Book Review Column


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Macroeconomics is in a state of flux. Of that there can be no doubt. And that is about the only thing in macroeconomics about which there can be no doubt. A new two-volume book edited by Gregory Mankiw and David Romer adds more doubt to what Keynesian macroeconomics is. It reprints thirty-four recent articles that the editors classify as New Keynesian Macroeconomics.

The two-volume collection is divided into seven sections, each with about five articles in it. It is preceded by a 17-page introduction by the editors which surveys the articles, surveys the series, and summarizes the editors’ view of New Keynesian economics.

The volumes are part of an MIT series designed to “help students and other potential researchers come rapidly to the frontier by providing carefully selected collections of readings in areas in which rapid progress has recently been made.” (Vol 1, p. x.) Whether these volumes on New Keynesian belong in such a series is questionable. While there has been enormous activity on the New Keynesian front, there is little agreement about whether that activity is progress.

There are many good articles in this collection, but, in my view, they do not fit together and make a coherent whole. The primary reason why is that the editor’s definition of New Keynesian economics is so broad that almost all macroeconomic work, other than New Classical, falls into their definition. With such a broad definition, the concept New Keynesian has little meaning.

The editors define New Keynesian economics in relation to two questions about a macroeconomic theory:
1. Does the theory violate the classical dichotomy?
2. Does the theory assume that real market imperfections in the economy are crucial for understanding economic fluctuations? (Vol. 1, p.2.)

They write. “Among the prominent approaches to macroeconomics, New Keynesian economics is alone in answering both questions in the affirmative.” (Vol. 1, p.2.) This statement would be news to most Keynesians I know, be they post-Keynesians, Neo-Keynesians, or just plain Keynesians. All would answer those questions affirmatively and thus would be New Keynesians. I know a number of them who would not like that.

Mankiw and Romer accept that “many older macroeconomic theories rejected the classical dichotomy” (I, for one, don’t know of any Keynesian macroeconomist who doesn’t reject that dichotomy), so it is the second part of the definition that Mankiw and Romer use to separate New Keynesians from other types of Keynesians. They give little support for their definition; in the one line of justification they do give to the second characteristic they retreat, writing “[Keynesians] usually did not emphasize real imperfections as a key part of the story. For example, most of the Keynesian economists of the 1970s imposed wage and price rigidities on otherwise Walrasian economics.” The ambiguity here is enormous; they do not say who “most of the Keynesian economists of the 1970s” include, or what Walrasian economics is, nor do they make it clear whether it is real or nominal wage and price rigidities which were imposed. I assume they are referring to the work of economists such as Barro and Grossman and Malinvaud, but, having studied macroeconomics in 1970s, I can assure the authors that such work is far from what “most Keynesians” studied or believed during that time. Thus their definition is neither clear nor defining, but is, instead, vaguely inclusive, best reminiscent of some of the definitions of what Post Keynesians (with and
Perhaps recognizing this ambiguity, Mankiw and Romer follow their positive definition with a negative definition of what New Keynesians are not. Here they say that New Keynesians do not necessarily believe in Keynesian activist policy, and that "much of new Keynesian economics could also be called new monetarist economics." (Vol. 1, p.3.) When one can replace "Keynesian" with "monetarist," the nomenclature has become hopelessly confused and is of little use. Frank Knight is reported to have said that Keynes said some things that were new and some things that were true but unfortunately the things that were new weren't true and the things that were true weren't new. A similar statement holds for these volumes. The book includes much that is new and much that is Keynesian; unfortunately the things that are new aren't Keynesian, and, except for one section, the things that are Keynesian are not new.

Because of this ambiguous definition instead of providing a map to the frontier, the introduction to these volumes provides a scrambled jigsaw puzzle. The book may lead readers to the frontier of macroeconomics, but it plops them there in uncharted territory rather than giving them some insight into that frontier and a sense of what is really going on.

This is not to say that frontier is not interesting or relevant; the articles in the volumes are both. Both the connections between the articles, why this collection of articles deserved to be called "New," and how the articles modify previously-held ideas is unclear.

What is missing is a sense of history, a sense of how Keynesian thinking has evolved and how, while the Keynesian research program has focused on particular aspects, the Keynesian vision has remained, at least until recently. That vision was one in which the aggregate economy was marked by instability which the government possibly could alleviate through collective action. The problem for Keynesians has always been how to model that vision formally. The term "Neo Keynesian" developed because a number of Keynesians felt that the formal model used by many Keynesians - the modified IS/LM model in which real wage rigidities caused unemployment - deviated significantly from Keynes' ideas and they wanted to distinguish it from Keynesian economics. Similarly with the term "Post Keynesian;" it developed because a group of economics has a different formal model to describe the aggregate economy. Unfortunately, in practice, the term "Post Keynesian" was used much more inclusively and it was never quite clear to non-Post Keynesians (and many post-Keynesians) exactly what the Post Keynesian model was. (On this side of the Atlantic, Post Keynesian generally referred to Weintraub's, Davidson's, and Eichner's models.)

Since I am partially responsible for creating the term "New Keynesian," I feel somewhat guilty about its misuse (Koford and Colander 1985, Colander 1986). I started using the term because I wanted a term which distinguished from other Keynesians the work of those Keynesians who were trying to provide a Keynesian answer to New Classicals. My distinguishing characteristics of New Keynesian economists were that their models were consistent with rational expectations and were developed in a multimeter Walrasian framework, but did not employ the New Classical market clearing assumption. My definition ruled out all neo-Keynesians and many other older Keynesians who felt that neither the Walrasian framework nor rational expectations belonged in the Keynesian research program. I stated that modeling techniques, as much as anything else, differentiated New Keynesians from other Keynesians.

I now regret my earlier definition which, while less vague than that of the editors of this collection, was nonetheless too vague and inclusive to be helpful to anyone trying to make sense of where the work currently being done in macroeconomics belongs in relation to other Keynesian work. I now realize that it is fundamentally important to make an even narrower definition. For something to warrant the prefix "new," it must substantially differ from previous work in how its ideas translate into a textbook model. Most of the articles in these volumes do not meet that test. Most fit as easily into various Neo-Keynesian models. For work to be usefully classified as New Keynesian, I now believe that it must meet the following criteria as well as those I previously listed: It must have Keynesian roots and be reducible to a formal model of the aggregate economy which differs substantially from previous Keynesian models.

Of the seven parts of the book, only one part, Part IV, belongs firmly in what I would now define as New Keynesian economics. The others are part of a broader research program designed to explore microfoundations of macroeconomics. This broader research program is as much a part
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of neo-Keynesian tradition as it is a part of the New Keynesian tradition, and (I apologise) it might best be called "new neo-Keynesian." Its practitioners try to add a micro foundation (generally a partial equilibrium micro foundation) to neo-Keynesian economics.

Part I on costly price adjustment, which includes Mankiw's work on menu costs, falls within this category, as does Part II on wage and price adjustment, which includes papers such as the Fischer and Taylor papers on staggered wage contracts. So too with Part III on imperfect competition, which the editors describe as fitting a New Keynesian theme that "deviations from perfect competition may be crucial for understanding economic fluctuations." As I stated above, there's nothing particularly New Keynesian about this theme; any Keynesian (and most other economists) accepts it. These papers provide some micro foundations for macro but since the micro foundations they provide are not a revolutionary step away from the existing paradigm, they cannot usefully be called new. They are, at most, inching away from the existing model. Such inching away may fall within the advertising parlance of "new" (i.e., the new improved Tide), but not within a meaningful concept of new.

The majority of the papers in the sections on the labor market, the credit market, and the goods market also do not fall within in New Keynesian economics, but for a different reason than the earlier papers. They are revolutionary but they are not Keynesian.

A key idea in the papers in this section is seen in the Stiglitz, et al., and Akerlof papers. The theme running through these papers is that in a world of incomplete, asymmetrically distributed, information, prices serve an informational role as well as an allocative role. Thus prices, wages, and interest rates are set at a level that will screen individuals and provide information about them and this will not be at a level where supply equals demand. Stiglitz and Weiss summarize the results of these models as follows:

The Law of Supply and Demand is not in fact a law, nor should it be viewed as an assumption needed for competitive analysis. It is rather a result generated by the underlying assumptions that prices have neither sorting nor incentive effects. The usual result of economic theorizing, that prices clear markets, is model-specific and is not a general property of markets - unemployment and credit rationing are not phantasms. (Vol. 2, p. 277.)

These papers warrant a "new" label, not a Keynesian label. They might be called Stiglitzian, Akerlofian, Spencerian, or perhaps Akerlitzian, but they have little relation to Keynesian. They are contributions to the theory of markets. They explore a type of equilibrium unemployment and credit or borrower rationing which is serving an informational function and is not dysfunctional in the sense that most older Keynesians conceive of unemployment and credit rationing. They are new but they are not Keynesian.

This leaves one section of papers that I believe deserves to be called "New Keynesian." That section concerns coordination failures. The papers in this section ask the Keynesian-type questions about the nature of aggregate equilibrium, but they do it by theorizing about the problems rational individuals in an economy would have in reaching an equilibrium. Unlike the Akerlitzian contributions, no informational role of prices is assumed. The key insight in these papers is that in the aggregate, major coordination failures are likely even if people have rational expectations.

This work follows in the Lerner-Clower-Leijonhufvud strand of Keynesians that most older Keynesians agree is not in Keynes but is in the Keynesian tradition. It has closer connections to post Keynesian models than it does to neo-Keynesian. This section includes the papers which deserve to be called New Keynesian. The Diamond and Shleifer models in this section nicely show how multiple equilibria come about and Woodford's paper provides a good summary of this coordination failure literature.

As I argued in Colander (1987), before New Keynesian work will be generally accepted it must be translatable into a simple textbook model which differs from the standard textbook model. The coordination failure work can be translated into a textbook model with Keynesian roots, and thus deserves a New Keynesian classification. The key insight of these papers is the Keynesian insight that aggregate supply and aggregate demand are interconnected. Not only does aggregate supply create some of its own aggregate demand but so, too, does the expectation of aggregate demand create aggregate supply. Because of this
interconnection, in the aggregate, economies face a bootstrap problem in which the equilibrium depends upon expectations.

Models of interconnected aggregate supply and demand lead to multiple equilibria and self-fulfilling expectations. These models are quite consistent with Keynes' vision, although they are not consistent with their Walrasian formal roots, they are not consistent with Keynes' exposition. They are not consistent with neo-Keynesian models which have a single equilibrium. Thus this work qualifies for the name New Keynesian.

The novelty of these coordination failure papers does not pop out to the reader because the authors of these papers do not attempt such a translation; they do not relate their contribution to the Neo-Keynesian model and hence do not show the way in which their multiple equilibria differ from neo-Keynesian models.

The key insight of these models which needs to be carried over to the simple model concerns aggregate supply, not aggregate demand. Whereas the neo-Keynesian model portrays Keynesian economics as a demand-based model, these New Keynesian models portray Keynesian economics as both a supply and demand based model. Specially, supply depends on aggregate demand in some fashion. Thus the defining element of New Keynesian economics is a change in the nature of the production function to include a coordination factor. (See Colander 1986, 1991).

The change can be most easily understood by considering the standard neo-Keynesian derivation of the aggregate demand curve from the IS/LM model. That derivation assumes that the IS curve represents aggregate demand only; thus one requires a separate theory of aggregate supply. New Keynesian economics sees the IS curve as representing a goods market equilibrium and thus already embodying an implicit theory of aggregate supply. This follows because in these models supply is determined simultaneously with demand; it is a psychologically based supply and is dependent on aggregate demand in some fashion. Thus whereas the neo-Keynesian economist sees movements along the normally derived aggregate supply curve as supply responds to disequilibrium, the New Keynesian economists sees shifts of the aggregate supply curve. This accounts for the multiple equilibria. To arrive at a formal New Keynesian model one must specify how aggregate supply depends upon aggregate demand.

New Keynesian models maintain a role for monetary and fiscal policy even with rational expectations because they provide an alternative path through which monetary policy and fiscal policy affect the real economy: monetary and fiscal policy affect aggregate demand and thereby affect aggregate supply, which further affects demand and so on. Thus, New Keynesian models bring the multiplier process into the analysis, not in a mechanical way, but in a psychological expectational way. The multiplier process is individually rational, but collectively irrational. Because of this different interpretation New Keynesian models cannot be presented in the normal AS/AD textbook model in which AS and AD are independent; they require showing the interconnection between AS and AD.

There is much the New Keynesian papers reprinted in this volume have not explained and the papers of many of the economists, such as Clower, Davidson, Leijonhufvud, Lerner, and Startz, who would be considered fundamental to this interpretation of New Keynesian are not included in the collection. Thus, the collection does not provide much of a roadmap to the frontier.

The frontier of New Keynesian economics is in that work which is exploring how money fits into multi-market model and how the short run and steady-state equilibria relate. Specifically, New Keynesian economics must explain why the economy often equilibrates at a reasonably high level and does not fluctuate enormously. (One possible explanation is provided by Leijonhufvud [1981]). Another of the frontiers on New Keynesian economics concerns how to integrate alternative coordination failures. Interdependent aggregate supply and demand curves are not the only ways in which coordination failures can occur. Elsewhere (Colander 1992) I have described an alternative coordination failure which could occur in steady state equilibrium in a monetary economy, and I suspect there are many others. In short, New Keynesian economics is still in its infancy.

Nonetheless, this work on coordination failures deserves to be called "New Keynesian" because the questions it poses are macroeconomic questions which fundamentally different than that of the questions posed by neo-Keynesians. New Keynesian models need not explain deviations from full employment; such deviations are inherent in their premises of uncoordinated interdependent expectations. New
Keynesian models must explain the opposite: why an economy is often at, or close to, full employment. In short, New Keynesian economics has a long way to go, and, except for one section, this collection does not help lead the way.

Notes
1. About the same time that I started using it, Michael Parkin, and probably others, started talking about New Keynesian models.

References


