



School of Economics and Finance

ECON 403 ADVANCED MACROECONOMIC THEORY B

Trimester One 2005

COURSE OUTLINE

Contact Details

Lecturer and Course Coordinator: Dr. Chia-Ying Chang

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Office Hours: Tuesday 2:30-3:30pm & Appointments

Class Times and Room Numbers

Class Time: Tuesday 11:30am-2:30pm
Location: RLWY 224

Prerequisite: ECON 305 and QUAN 201
Final Examination Period: May 30th – June 18th

Course Objectives

The objective of ECON 403 and ECON 402 is to provide an in-depth understanding of modern macroeconomic theory. ECON 402 focuses on developments in New Classical and Real Business Cycle macroeconomics while the emphasis in ECON 403 is on Non-Walrasian and New-Keynesian macroeconomics, including analysis of the macroeconomic implications of quantity constraints, imperfect competition, explanations for and implications of nominal rigidities, real rigidities, financial market imperfections and hysteresis.

ECON 403 can be broadly described as examining a Non-Walrasian approach to macroeconomics. This approach allows us to describe rigorously states of an economy for which, in the absence of a "Walrasian auctioneer", either demand and supply do not match in all markets or if they do, the resulting equilibrium is crucially affected by information deficiencies, the presence of imperfect competition, etc. The course commences with a review of traditional Keynesian theories of macroeconomic fluctuations and goes on to examine the modern micro foundations of imperfect information and monopolistic

competition in product, labour and financial markets and their implications for the macroeconomy and business cycles.

In order to solve the central problems of New Keynesian macroeconomics, several mainstreams have been taken, such as *costly price adjustment* and *staggered price*. *Imperfect competition* has more recently been considered as an explanation for macroeconomic multiplier processes. In this approach market power enables firms to influence price and profitably set price above marginal cost. Imperfect competition typically gives rise to a Pareto-inefficient equilibrium in which there is too little output and employment. These models exhibit Keynesian-type multiplier processes which depend on the degree of competition. Prices are nevertheless flexible.

There is considerable evidence to show however, that prices and wages are "sticky". The next part of the course examines possible micro-foundations for price and wage rigidity and the macroeconomic implications. A number of themes emerge from this literature. One theme involves the problem of coordination of price-setters and the presence of *nominal price rigidities* and *price and wage staggering* and the way this can influence the transmission of aggregate demand movements to real output. When there are "menu costs" of price adjustment it may be optimal for firms to maintain nominal price in the presence of demand shocks but this decision may be sub-optimal from a social welfare perspective – individual firm decisions can contribute to an *aggregate demand externality*.

We first consider these ideas in the context of a static monopolistic competition based macro model. The basic model can be extended to consider dynamic implications of time-dependent pricing rules, staggered pricing and the effects of monetary policy. Another theme is the dynamic implications of state-dependent pricing rules and the potential for nominal demand shocks and monetary policy to have asymmetric effects on prices and real output. The presence of asymmetric price and output reactions has potentially important policy implications.

Real price rigidities can contribute to nominal price rigidity. Real price rigidity refers to the idea that goods, labour and financial markets differ in important ways from the market-clearing paradigm and are essential for explaining why changes in demand are accommodated by quantities rather than by changes in relative prices. Explanations of real price rigidities also provide rigorous foundations for the explanation of involuntary unemployment, excess production capacity, etc. The efficiency wage model of the labour market is one example.

Information asymmetries and the presence of "lemons markets" is an idea that provides micro-foundations for real rigidities and for the potential existence in financial markets of *credit rationing*, a *credit channel* for monetary policy, and a *financial accelerator*. This developing literature provides another explanation for the Keynesian multiplier processes, but one which is based on conditions prevailing in financial markets.

The preceding topics illustrate that the presence of information asymmetries, lump-sum adjustment costs, monopolistic competition, learning-by-doing provide micro-foundations for multiplier effects and business cycles. But they may also result in *hysteresis* being associated with business cycles. This idea can be examined in the context of the labour market, fixed capital investment and the impact of exchange rate volatility on exporting.

In the discussion of these ideas, primary emphasis will be on theory and relevant empirical research, but the policy relevance of theory and issues arising from empirical evidence are also given attention. Despite a long history, the debate concerning the appropriate *stabilization role of fiscal policy* remains a lively one. In large part this debate swings on views about expectations, the micro-foundations of the macro-economy as well as political economy issues. The final section of the course examines the contemporary debate surrounding the role of fiscal policy and the contemporary role of monetary policy.

Course Content

	Topic
Week 1	Introduction
Week 2	Costly Price Adjustment
Week 3	Staggered Price
Week 4	Imperfect Competition and Macroeconomic Fluctuations
Week 5	Coordination Failures
Week 6	The Goods Market
Week 7	The Money Market (Monetary Search-Theoretical Theory)
Week 8	The Credit Market
Week 9	The Financial Accelerator
Week 10	Labor Market, Growth and Search
Week 11	Stabilization Policy: Monetary Policy
Week 12	Stabilization Policy: Fiscal Policy

Readings

All books listed are on closed reserve in the Library. All journal articles not included in any listed book are on closed reserve in the Periodicals Department of the Library
Chapters from the following books will be prescribed for this course:

1. (BF)Blanchard, Olivier Jean, and Stanley Fischer (1989), *Lectures in Macroeconomics*, Cambridge, The MIT Press.
2. (R) Romer, David (1996, 2001), *Advanced Macroeconomics*, New York, McGraw-Hill/Irwin. (Note: First edition (1996) does not have include the Chapter 11 on “Budget Deficits and Fiscal Policy”).
3. (MR) Mankiw, Gregory and David Romer (1991), “New Keynesian Economics, Cambridge, MIT Press.
4. Economic Journals (e.g. American Economic Review, Journal of Economic Theory...etc.)

Other useful text:

- (HV) Ben J. Heijdra and Frederick Van Der Ploeg (2002), "The Foundations of Modern Macroeconomics", Oxford Press.

(..) denotes the abbreviation of the book

**A detailed reading list will be distributed separately on the first day of the class.

Materials and Equipment

Students will not be allowed to use machines, such as computers or electronic devices in examinations.

Assessment Requirements

There will be 12 meetings during the semester. The topics are listed above and the materials are shown below under “Topics and Reading List”. You will be expected to read the relevant literature before each meeting and take part in class discussion. Occasionally you will be asked to briefly review and comment on some parts of the prescribed reading.

You are required to submit an answer to two short assignments and one essay of about 3000 words (the topic can be chosen from the content in page 3 of this outline, and a detailed instruction will be provided on the first day of the class). Due dates are specified below. Any late submission is subject to 50% discount. Unlike the situation that exists in undergraduate papers, your final grade will be determined on the basis of your overall performance in the Honours programme. However, as a guide to the allocation of your efforts, the assessment in ECON 403 will be based on:

20% for assignments (due **March 22th** and **May 17th** 11:30am in class)

20% for the essay, due **May 10th, 4pm, via email in PDF format.**

60% for the final two-hour examination (May 30th –June 18th, 2005).

Penalties

Students must be aware that any late submission is subject to 50% discount.

Mandatory Course Requirements

It is clear that in order to pass the course, students must study hard and perform well in not only assignments and essays but also the final examination.

Communication of Additional Information

Additional information or information on changes will be announced in class and also posted on Blackboard.

General University Policies and Statutes

Students should familiarise themselves with the University's policies and statutes, particularly those regarding assessment and course of study requirements, and formal academic grievance procedures.

Student Conduct and Staff Conduct

The Statute on Student Conduct together with the Policy on Staff Conduct ensure that members of the University community are able to work, learn, study and participate in the academic and social aspects of the University's life in an atmosphere of safety and respect. The Statute on Student Conduct contains information on what conduct is prohibited and what steps can be taken if there is a complaint. For queries about complaint procedures under the Statute on Student Conduct, contact the Facilitator and Disputes Advisor. This Statute is available in the Faculty Student Administration Office or on the website at: www.vuw.ac.nz/policy/StudentConduct.

The policy on Staff Conduct can be found on the VUW website at:

www.vuw.ac.nz/policy/StaffConduct.

Academic Grievances

If you have any academic problems with your course you should talk to the tutor or lecturer concerned or, if you are not satisfied with the result of that meeting, see the Head of School or the Associate Dean (Students) of your Faculty. Class representatives are available to assist

you with this process. If, after trying the above channels, you are still unsatisfied, formal grievance procedures can be invoked. These are set out in the Academic Grievances Policy which is published on the VUW website:

www.vuw.ac.nz/policy/AcademicGrievances.

Academic Integrity and Plagiarism

Academic integrity is about honesty – put simply it means **no cheating**. All members of the University community are responsible for upholding academic integrity, which means staff and students are expected to behave honestly, fairly and with respect for others at all times.

Plagiarism is a form of cheating which undermines academic integrity. Plagiarism is **prohibited** at Victoria.

The University defines plagiarism as follows:

Plagiarism is presenting someone else's work as if it were your own, whether you mean to or not.

'Someone else's work' means anything that is not your own idea, even if it is presented in your own style. It includes material from books, journals or any other printed source, the work of other students or staff, information from the Internet, software programmes and other electronic material, designs and ideas. It also includes the organization or structuring of any such material.

Plagiarism is not worth the risk.

Any enrolled student found guilty of plagiarism will be subject to disciplinary procedures under the Statute on Student Conduct (www.vuw.ac.nz/policy/studentconduct) and may be penalized severely. Consequences of being found guilty of plagiarism can include:

- an oral or written warning
- suspension from class or university
- cancellation of your mark for an assessment or a fail grade for the course.

Find out more about plagiarism and how to avoid it, on the University's website at:

www.vuw.ac.nz/home/studying/plagiarism.html.

Students with Disabilities

The University has a policy of reasonable accommodation of the needs of students with disabilities. The policy aims to give students with disabilities an equal opportunity with all other students to demonstrate their abilities. If you have a disability, impairment or chronic medical condition (temporary, permanent or recurring) that may impact on your ability to participate, learn and/or achieve in lectures and tutorials or in meeting the course requirements, then please contact the Course Coordinator as early in the course as possible. Alternatively you may wish to approach a Student Adviser from Disability Support Services to confidentially discuss your individual needs and the options and support that are available. Disability Support Services are located on Level 1, Robert Stout Building, or phoning 463-6070, email: disability@vuw.ac.nz. The name of your School's Disability Liaison Person can be obtained from the Administrative Assistant or the School Prospectus.

Student Support

Staff at Victoria want students' learning experiences at the University to be positive. If your academic progress is causing you concern, please contact the relevant Course Co-ordinator, or Associate Dean who will either help you directly or put you in contact with someone who can.

The Student Services Group is also available to provide a variety of support and services. Find out more at www.vuw.ac.nz/st_services/ or email student-services@vuw.ac.nz.

VUWSA employs two Education Coordinators who deal with academic problems and provide support, advice and advocacy services, as well as organising class representatives and faculty delegates. The Education Office is located on the ground floor, Student Union Building, phone 463 6983 or 463 6984, email education@vuwsa.org.nz.