INTRODUCTION

Modern macroeconomics seems to be radically different from what it was twenty years ago. The change has come about largely through the endeavours of new classical economists and is a reflection of the fact that 'dynamic economic theory [...] has simply been reinvented in the last forty years.' This reinvention was confined initially to pure general equilibrium theory, but macroeconomic theory has now undergone the full impact of these innovations, with the result that Lucas (1987) is able to claim that the dynamic general equilibrium model of Kydland and Prescott (1982) is an example of how empirical macroeconomics should be conducted. It is essentially a generalized version of this claim that is the subject of this article.

In correspondingly general fashion we can view the new classical method as a return to 'the discipline imposed by classical economic theory, a discipline imposed by its insistence on adherence to the two postulates (a) that markets clear and (b) that agents act in their own self-interest.' It is argued that these two axioms of rationality and equilibrium can be usefully employed to explain, for instance, business cycle phenomena, if and when they are incorporated in explicitly dynamic models. As Lucas and Sargent (1981iii) write:

'When Keynes wrote, the terms "equilibrium" and "classical" carried certain positive and normative connotations which seemed to rule out either modifier being applied to business cycle theory. The term equilibrium was thought to refer to a system at rest [...].

In recent years, the meaning of the term equilibrium has changed so dramatically that a theorist of the 1930's would not recognize it. An economy following a multivariate stochastic process is now routinely described as being in equilibrium, by which is meant nothing more than

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that at each point in time, postulates (a) and (b) above are satisfied. [...] The new classical models still assume that markets clear and that agents optimize; agents make their supply and demand decisions based on real variables, including perceived relative prices. However, each agent is assumed to have limited information and to receive information about some prices more often than other prices. On the basis of their limited information [...] agents are assumed to make the best possible estimate of all of the relative prices that influence their supply and demand decisions.  

The key concepts to be discussed, then, are clear: rationality and equilibrium, information and (rational) expectations, and the microfoundations of macroeconomics supplied by dynamic general equilibrium theory. I shall discuss them from the point of view of the theoretical economist, which is not to say that empirical considerations will be absent in the sequel. On the contrary, economics is an empirical science and the two-fold fundamental objective for the theoretical economist is therefore (i) to form inductively, on the basis of empirical evidence, concepts which are demonstrably appropriate representations of basic traits of economic reality – and (ii) to employ these concepts in the, once again, inductive, formulation of hypotheses and theories which purport to explain actual economic processes and which can, subsequently, be put to further empirical tests. The main ‘empirical’ question I shall be addressing pertains to the first partial objective: do the key new classical concepts represent economic reality satisfactorily? Since I am not convinced that this question should be answered affirmatively, I pay much less attention to the adequacy of new classical theories as explanations of reality. The reader looking for a survey of the, by now extensive, literature relevant to this topic will be disappointed, but what follows is a logical preliminary: an answer to the question of whether undertaking such a survey is worthwhile at all.

2 RATIONALITY AND EQUILIBRIUM

The business cycle is the unfolding of a dynamic general equilibrium path of a stochastic economy. This is the basic claim of new classical theory. It was a very contentious one initially. After decades of Keynesian ‘disequilibrium’ modelling of macroeconomic fluctuations, the return to the twin classical axioms of rationality and equilibrium was certainly a radical move and one that seemed to be at odds with engrained ideas about the stylized facts as well. During the fifteen years which have passed since the publication of Lucas’ seminal article on equilibrium business cycle theory the controversy surrounding the use of the general equilibrium method has gradually died down. Equilibrium

4 Lucas (1972).