purposes.

A relevant synthesis of the directions of macroeconomic research divides these directions into 3 main categories (Mankiw, 1988); the classification is very useful, in that it provides a better understanding of the motivations and goals of the research programmes undertaken by macroeconomists during the past four

decades. We discuss these directions of research, bringing forth their advantages and disadvantages, as well as the pros and cons for each category.

▪ **Microeconomic foundations and rational expectations**

Following Lucas' (1976) attack on standard macroeconomic practice – which focused on the improper manner of dealing with expectations – economists' first task was to find ways to approach the predictions of rational economic agents. At the beginning of the New Classical revolution, many economists believed the existing models could be “repaired” quite easily, by replacing the current approximations and estimations of expectations with the RATEX hypothesis. But this vision proved too optimistic, so that the main goal of the New Classical revolution was to rebuild macroeconomics starting from microeconomic principles regarding agents' preferences and technology. To attain this goal, the New Classical School maintained the assumption that economic agents have optimizing behaviours, and that markets tend towards equilibrium.

A major part of recent research has been trying to model expectations in a more “satisfactory” manner than 30 years ago. Once the attention of macroeconomists turned to the central role of expectations, economists focused on rebuilding macroeconomic theory, to take into account the way private decision-makers form expectations appropriate to their environment. The incorporation of expectations into existing econometric models can lead to new and surprising implications at the macroeconomic level. The wide acknowledgement of this axiom has probably been the most important achievement in macroeconomics during the past three decades. In essence, just as we agree that firms maximize profits and consumers maximize utility, it would be absurd to reject the assumption that individuals behave rationally when making predictions about the future.

By itself, the rational expectations hypothesis has no direct empirical implication, just as the assumption of utility maximization has no direct empirical implication. Yet, together with other auxiliary hypotheses – like the example presented above regarding monetary policy – it can have profound and startling implications. But the most important consequence of the rational expectations “revolution” is that it replaced the work on the large-scale macroeconometric models of Keynesian inspiration, which prevailed at that time.

Expectations are not new in economic analysis, but the most important feature of the RATEX revolution is the introduction of the term “rational” (Barro, 1984). This places its opponents in a rather awkward position: to reject the rational expectations hypothesis is to claim that economic agents are irrational. However, the evidence points out that the RATEX hypothesis has been accepted by and large, by most economists. Its decisive victory is attested by the fact that many of

the new Keynesian models have incorporated it, while maintaining wage or price rigidities.

In the same paper, Barro asserts that the use of rational expectations in macroeconomics is closely connected to one of the most controversial issues debated by economists – monetary neutrality. A relevant example is the New Classical business cycle theory, which postulates that the incomplete information available to economic agents on the money supply and the general price level can lead to monetary non-neutrality. In other words, a shift in the money supply will result in temporary confusions between the general price level and the relative prices of goods, which, in turn, will lead to shifts in output and employment. Some versions of this business cycle model lead to the conclusion that the real effects of monetary disturbances persist long enough to correspond to the cycles observed in national economies. Moreover, the rational expectations assumption has surprising implications for monetary policy: systematic policy measures are irrelevant to rational economic agents, while unpredictable, inconsistent measures even tend to have harmful effects.

Another important issue regarding the micro foundations of macroeconomics refers to the role of rational expectations in the – often political – Keynesian debates. At least implicitly, many economists consider that the valid hypotheses of rational expectations theory are incompatible with the Keynesian framework; however, many New Keynesian economists have incorporated rational expectations into their macroeconomic analyses. According to Barro, this theoretical endeavour is still not enough to support monetary non-neutrality, to improve the Keynesian theory, or to eliminate its theoretical and empirical flaws. The Keynesian model is nothing short of an incomplete theory that provides numerous policy prescriptions, but preserves considerable inconsistencies with individuals' rational behaviour. In particular, so far, no economist has been able to use such elements as the cost of information or that of labour mobility – which provide feasible explanations for market coordination failures – in Keynesian analyses. At the same time, Keynesian models still preserve important deficiencies regarding inflation and supply shocks – which are, in part, responsible for the dissatisfaction generated ever since the '70s.

To conclude, we can rightfully ascertain that today, the rational expectations axiom represents the standard approach in empirical research and is used in the analysis of numerous and various issues – such as labour demand and supply, consumption, investment, stock accumulation, to name just a few. And even though these new techniques are unlikely to replace the outdated econometric models completely, they have become quite an important empirical tool.

Very few economists on the other hand, stand against rational expectations; these economists claim that while the RATEX assumption is indeed valid, economists should also consider and explore other premises. They acknowledge the importance and the essential role of expectations in current economic analysis, especially those expectations which are not mere generalizations of past experience. In the particular case of political science, expectations are not a new issue, but they have been introduced recently in economic science and their use still has unexplored consequences. Despite being a New Classical economist, Herbert Stein (1988) considers that by incorporating rational expectations into economic analysis, we venture upon slippery ground, because we don't know either what determines individuals' expectations, or how they can be influenced. The main objection raised by the RATEX opponents is that it often leads to different – even conflicting – opinions by different economists, meaning that its premises are not rigorously defined and we lack precise quantitative information on the pattern of rational expectations. This high degree of uncertainty can be reduced by adopting strict rules of monetary policy. But this is not a feasible solution; economists need further investigations in order to provide a “more scientific” foundation for expectations.

▪ **The market-clearing model**

An important theoretical approach attempts to explain macroeconomic phenomena using New Classical models – or *market-clearing* models – which start from the premise that prices adjust continuously to equilibrate supply and demand. The view that markets always clear is closely related to the idea that private markets function efficiently. Specifically, on cleared markets, it is impossible to improve on any outcomes by matching potential buyers and sellers of goods or potential borrowers and lenders: cleared markets already accomplish all of these mutually advantageous trades. Market clearing reflects the optimizing behaviour of individuals, which is related to the microfoundations of the macroeconomic model. On the one hand, people determine their individual choices of work, consumption and so on, to make themselves as well off as possible. On the other hand, market clearing means that people who participate on the market – and are guided by the pursuit of their own interest – do not waste resources, and therefore achieve efficient outcomes. Recent research has pointed out more profound implications than 40 years ago, when disequilibrium models were prevalent in macroeconomic analysis.

As to the concept of equilibrium, in accordance with microeconomic principles, New Classical economists start from the assumption that certain conditions must be fulfilled when we add up the actions of all individuals. These conditions are usually referred to as “aggregate consistency” conditions and they refer to: (i) the

equality between the quantities demanded and supplied on the goods market; (ii) the equality between the amounts borrowed and lent and (iii) the equality between money demand and money supply. These three conditions provide information on how aggregate variables must behave, so that the analysis may have internal consistency. Any viable macroeconomic model must comply with these conditions, and one way to ensure this is to assume that markets tend towards equilibrium, in other words the price level and the interest rate adjust simultaneously, so that aggregate demand and aggregate supply become equal (Dobrescu et al., 2012). This approach, known as the *market-clearing* model, is founded on Walras' Law and refers to the equality between demand and supply on the goods market and on the monetary market.

In Robert Barro's vision, the market-clearing model can be depicted as follows:

- for the goods market, the equilibrium condition is:

$$Y(R, \dots) = C(R, \dots),$$

where  $Y$  and  $C$  are the aggregate supply and the aggregate demand, and  $R$  is the interest rate.

On the goods market, only the effects of the interest rate on aggregate demand and aggregate supply are taken into consideration; thus, *a higher rate of interest implies intertemporal substitution effects, which reduce current demand  $C$  and increase current supply  $Y$* , through the increase in the amount of labour supplied. However, there are other variables that influence demand and supply, such as the substitution and income effects induced by the shift in the production function. These variables are omitted from the analysis – they are marked accordingly by dots in the demand and supply functions.

The central idea behind the goods market equilibrium is that, starting from this equality, we can determine the equilibrium levels of the interest rate and of output.

- for the monetary market, the equilibrium condition is:

$$M = P \times L(R, Y, \dots)$$

where  $M$  is the money supply,  $P$  is the price level and  $L$  is the demand for money

In real terms, money demand –  $M/P$  – is in a direct relation to current demand  $C$  and in an inverse relation to the interest rate; in the money demand equation, it is therefore convenient to replace current demand by current supply, since they are equal when the goods market is in equilibrium.

In this manner, starting from the two equations, we can determine the levels of the equilibrium interest rate and price. First of all, the equality between supply and

demand on the goods market allows for the determination of the interest rate  $R^*$  and then for the determination of output and aggregate consumption  $Y^* = C^*$ . Then, by substituting the values of the interest rate  $R^*$  and output (aggregate supply)  $Y^*$  in the money demand equation, when the money supply  $M$  is given, we can determine the general price level corresponding to equilibrium on both markets. In this manner, we do not need to know the price level in order to determine the interest rate. The simplicity and originality of the procedure derives from the fact that the price level is not part of the first equation, which focuses on the goods market; in other words, the *price variations do not modify the demand and supply curves*. This is the simplified market-clearing model in Robert Barro's vision.

On the basis of this model, we can subsequently analyze the shifts – either temporary or permanent – in the production function. The author also demonstrates how a temporary reduction in the production function leads to a decrease in output and a simultaneous increase in the interest rate and the price level; at the same time, the effect on labour supply is undetermined. If the shift in the production function is permanent, on the other hand, the interest rate does not rise, but remains constant; the explanation is that the interest rate is a signal showing the cost of using resources at present rather than the future. When the decrease in the production function is temporary, we deal with the relative scarcity of present goods compared to the future, and a superior interest rate is justified, since it determines people to consider the present relative scarcity in choosing their levels of consumption and work effort. On the other hand, a permanent decrease does not alter the present situation compared to the future and the interest rate remains constant, because the cost of using resources at present compared to the future is constant. Another important implication of this model is monetary neutrality: a once-and-for-all change in the aggregate money supply will affect the nominal variables, but will leave the real variables – such as output and employment – unchanged.

Economists often use the word *equilibrium* when they refer to the market-clearing model; this is not however, the best choice: the term equilibrium has had so many connotations throughout time, that its significance has become at least ambiguous, if not confusing. To name just one example, some economists regard the Keynesian model as a disequilibrium model, whereas others approach it as a different concept of equilibrium. Apart from such controversies, economists generally agree on the basic features of the market-clearing model. First of all, the model postulates that private markets function efficiently. On these markets, each participant may buy or sell as much as they wish at the equilibrium price level; on the other hand, a possible improvement of their functioning by matching additional sellers and buyers is practically impossible, because markets already

incorporate all the mutually profitable trades. Furthermore, the model is closely connected to the optimizing behaviour of individuals, which lies at the microeconomic foundations of macroeconomics. Thus, on the one hand, economic agents adopt decisions regarding their choices of consumption and work effort, decisions that will best satisfy their needs and interests; on the other hand, the market-clearing model postulates that agents that operate on the market and are guided by their own interests, do not waste resources and therefore, achieve efficient outcomes. In this manner, the market-clearing model becomes the natural macro-complement of the microeconomic principles underpinning it.

This brief presentation of the model cannot leave out its practical utility, namely the importance of its approach at the macroeconomic level. In this context, it is worth noting that once the theoretical apparatus has been constructed, the basic model can be developed and extended so as to be applied to numerous macroeconomic issues. The most important of these issues regard the study of supply shocks and business fluctuations, of the labour market, of long-term economic growth, of the role of public acquisitions and public services, of monetary and fiscal policies, and last, but not least, of globalization.

#### ▪ **Nominal and real rigidities**

The third category – specific to New Keynesian models – tries to rebuild macroeconomic theory, using a non-Walrasian approach which combines the IS-LM diagram with the modern version of the Phillips curve, adapted to rational expectations. This direction of research can be considered as an attempt to provide Keynesian analyses the microeconomic foundation they lacked. The term “Keynesian” however, is so vast, that we can rightfully assert the only feature uniting Keynesian theories is the hypothesis that economic fluctuations do not reflect the Paretian response of the economy to shifts in preferences and technologies, but rather a market failure on a grand scale. The most frequent explanation is the failure of prices and wages to adjust instantly to equilibrate supply and demand. This was the key assumption of Keynesian theories during the ‘60s, but the lack of a proper theoretical justification was one of the fatal flaws that undermined the consensus in economics.

Another important criticism – coming from the New Classical School this time – points out that the nominal rigidities assumption is incoherent from a theoretical point of view: not only does this assumption lack micro foundations; it is also inconsistent with all pertinent microeconomic hypotheses. The New Keynesians however, believe they have neutralized this argument, since research has progressed beyond the microeconomic foundations: today we do not question whether these models can be constructed, but rather, whether they describe



economic reality correctly (Frâncu, Hociung, 2012). In this context, the New Keynesians' research endeavours are focused on three main directions:

- The first direction focuses **on small nominal barriers to price adjustment**. So far, economists have undertaken relatively few studies of price adjustment at the firm level, and the results are somewhat ambiguous, and some of them quite contrasting. Moreover, they stand out through the idiosyncratic character of both firms, and the goods under analysis, and therefore, we cannot be sure that studies of different firms or of different goods will generate similar conclusions. In short, economists have not yet managed to figure out either the strategies and price policies of firms, or their adjustment mechanisms.

Knowing the precise nature of the microeconomic barriers to price adjustment is all the more important, as they seem to have considerable implications at the macroeconomic level. On the other hand, Caplin and Spulber (1987) provided an example in which the microeconomic costs of the adjustment process failed to produce aggregate nominal rigidities. The authors' vision was founded on two key assumptions: (i) all adjustments are made in the same direction, that is all prices increase, and (ii) all firms increase their prices only when aggregate demand increases by a certain fixed amount, compared to the previous price adjustment. Based on these two assumptions, the authors demonstrate that the share of firms that actually make the adjustments may vary – relatively to the size of nominal shocks – in such a manner, that the real gross product in the whole economy will remain unchanged.

Other assumptions regarding the microeconomic characteristics of nominal obstacles have, however, very different implications on aggregate macroeconomic behaviour. For instance, the time factor is very likely to play an important role within firms' adjustment policies; this means that, to a certain extent, firms are more likely to adjust their prices with a time lag, rather than right after an increase in demand. If these price policies are associated with considerable real rigidities, then the effects of nominal disturbances will not only be large, they will also be long-lasting. In this case the share of firms that do modify prices at one point reacts only slightly to nominal shocks, and the existence of real rigidities determines firms to undertake only small price changes (Blanchard, 1982). Taking into account that the characteristics of firms' price adjustment policies decisively influence the macroeconomic effects of nominal shocks, we can conclude that analyzing adjustment barriers is undoubtedly a pressing topic on economists' research agenda.

- The second direction of research is focused on the study of **real rigidities**. If we accept the hypothesis that demand shocks can have substantial real effects – and not just on nominal prices – then it means that there exist a series of factors

which determine firms to seek only small adjustments of relative prices, in response to the demand-induced shifts in aggregate output. The analysis of these real rigidities must clarify the reasons why large shifts in output and employment are accompanied by merely small shifts in real wages. In this context, the active topics in current research include: *efficiency wage* models, market externalities, capital market imperfections, the cyclical evolution of demand elasticity, and a variety of other potential sources of real rigidities.

- Last, but not least, the third direction of research starts from the observation that studying microeconomic phenomena – such as adjustment difficulties or real rigidities – turned out to be insufficient to explain large shocks in the economy; therefore, it is necessary to correlate these rigidities with the **macroeconomic phenomena** which they underpin and which we want to understand. Understanding the way microeconomic characteristics and principles generate macroeconomic phenomena is in itself a realistic purpose for economists. But this undertaking cannot itself become synonymous to unifying the micro and macro levels of the economy: more often than not, simplifications that prove extremely useful in understanding microeconomic phenomena can lead to fatal mistakes in analyzing macroeconomic fluctuations.

Therefore, the third direction in recent theoretical research focuses on the examination of macroeconomic evidence regarding the effects of monetary disturbances and other aggregate demand shocks. Analyses that place aggregate demand shifts at the heart of business fluctuations have been an issue of major interest in economic research for a long time; and taking into account the difficulty and importance of the problem they try to deal with, they will certainly remain so for a long time to come.

If we admit that individual price adjustments are not synchronized, then the general price level will only increase if some firms want to increase their relative prices. Once the general price level has completely adjusted to the increase in the money supply, and supply and demand have returned to their initial levels, the relative prices targeted by producers will also reach their previous levels; but this only happens at the end of the adjustment process, resulting in a very important implication: the adjustment speed of the general price level depends on the elasticity of relative prices desired by producers to the shifts in demand. The larger this elasticity, the stronger producers' desire to raise prices, hence the faster the increase in the general price level, and consequently, the shorter the effects of money supply on prices. This observation usually takes the following form: in order to explain the substantial nominal rigidity of prices, additional real rigidities are required – such as this low elasticity of the prices desired by producers to the shifts in demand.

The above implication is extremely important, since it points out to the existence of an interaction between nominal rigidities and other types of imperfections in the economy. If such imperfections are in a position to generate real rigidities – which is still questionable – then they can contribute to the explanation of the substantial nominal rigidities manifested in modern economies.

### Implications of recent theoretical progress on economic policy

As we can see, the theoretical progress ever since the '70s has indeed been considerable. But what happened in practice, did the evolutions in the field of policy actually keep up with the theoretical achievements? Economists generally agree that, in opposition to the radical changes of vision in academic thinking, practitioners have not radically changed the way they analyse the economy and continue to use the outdated IS-LM model together with the modern version of the Phillips curve in the formulation of economic policy (Mankiw, 1990). Governments continue to use extremely complex macroeconomic models for forecasts and interpretations, which suggests that the theoretical evolutions of the past four decades have had little impact on applied macroeconomics.

The 7<sup>th</sup> and 8<sup>th</sup> decades represented a prolific period for economic research, marked by the endorsement of important theoretical insights, particularly in macroeconomics: the approaches of rational individual behaviour, the simple relationship between monetary creation and price increases, the natural rate of unemployment and the strategic role of aggregate supply were all generalized during this period. All these analyses converged towards the denigration of interventionism and the reduction of states' role in the economy. While the Keynesian revolution founded economic policies on the strategic role of aggregate demand – which implied the analysis of uncertainty and anticipations – the new theoretical trends and streams actually represented a liberal retaliation. Most importantly, this counter-offensive was not merely theoretical, it was also put into practice through the political orientation of decision-makers and through the liberal economic policies of developed countries adopted in the '70s. Two renowned political figures are most commonly associated with the institution of liberal regimes in the developed world: former UK Prime Minister Margaret Thatcher, and former US president Ronald Reagan. Moreover, following the conferences held in the UK, Nobel-prize economist Milton Friedman proposed a shock therapy for the British economy, inspired, in part, by that applied in Chile (Friedman, 1977). Among other things, this shock therapy implied the acceleration of privatization and de-regulation, which were implemented starting from 1979. In the USA, President Reagan criticized the increased role of interventionism and the neglect of monetary policy, claiming that governments'

task should be limited to building a solid and stable framework for the long run, in which the private sector must constitute the main engine of growth, employment and improved life standards. To this aim, the main objective was to improve economic performance by reducing the role of the federal government, particularly by avoiding past economic “*stop and go*” policies, since – by adopting a short-term approach – they aggravated the existing imbalances. These political evolutions triggered heavy criticism from post-Keynesians, institutionalists, radicals, Marxists and other heterodox economists, but they were also condemned by the neoclassical synthesis economists, who constantly denigrated monetarism, particularly in its political upsurge.

The distinctive feature of the monetarist school and the real source of conflicts however, is not the monetarist theory itself, but the role it should play in the formulation of stabilization policies. The opponents of monetarism subscribe to the general practical message of Keynes’ General Theory: that free market economies need to be stabilized, can be stabilized and have to be stabilized by means of monetary and fiscal policies. By contrast, monetarist economists believe that economic stabilization by state intervention is not necessary. And even if it were necessary, it could not be done, since stabilization policies are more likely to enhance than reduce stability and governments should not trust they have the ability to implement such policies.

Another attack on monetarism came from the monetarists’ very own disciples and took a quite different shape: these economists, who share the monetarists’ political vision, were even more radical about state intervention. But they criticize both Monetarist and Keynesian economists for the lack of theoretical rigour, particularly in what regards the microeconomic foundations of their macroeconomic models. The analyses undertaken by the New Classical economists started from Friedman and Phelps’ reflections on the long-run Phillips curve and unemployment and led to the rejection of traditional econometric models and of the traditional theory of economic policy (Lucas, 1980b). Both traditional Monetarist and Keynesian models rely on the premise that economic agents adopt behaviour patterns that are invariable to economic policies and, more importantly, to shifts in economic policy. Using this line of reasoning, the models are not able either to foresee or to explain the effects of the huge budget deficits and money supply increases on output, employment and prices experienced during the ‘70s. Taking into account that the structure of an econometric model consists of optimal decision rules and that these rules vary systematically together with the shifts in the structure of the decision-making apparatus, it means that every policy change will systematically modify the structure of econometric models. Under these circumstances, any economic policy to stimulate aggregate demand that is anticipated and systematic cannot have any effect whatsoever on

production and unemployment. This theoretical formulation belongs to New Classical economists Th. Sargent, R. Wallace and R. Barro and is usually referred to as the theorem of neutrality or of policy inefficiency. Policy decision makers react depending on economic circumstances, whereas economic agents end up adapting their behaviour accordingly. The deviation of the real unemployment rate from its natural rate derives from random shocks, not from authorities' systematic policies.

One of the first – and most controversial – consequences of rational expectations was that systematic monetary policy is irrelevant to the evolution of consumption levels and of the unemployment rate (Sargent, Wallace, 1975). In formulating this conclusion, they applied rational expectations theory to the new version of the Phillips curve, as depicted by Friedman and Phelps in 1968. The latter questioned the validity of the long-run Phillips curve, while admitting that the inflation-unemployment trade-off might work over the short-term (Friedman, 1968 and Phelps, 1968). The explanation was that in the short run, agents could be fooled to make more investments by the increased money supply, but in the long run, they would realize their purchasing power diminishes and decrease production, thus reducing output and employment to their previous levels. Further on, using this model of the Phillips curve, Sargent and Wallace claimed that while anticipated inflation did not influence output and employment, unanticipated inflation might reduce the unemployment rate below its natural level. The role of the rational expectations axiom is essential: in essence, this axiom states that economic agents cannot be surprised by events that occur in a uniform and consistent fashion. Starting from this observation, Sargent and Wallace argue that systematic monetary policy can only generate anticipated inflation and therefore, is not in a position to influence the level of unemployment, in other words, it is inefficient. The bold conclusions of Sargent and Wallace generated confusion and ambiguities, in that economists interpreted the inefficiency of monetary policy as the direct and exclusive consequence of rational expectations theory. Today we are aware however, that things are not as simple as that: in the late '70s, Fischer (1977) demonstrated the possibility to construct rational expectations models, where systematic monetary policy can result in economic stabilization; thus, Fischer's model, in which wage rigidity plays the central role, provides Keynesian policy prescriptions, while integrating the rational expectations assumption at the same time.

The analyses of the New Classical economists are very diverse from a theoretical point of view, and they formulate numerous implications for economic policy. Sargent actually denied that we could speak of a proper rational expectations school as designating a group of economists with a unique economic model and a common vision on optimal monetary and fiscal policies. But we can however,

identify a common attitude towards economic policy. In this respect, the New Classicals' positions are radical and marked by absolute scepticism towards the efficiency of interventionist policies. The New Classical economists consider that it suffices to formulate stable, clear, well known rules of policy. Lucas (1980a) formulates these rules, stating that they are just an amendment of Friedman's previous work on the monetary and fiscal context of stabilization policy. Thus, the first rule refers to the institution of a stable growth rate of money supply for each year. The second rule refers to a rate of public expenses and transfers that does not vary – in real terms – throughout the cycle. Finally, the third rule refers to fixed tax rates, whose objective is to equilibrate the budget over the long term. To these three rules, Lucas adds a fourth: a clearly formulated policy, where the prices and wages set by means of private agreements between economic agents will not generate governmental action in any way. These rules are thus, minimal rules. In a way, the best economic policy, in the New Classical approach, is the absence of economic policy.

Departing from the traditional Keynesian theory, a New Keynesian on the other hand, can also share the Monetarists' or the New Classicals' reluctance to state intervention. However, most of the research of New Keynesian economists shows that the normal functioning of monetary economies – which implies perfect rationality of economic agents – does not lead to the stability and equilibrium postulated by the Monetarist and the New Classical models. As a consequence, most New Keynesian economists do believe that state intervention can indeed improve the functioning of the economy. The problem is to find the suitable policy, by choosing between alternative economic measures.

In conclusion, a major part of macroeconomic research during the past 4 decades has been trying to deal with the problems that triggered the “crisis” in economics. Economists have focused upon founding their macro theories on sound microeconomic principles. In the search for a new paradigm, interdisciplinary research and new methods of economic analysis play an important role. Unfortunately, the relevance of research to the current economic problems is often neglected and there seems to be a large gap between theoretical progress and economic practice, as economists have failed to incorporate the new contributions into their policies. Economists still use the large econometric models based on the IS-LM diagram and the modern version of the Phillips curve. Macroeconomists should try to abandon the old ways and incorporate the new theoretical developments into their policies. Instead of holding on to outdated policy prescriptions, they should be more innovative in their thinking, address the causes of the business cycle and correlate them with the proposed remedies.

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