3 Neoclassical Macroeconomics Reproposed

3.1 THE NEOCLASSICAL THEORY OF A MONETARY ECONOMY: THE WALRASIAN MODEL

In reviewing Keynesian macroeconomic theory we established that it is divided into three phases: (1) the reconstruction of the traditional view; (2) criticism; and (3) the proposal of an alternative model. The debate on the theoretical innovations in Keynes's work also involves all these three phases. Patinkin's contribution to the debate (Patinkin, 1965) can be regarded as a re-elaboration of the so-called Pigou effect but it would be a restrictive view because it ignores the importance of phases (1) and (2). Patinkin, like Keynes, starts from a reconstruction of the neoclassical point of view, but his analysis is a criticism of the reconstruction Keynes made.

In Keynes's reconstruction of the classics we can say that

(a) the theory of employment is the result of the partial equilibrium analysis of the labour market;
(b) Say's law is used to justify a methodology which ignores interdependence; and
(c) a macroeconomic approach lacks microeconomic foundations, particularly in the quantity theory.

Patinkin's contribution changes the perspective. He purposely adopts the Walrasian point of view, which is based on individual motivation. The system, therefore, is the reflection of simultaneous action of all agents and the interdependencies reflect multiple markets. Consequently, since the economic system is no longer analysed as if it were a single market, a model of a monetary economy comparable to the one we drew for the traditional neoclassical theory can be reconstructed by starting from individual actions. First a barter economy is described. Then by adding the quantity theory of money to the barter economy, a monetary economy is obtained. The result is a
system where the real forces are separated from the monetary forces. In addition, the system provides a basis for the doctrine of money as a veil which affects only nominal quantities (and not real quantities).

When the idea of classical dichotomy is viewed against the background of the general equilibrium theory, it becomes clear that the primary cause of the dichotomy is an unsound theoretical foundation. It can be shown mathematically that the dichotomy is created by contradictory conditions. This becomes evident when the markets are regarded as reflections of individual behaviour. The reasoning is as follows.

In Walrasian microeconomics, rational individuals maximise a utility function \( U(q_1, q_2, \ldots, q_n) \) under the budget constraint. The variables in this function are only physical goods \( q_i \). From first-order conditions for a maximum we can draw zero-degree homogeneous demand functions which — given Walras’s law — imply that the excess demand for money must be a one-degree homogeneous function. This contradicts the quantity theory of money (Patinkin, 1965, pp. 475–6; see also, Chiriciello, 1983; Grandmont, 1983).

Patinkin indicates how money can be integrated into the theory of consumer choice by abandoning the classical theory of money and assuming the utility function
\[
U = U(q_1, q_2, \ldots, q_n, M/P, B/rP)
\]

This function includes variables which are both physical quantities of goods \( q_i \), and real quantities of money \( M/P \) and bonds \( B/rP \). The latter are included in the utility function for two reasons. First, it is assumed that money and bonds provide direct services to the individual so that he can avoid the inconvenience of default on payment at the right time. Second, only the real values of both money and bonds (that is, their effective purchasing power) are considered because rational agents do not suffer from money illusion. They consider money and bonds as instruments for transferring desired purchasing power to the future. From this enlarged set of choices, we obtain the following individual demand functions (for goods, money and bonds) which depend on the price of goods and interest rate as well as on the real stock of money initially held:
\[
q_i^d = q_i^d (p_1, \ldots, p_n, r, \bar{M}/P) \quad (i = 1, \ldots, n)
\]