



School of Economics and Finance

ECON402 ADVANCED MACROECONOMIC THEORY A

Trimester One 2010

COURSE OUTLINE

Names and Contact Details

Course Coordinator and Lecturer (Week 1-6):

Dr. Chia-Ying Chang

Contact Information: Room 431, Level 4, Rutherford House,
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Office Hours: Fridays 2-3pm and by appointment.

Lecturer (Week 7-12):

Dr. Christoph Thoenissen

Contact Information: Room 428, Level 4, Rutherford House,
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Email: christoph.thoenissen@vuw.ac.nz

Office Hours: by appointment.

Trimester Dates

Teaching Period: Monday 1st March – Friday 4th June 2010

Study Period: Monday 7th June – Thursday 10th June 2010

Examination Period: Friday 11th June – Wednesday 30th June 2010 (inclusive)

Withdrawal from Courses:

Information available via

Withdrawal dates: Late withdrawals with Associate Dean (Students) permission
(See Section 8: Withdrawals - from the Personal Courses of Study Statute)

<http://policy.vuw.ac.nz/Amphora!~policy.vuw.ac.nz~POLICY~000000001743.pdf>

Withdrawal dates: refunds:

<http://www.victoria.ac.nz/home/admisenrol/payments/withdrawalsrefunds.aspx>

Class Times and Room Numbers

Fridays, 10:30am-12:20pm, RWW 129, (except on Good Friday, April 2nd)

Prerequisite: ECON 305, QUAN 203

Co-Requisites: ECON 403

Course Content

ECON 402 commences with a brief perspective on major modern approaches to macroeconomic theory. It then introduces models based on a representative agent's intertemporal optimisation problem. It is shown how the issues that pertain to consumption, investment and fiscal policy are investigated in these models.

The course then covers linear rational expectations models in some analytical detail. The concept of rational expectations and the characteristics of rational expectations solutions are discussed. Issues that pertain to macroeconomic stabilisation policy under rational expectations, e.g. the Lucas critique, policy neutrality, discretionary policy vs. rules, are reviewed. Implications of rational expectations for the behaviour of foreign exchange markets and business cycles are also discussed.

The primary emphasis in ECON 402 is on theory, but the policy relevance of theory and issues arising from empirical evidence are also given attention.

Week(s)	Topics
1	Major Modern Approaches to Macroeconomic Theory
1-2	Inter-temporal Consumption
3	Business Fixed Investment
4-5	Effects of Fiscal Policy
6	The Natural Rate Hypothesis and the Stabilisation Policy
7-8	The Rational Expectations Hypothesis and Solutions of Rational Expectations Model
8-9	Flexible v.s. Sticky Price Model of Exchange Rate Determination
10-12	Business Cycle Fluctuations

Course Learning Objectives

The learning objectives of ECON 402 are:

1. To provide students with a comprehensive knowledge of modern open economy macroeconomic theory.
2. To develop knowledge in New Classical Macroeconomics.
3. To formulate and solve macroeconomic problems analytically
4. To generate a general appreciation of how policymakers can use the analysis in practice

Expected Workload

Class attendance: 2 hours/week

Reading and Reviewing: 10 hours/week

Assignments: 2 hours/week on average.

Readings

The textbook for the course is:

Obstfeld, Maurice and Kenneth Rogoff, *Foundations of International Macroeconomics*, Cambridge, MIT Press, 1996, Pp 804 + xxiii.

In addition to the textbook, the following book will be used in several sections of the course.

McCallum, Bennett T, *Monetary Economics: Theory and Policy*, New York, Macmillan, 1989, Pp 356 + xii.

In choosing the following reading material, we have generally tailored the degree of readability for beginning graduate students. Other relevant and more technical articles will be mentioned in the relevant class.

Week 1: Major Modern Approaches to Macroeconomic Theory (0.5 lecture) (Chia-Ying)

This will provide a brief perspective on the major developments in approaches to

Macroeconomic theory since early 1970s.

- *Mankiw, N Gregory, "A Quick Refresher Course in Macroeconomics", *Journal of Economic Literature*, 28(4), December 1990, pp. 1645-1660.
- *McCallum, Bennett T, "New Classical Macroeconomics: A Sympathetic Account", *Scandinavian Journal of Economics*, 91(2), 1989, pp. 223-264.
- *McCallum, Bennett T, "Macroeconomics After Two Decades of Rational Expectations", *Journal of Economic Education*, Summer 1994, pp. 219-234.
- *The Economic Record*, June 1989, Symposium on Macroeconomics, pp. 177-189 (contributions by Robert J Gordon, and John B Taylor)
- **American Economic Review*, Papers and Proceedings, May 1997, "Is There a Core of Practical Macroeconomics that We Should All Believe?", pp. 230-246 (contributions by Robert M Solow, John B Taylor, Martin Eichenbaum, Alan S Blinder, and Oliver Blanchard)
- Taylor, John B and Michael Woodford, "Preface", *Handbook of Macroeconomics*, Amsterdam, Elsevier North-Holland, 1999.

Week 1-2 Intertemporal Consumption (1.5 lectures) (Chia-Ying)

Models of consumption demand from the point of view of inter-temporal optimisation are presented and critically appraised.

- Obstfeld and Rogoff, Chs. 1(pp. 1-5, 28), 2(pp. 60-66, 70-72, 79-85, 96-98), Ch3(pp. 133-136, 146-147).
- Hall, Robert E, "Consumption", Ch. 4 in Robert J Barro (ed.), *Modern Business Cycle Theory*, Cambridge, Harvard University Press, 1989, pp. 153-177.
- *Abel, Andrew B, "Consumption and Investment", Ch. 14 in B M Friedman and F H Hahn (eds.), *Handbook of Monetary Economics*, Vol II, Elsevier, 1990, pp. 725-750, 774-778.
- Campbell, J Y and N G Mankiw, "Consumption, Income and Interest Rates: Reinterpreting the Time Series Evidence", in O J Blanchard and S Fischer (eds.), *NBER Macroeconomics Annual 1989*, Cambridge, MIT Press, pp. 185-245.

Week 3 Business Fixed Investment (1 lecture) (Chia-Ying)

Various approaches to the explanation of business fixed investment are discussed. Particular attention is given to the q theory, which is an intertemporal optimization approach that explicitly takes account of adjustment costs. Empirical relevance of q theory is also investigated.

- Obstfeld and Rogoff, Ch. 2(pp. 99-113).
- *Abel, Andrew B, "Consumption and Investment", Ch. 14 in B M Friedman and F H Hahn (eds.), *Handbook of Monetary Economics*, Vol II, Elsevier, 1990, pp. 753-771, 774-778.
- Hayashi, F, "Tobin's Marginal q and Average q: A Neoclassical Interpretation", *Econometrica*, January 1982, pp. 213-224.
- McKibbin, Warwick J and Eric S Sieglhoff, "A Note on Aggregate Investment in Australia", *The Economic Record*, 64(186), September 1988, pp. 209-215.

Week 4-5 Effects of Fiscal Policy (2 lectures) (Chia-Ying)

Effects of fiscal policy are analysed using the intertemporal optimisation framework.

Implications of overlapping generation models are compared with those of representative agent models. Models that integrate the overlapping generations and representative agent models are also investigated.

- Obstfeld and Rogoff, Ch. 3(pp. 130-136, pp. 141-145, pp. 174-184, pp. 190-191).
- “Symposium on the Budget Deficit”, Journal of Economic Perspectives, Spring 1989, pp. 1793, (contributions by Yellen, Barro, Bernheim, Eisner, and Gramlich).
- Bohn, Henning, “Budget Balance through Revenue or Spending Adjustments?”, Journal of Monetary Economics, 27, 1991, pp. 333-359.
- Frenkel, Jacob A and Assaf Razin, Fiscal Policies and Growth in the World Economy, 3rd edition, Cambridge, MA: MIT Press, 1996, Ch. 9.
- Wells, Graeme, “Fiscal Policy”, Ch. 10 in Brian Silverstone, Alan Bollard, and Ralph Lattimore (eds.), A Study of Economic Reform: The Case of New Zealand, Amsterdam, North-Holland, 1996.
- *Abel, Andrew B, “Consumption and Investment”, Ch. 14 in B M Friedman and F H Hahn (eds.), Handbook of Monetary Economics, Vol II, Elsevier, 1990, pp. 750-753.
- *Auerbach, Alan J, Jagadeesh Gokhale, and Laurence J Kotlikoff, “Generational Accounting: A Meaningful Way to Evaluate Fiscal Policy”, Journal of Economic Perspectives, Winter 1994, pp. 73-94.

Week 6 The Natural Rate Hypothesis and the Stabilisation Policy (1 lecture) (Chia-Ying)

Alternative explanations of inflation-unemployment correlations and their implications for stabilisation policy are discussed. The concept of dynamic inconsistency and its relevance to the policy rules versus discretion debate is also covered.

- *McCallum, Bennett T, *Monetary Economics: Theory and Policy*, New York, Macmillan, 1989, Pp 356 + xii, Chs. 9, 10, 11 & 12.
- Walsh, Carl E, *Monetary Theory and Policy*, 2nd Edition, Cambridge, MIT Press, 2003, Pp 612 + xviii, Sections 5.3.3, 8.1 & 8.2.
- Woodford, Michael, “The Return of Monetary Rules”, Chapter 1, *Interest and Prices*, Princeton, Princeton University Press, 2003, pp. 1-58.
- Obstfeld and Rogoff, Ch. 9(pp. 634-647).

Week 7 The Rational Expectations Hypothesis and Solutions of Rational Expectations Models (1.5 lectures) (Christoph)

This session covers the basic properties of and solution procedures for linear rational expectations models. Topics covered also include (a) comparison between fundamental and bubble solutions, and (b) a brief introduction to how nonlinear rational expectations model can be analysed by loglinearising the necessary conditions for optimisation around the steady state.

- McCallum, Bennett T, *Monetary Economics: Theory and Policy*, New York, Macmillan, 1989, Pp 356 + xii, Chs. 7 & 8.
- Obstfeld and Rogoff, Ch. 8(pp. 515-523).
- McCallum, Bennett T, “On Non-Uniqueness in Rational Expectations Models: An Attempt at Perspective”, *Journal of Monetary Economics*, March 1983, pp. 139-168.
- Uhlig, Harald, “A Toolkit for Analysing Nonlinear Dynamic Stochastic Models Easily”, mimeo. at <http://www.wiwi.hu-berlin.de/wpol/html/toolkit.htm>, and also Ch.3 in Ramon Marimon and Andrew Scott (ed.), *Computational Methods for the Study of Dynamic Economies*, Oxford University Press, 1999.

Week 8-9 Flexible vs. Sticky Price Models of Exchange Rate Determination

(1.5 lectures) (Christoph)

In this session we present and evaluate the implications of rational expectations for the behaviour of foreign exchange markets in the light of empirical evidence. An interesting topic covered here is the relative importance of real shocks and nominal shocks as sources of exchange rate fluctuations. The implications of flexible price (i.e. market-clearing) models and sticky price (i.e. non-market-clearing) models are compared. The degree of empirical support for the different approaches is also discussed.

- McCallum, Bennett T, *Monetary Economics: Theory and Policy*, New York, Macmillan, 1989, Pp 356 + xii, Ch. 14(ss. 14.1-14.4).
- Obstfeld and Rogoff, Ch. 8 (pp. 526-530, pp. 546-547).
- Blanchard, Oliver J and Danny Quah, "The Dynamic Effects of Aggregate Demand and Supply Disturbances", *American Economic Review*, 79(4), September 1989, pp. 655-673.
- Enders, Walter and Bong-Soo Lee, "Accounting for Real and Nominal Exchange Rate Movements in the Post-Bretton Woods Period", *Journal of International Money and Finance*, Vol. 16, No. 2, 1997, pp. 233-254.
- McCallum, Bennett T, "Unit Roots in Macroeconomic Time Series: Some Critical Issues", *Economic Quarterly*, Federal Reserve Bank of Richmond, Spring 1993, pp. 13-43.
- Stockman, Alan C, "The Equilibrium Approach to Exchange Rates", *Economic Review*, Federal Reserve Bank of Richmond, March-April 1987, pp. 12-30.

Week 10-12. Business Cycle Fluctuations (3 lectures) (Christoph)

In these sessions, the main ideas and tools of the Real Business Cycle (RBC) approach to business cycle fluctuations are explained. In this approach, business cycles are considered to be equilibrium outcomes of optimizing behaviour by individual agents. Stochastic general equilibrium models built on the foundations of intertemporally optimizing behaviour of economic agents are used. The model parameters are typically calibrated rather than estimated. Dynamic simulation techniques are used to analyze the models. Some of the criticisms of early RBC models and recent developments in the RBC literature are discussed. The impact of the RBC approach on recent developments in modelling for practical policy analysis is also discussed.

- Obstfeld and Rogoff, Ch. 7(pp. 496-507).
- Blanchard, Oliver J and Danny Quah, "The Dynamic Effects of Aggregate Demand and Supply Disturbances", *American Economic Review*, 79(4), September 1989, pp. 655-673.
- Boldrin, Michele, Lawrence J Christiano, and Jonas D M Fisher, "Habit Persistence, Asset Returns and the Business Cycle", *American Economic Review*, 91(1), March 2001, pp. 149-166.
- Buckle, Robert A, Kunhong Kim, Heather Kirkham, Nathan McLellan, and Jared Sharma, "A Structural VAR Business Cycle Model of a Volatile Small Open Economy", *Economic Modelling*, 24, November 2007, pp. 990-1017.
- Carlstrom, Charles T and Timothy S Fuerst, "Agency Costs, Net Worth, and Business Cycle Fluctuations: A Computational General Equilibrium Analysis", *American Economic Review*, 87, December 1997, pp. 893-910.
- Horvath, Michael, "Sectoral Shocks and Aggregate.

Assessment Requirements

There will be 11 meetings during the trimester (Public holiday on April 2nd <Good Friday>). Students are expected to read the relevant literature before each meeting and to take part in class discussion.

20% One report (due April 23rd at 10:30am before class in PDF/Word format via email)

20% One assignment (due May 28th at 10:30am in class)

60% for final examination (see below for dates)

Examinations

The final examination for this course will be scheduled at some time during the period from

Examination Period: Friday 11th June – Wednesday 30th June 2010

It is a two-hour examination.

Penalties

Any late assignment will be awarded a grade of zero (unless a VALID medical certificate issued by licensed medical centre is presented or a valid form of proof that an extension is warranted).

Mandatory Course Requirements

One assignment and one report must be submitted ON TIME

CLASS REPRESENTATIVE

A class representative will be elected in the first class, and that person's name and contact details (both to be announced after the election) will be available to VUWSA, the Course Coordinator and the class. The class representative provides a communication channel to liaise with the Course Coordinator on behalf of students.

Communication of Additional Information

How additional information or information on changes will be conveyed to students via lectures and Blackboard.

Use of Turnitin

The following words below (modified as necessary for particular circumstances) should be added to the section on plagiarism when work submitted by students is likely to be checked by Turnitin.

Student work provided for assessment in this course may be checked for academic integrity by the electronic search engine <http://www.turnitin.com> Turnitin is an on-line plagiarism prevention tool which compares submitted work with a very large database of existing material. At the discretion of the Head of School, handwritten work may be copy-typed by the School and subject to checking by Turnitin. Turnitin will retain a copy of submitted materials on behalf of the University for detection of future plagiarism, but access to the full text of submissions will not be made available to any other party.

For the following important information follow the links provided:

Academic Integrity and Plagiarism

<http://www.victoria.ac.nz/home/study/plagiarism.aspx>

General University Policies and Statutes

<http://www.victoria.ac.nz/home/about/policy>

AVC (Academic) Website: information including: Conduct, Academic Grievances, Students with Impairments, Student Support

http://www.victoria.ac.nz/home/about_victoria/avcadademic/Publications.aspx

Faculty of Commerce and Administration Offices

<http://www.victoria.ac.nz/fca/studenthelp/>

Manaaki Pihipihinga Programme

http://www.victoria.ac.nz/st_services/mentoring/