

School of Economics and Finance

ECON 403 ADVANCED MACROECONOMIC THEORY

Trimester Two 2006

COURSE OUTLINE

Contact Details

Lecturer and Course Coordinator: Dr. Chia-Ying Chang

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Office Hours: Wednesday 10-12pm.

Class Times and Room Numbers

Class Time: Thursdays 3:30pm-5:30pm

Location: GB117

Prerequisite: ECON 305 and QUAN 201

Final Examination Period: Oct. 16th -Nov. 10th

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 or 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 mainstays 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.

The insights from real business cycles such (micro foundations and dynamics) will be integrated with insights from the New Keynesian models (rigidities in price and wage adjustments) when we look at Dynamic New Keynesian Models. Time permitting, we will explore how to specify and solve these models in MATLAB. Finally, we will consider how to use such models to analyze the optimal conduct of monetary policy.

Course Content

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	Calvo Pricing and the New Keynesian Phillips Curve
Week 8	The Labor Market
Week 9	The Money Market (Monetary Search-Theoretical Theory)
Week 10	The Credit Market and the Financial Accelerator
Week 11	Dynamic New Keynesian Models
Week 12	Monetary Policy

Expected Workload

Class Attendance: 3 hours/week

Reading and Reviewing: 15 hours/week

Assignment: 1 hour/week on average

Readings

All books listed are on closed reserve/3 day loan in the Commerce Library. Most journal articles can be accessed on-line.

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, *Advanced Macroeconomics*, 3rd edition, New York, McGraw-Hill/Irwin. (Note that several chapters have been amended significantly from the previous editions. Materials taught in this class will be based on the 3rd edition.)
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.
- Woodford, Michael (2003), *Interest and Prices: foundations of a theory of monetary policy*, Princeton University Press.

(..) denotes the abbreviation of the book

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

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”. Students are 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 two short reports of about 800-1000 words each (the detail 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 Honors program. However, as a guide to the allocation of your efforts, the assessment in ECON 403 will be based on:

20% for two assignments (due August 10th and October 5th 3:30pm in class)

20% for two reports (due August 17th, and October 12th, 3:30pm *before* class, **in PDF format via email**)

60% for the final two-hour examination (October 16th-November 10th, 2006).

Penalties

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

Responsibilities for Practicum Arrangements

(for practicum courses only - for non-practicum courses please remove this section)

Statements on establishment of the placement, who is responsible for arranging and approving the placement, and for the supervision of the student on-site, what is expected of on-site supervisors, and who briefs them. The assessment of the practicum is the responsibility of the University with possible input from the on-site supervisor. It should be specified whether the outcome will be a standard grade or just a pass/fail.

Mandatory Course Requirements

Students must submit the two assignments AND two reports.

Communication of Additional Information

Communication of additional information will be posted on Blackboard through an Announcement.

Faculty of Commerce and Administration Offices

Railway West Wing (RWW) - FCA Student and Academic Services Office

The Faculty's Student and Academic Services Office is located on the ground and first floors of the Railway West Wing. The ground floor counter is the first point of contact for general enquiries and FCA forms. Student Administration Advisers are available to discuss course status and give further advice about FCA qualifications. To check for opening hours call the Student and Academic Services Office on (04) 463 5376.

Easterfield (EA) - FCA/Education/Law Kelburn Office

The Kelburn Campus Office for the Faculties of Commerce and Administration, Education and Law is situated in the Easterfield Building - it includes the ground floor reception desk (EA005) and offices 125a to 131 (Level 1). The office is available for the following:

- Duty tutors for student contact and advice.
- Information concerning administrative and academic matters.
- Forms for FCA Student and Academic Services (e.g. application for academic transcripts, requests for degree audit, COP requests).
- Examinations-related information during the examination period.

To check for opening hours call the Student and Academic Services Office on (04) 463 5376.

General University Policies and Statutes

Students should familiarise themselves with the University's policies and statutes, particularly the Assessment Statute, the Personal Courses of Study Statute, the Statute on Student Conduct and any statutes relating to the particular qualifications being studied; see the Victoria University Calendar available in hard copy or under 'About Victoria' on the VUW home page at www.vuw.ac.nz.

Student 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 are to be taken if there is a complaint. For information about complaint procedures under the Statute on Student Conduct, contact the Facilitator and Disputes Advisor or refer to the statute on the VUW policy 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; class representatives may be able to help you in this. If you are not satisfied with the result of that meeting, see the Head of School or the relevant Associate Dean; VUWSA Education Coordinators are available to assist in 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 at 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. The University defines plagiarism as follows:

The presentation of the work of another person or other persons as if it were one's own, whether intended or not. This includes published or unpublished work, material on the Internet and the work of other student or staff.

It is still plagiarism even if you re-structure the material or present it in your own style or words.

Note: It is however, perfectly acceptable to include the work of others as long as that is acknowledged by appropriate referencing.

Plagiarism is prohibited at Victoria and is not worth the risk. Any enrolled student found guilty of plagiarism will be subject to disciplinary procedures under the Statute on Student Conduct and may be penalised severely. Consequences of being found guilty of plagiarism can include:

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

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 Impairments

The University has a policy of reasonable accommodation of the needs of students with disabilities. The policy aims to give students with disabilities the same opportunity as 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, 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 (DSS) to discuss your individual needs and the available options and support on a confidential basis. DSS are located on Level 1, Robert Stout Building, telephone (04) 463 6070, email disability@vuw.ac.nz. The name of your School's Disability Liaison Person is in the relevant prospectus or can be obtained from the School Office or DSS.

Student Support

Staff at Victoria want students to have positive learning experiences at the University. Each Faculty has a designated staff member who can either help you directly if your academic progress is causing you concern, or quickly put you in contact with someone who can. Assistance for specific groups is also available from the Kaiwawao Māori, Manaaki Pihipihinga or Victoria International.

In addition, the Student Services Group (email student-services@vuw.ac.nz) is available to provide a variety of support and services. Find out more at www.vuw.ac.nz/st_services/.

VUWSA employs 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 (tel. (04) 463 6983 or (04) 463 6984, email education@vuwsa.org.nz) is located on the ground floor, Student Union Building.

Manaaki Pihipihinga - Māori and Pacific Mentoring Programme (Faculty of Commerce and Administration)

This is a mentoring service for Māori and Pacific students studying at all levels. Weekly one hour sessions are held at the Kelburn and Pipitea Campuses in the Mentoring Rooms, 14 Kelburn Parade, and Room 210 and 211, Level 2, Railway West Wing. Sessions cover drafting and discussing assignments, essay writing, and any questions that may arise from tutorials and/or lectures. A computer suite networked to Cyber Commons is available for student use.

To register with Manaaki Pihipihinga, please contact one of the following:

Puawai Wereta
Room 210, Level 2
Railway West Wing
Tel. (04) 463 8997
Email: Puawai.Wereta@vuw.ac.nz

Fa'afai Seiuli
Room 109 B
14 Kelburn Parade
Tel. (04) 463 5842
Email: Faafoi.Seiuli@vuw.ac.nz