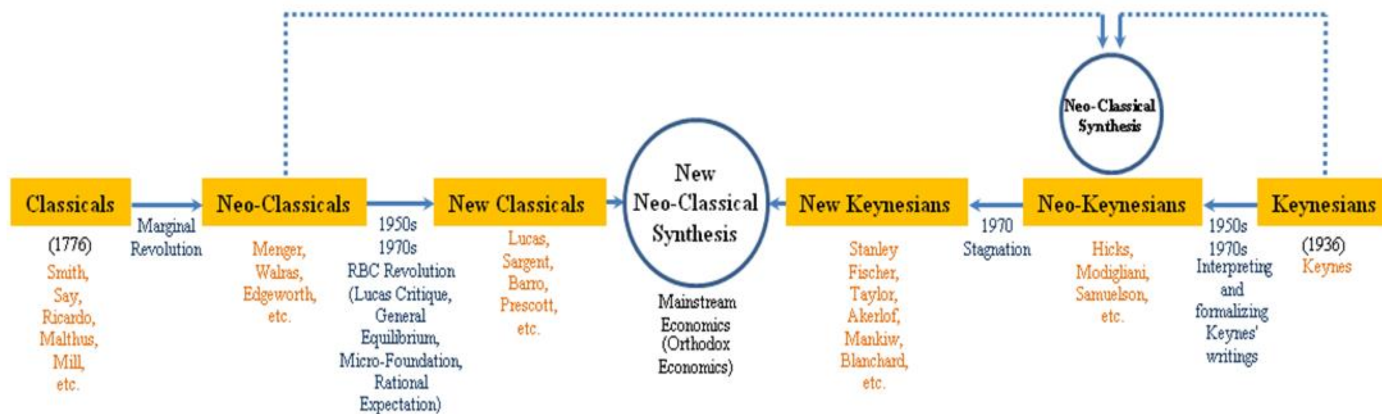
Major Schools of Economic Thought (from Seyyed Ali Zeytoon Nejad Moosavian. 2018. *Classicals Versus Keynesians: A Comprehensive Table to Teach 50 Distinctions,* Conference Paper)

between Two Major Schools of Economic Thought

A school of economic thought is a group of economists who share common ideas about economic philosophy, hold similar opinions on how the economy functions, and usually apply similar methodologies in their analyses. The main schools of economic thought that have emerged in the past few centuries include Classicals, Neo-Classicals, New Classicals, Keynesians, Neo-Keynesians, and New Keynesians, which can be classified under the two broad categories of Classicals versus Keynesians. Figure 1 exhibits the evolution process of the two major schools of economic thought as well as that of the new neo-classical synthesis, and summarizes a sequence of momentous events occurred in the course of the formation of these schools of economic thought.

Figure 1: A visual describing the evolution of the two major schools of economic thought and the new neo-classical synthesis, and summarizing the major events occurred in the formation of these schools of economic thought



According to Blaug (1987), **classical economics** (aka liberal economics) affirms that markets perform best with minimal government intervention. This school of economic thought was established in the late 18th and early 19th century by classical economists such as Adam Smith, Jean-Baptiste Say, David Ricardo, Thomas Robert Malthus, and John Stuart Mill. Adam Smith's (1776) seminal book, entitled "An Inquiry into the Nature and Causes of the Wealth of Nations," is regarded as the bible of classical economics. The main idea of his influential book is the fact that the wealth of nations, which is indeed their productive capacity, is formed on the basis of trade (free exchange of value) and not gold or other natural resources. The main difference between classical economics and modern libertarian economics is the role that they consider for the government in providing for public goods and managing common resources. Classical economists assert that markets generally regulate and adjust themselves, and often have a tendency to move towards equilibrium through an "invisible hand." They believe in the notion that private incentives are aligned with societal well-being maximization under certain competitive conditions (Blaug, 2008).

Neoclassical economics is a school of economic thought that primarily focuses on the determination of goods, outputs, and income distributions in markets from the perspective of supply and demand (Campus,

1987). This determination is generally facilitated through a utility constrained maximization by individuals and profit maximization by firms given a cost function, which technically contains information on a production function, available information, and factors of production. The transition from classical economics to neoclassical economics is usually called the "marginal revolution," and has been made through the works done by economists such as William Stanley Jevons, Carl Menger, and Leon Walras.

New classical economics is a school of macroeconomic thought that conduct macroeconomic analyses fully on a neoclassical framework, and emphasizes the significance of rigorous neoclassical microeconomic foundation (i.e. micro-foundations, e.g. optimizing agents), and rational expectations, resulting in the introduction of Real Business Cycle Theory and RBC models. New classical economics is in contrast with the original Keynesian economics and Neo-Keynesian economics (to be briefly introduced in what follows), which mostly provided ad-hoc analyses, and lacked micro-foundation. New classical economics is also in contrast with new Keynesian economics (to be briefly introduced below) that uses Keynesian micro-foundations, such as nominal price rigidities and imperfect competition to create new versions of macroeconomic models, which in principle are still in line with the original Keynesian models.

Keynesian economics is a school of economic thought formed primarily based on the various existing theories about how economic output (i.e. aggregate supply) is strongly influenced by aggregate demand in the short run. Keynesian economists claim that aggregate demand can be influenced by multiple factors, and sometimes can behave very erratically, and consequently affect the levels of output, employment, and inflation (Jahan and Papageorgiou, 2014). In fact, they mean aggregate demand is not necessarily equal to the productive capacity of the economy, as argued by classical economics, and that there could be disequilibria and inefficient macroeconomic outcomes, which can be avoided or, at least, moderated by active economic policy responses, such as countercyclical monetary policy and/or countercyclical fiscal policy in order to stabilize the output level in the economy over business cycles. Keynesian economics has its original roots in John Maynard Keynes's (1936) influential book, entitled "The General Theory of Employment, Interest and Money," which founded macroeconomics as a separate branch of economics. Keynes' ideas were in contrast with those of the aggregate supply-focused classical economics preceding him.

Neo-Keynesian economics is a school of macroeconomic thought that was initially developed in the post-war period from Keynes's seminal book. This school consists of a collection of economists, such as John Hicks, Franco Modigliani, and Paul Samuelson, whose main objective was to interpret and formalize Keynes' ideas in a standard, conventional manner in economics. Subsequently, they synthesized those thoughts and ideas with the neoclassical economic models, and formed the so-called neo-classical synthesis, and created the models that shaped the fundamental ideas of neo-Keynesian economics. Keynesian economics together with Neo-Keynesians economics served as the standard macroeconomic model in the developed countries during 1940s–1970s, but they lost their popularity in the aftermath of the oil shock and stagflation of the 1970s (Fletcher, 1989).

In the 1970s, the appearance of a sequence of events, such as the introduction of stagflation as a newly-emerged economic phenomenon, called into question the neo-Keynesian theoretical predictions. Then, a series of new ideas (e.g. utilizing a microeconomic basis, or the so-called micro-foundation, in macroeconomic analyses) was put forth to bring novel tools to original Keynesian and Neo-Keynesian analyses, so that the **new Keynesian models** can explain the newly-emerged economic phenomena and events of the 1970s. The resulting school of thought was called new Keynesian economics, which, together

with new Classical economics, subsequently helped the creation of the so-called “new neoclassical synthesis,” which presently forms the mainstream macroeconomics (Goodfriend & King, 1997; Mankiw, 2006; Woodford, 2009).

As mentioned before, these six schools of economic thought can be classified into the two broader categories of **Classicals** versus **Keynesians**, each of which encompasses its three respective schools.