

S. Ramachandran

University of Goettingen

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s.ramachandran@wiwi.uni-goettingen.de

Room: OEC 2.240

Tel: +49 (0)551 39 14209

Applied Macro-Economics

Friday, 10:00 to 11:45hrs; 6 credits

April to July 2014

Macro-economics examines why economic aggregates such as income and employment fluctuate, and “applied” examines what (if anything) governments could do to prevent such output declines. Aggregates such as output, consumption etc. result from many decisions, some made *individually* (e.g. what we choose to eat, how many clothes and cars we buy) and others *collectively* (e.g. how much the government taxes, roads it builds, wars it fights etc.). Collective choices and expectations also affect individual decisions; so the relationships are complex.

This course is for undergraduates who have already had *at least one economics course*; so they know the tools of analysis (supply, demand and equilibrium). An earlier macro-economics course is useful, but not essential. Unlike courses where the IS-LM framework is presented as “the truth,” this course emphasizes skeptical questioning. As the economic slowdown since 2008 shows, there is much we do not fully understand and you will see why economists often disagree about what to do. This may be the last course in macro-economics for many, and I hope you learn a way of thinking is useful.

The course may be frustrating and confusing initially, but like learning to ride a bicycle, the subject is enjoyable once you “get it.” All of you can “get it” *with a bit of effort*, and *I am here to help*. Some suggestions: **first**, understand each term we use, and use each term precisely. It is not correct to say “rich people consume more because they have a lot of money:” the rich have higher income (a flow) and more wealth (a stock) but Bill Gates and I probably carry the same amount of money in our wallets. **Second**, *the right term helps you think clearly*. Bill Gates consumes more than I do (although our stomachs have the same capacity) because he has more income &/or wealth. **Third**, *develop your economic reasoning through practice*. Form a study group (3-5 students is a good size) to discuss topics and assignments, but answer the questions *individually first* so you have views to present and defend in the group. Bring any unresolved issues for discussion in class or come to my office individually or in groups: no appointment needed.

My lectures will be structured discussions that supplement – and do not substitute for – readings and textbook which is Richard Mishkin’s *The Economics of Money, Banking and Financial Markets* (Prentice Hall 10th edition, 2012).¹ Reading the whole textbook will help you see the many links to finance and to other subjects you may be studying. Come prepared to the lectures and speak up in class, especially if you do not understand something. *Never be afraid of making mistakes*: we are all here to learn, and mistakes are a part of learning.

¹ Earlier editions are cheaper and would serve. Other textbooks may also suffice if they cover the same material.

Examination & Grades

The grade will be based on a mid-term assignment (30 points) and a final exam (70 points). We would **not** have discussed the questions in class; but you can answer them if you understand the subject (i.e. memorization will not help). Answering such questions requires both good economic reasoning and the ability to express your ideas clearly; so practice this in your study groups.

Carlos Villalobos is the Teaching Assistant. His room number is OEC 2.145; telephone is 0551-398167; and e-mail is cvillal@uni-goettingen.de

Lecture 1 (Friday, April 25): Output, Aggregates & Measurement

Review what GDP, consumption and investment measure. Identities (e.g. national income) *versus* behavioural relations (e.g. consumption function). Price indices and their construction; real *versus* nominal variables.

Mishkin: Appendix to Chapter 1 pp 64-66;

Lecture 2 (Friday, May 2): Re-examining IS-LM & Aggregate Demand & Supply

Although modern business cycle theories have moved away from IS-LM analysis, the terms (e.g. multiplier) linger in the vocabulary of journalists and policy makers. Review the IS-LM framework and its implicit assumptions. Begin with government spending and the fiscal multiplier.

Chapter 21: *The IS Curve* pp 551-568;

Lecture 3 (Friday, May 9): Fiscal Multipliers, Consumption Function & Expectations

Chapter 22: *Monetary Policy and Aggregate Demand Curves* pp 569-581.

Lecture 4 (Friday, May 16): More Expectations: The Phillips Curve & Unemployment

Aggregate Supply elasticity in the short and medium term. Labour market structure (overtime, labour laws etc.) and how expectations affect effort. Concept and measurement of unemployment. Many myths: Phillips Curve; stagflation; “cost-push” *versus* “demand-pull” inflation?

Mishkin: Appendix to Chapter 23 The Phillips Curve and the Short run Aggregate Supply Curve pp 616-623

Milton Friedman *Nobel Lecture* 1976

Lecture 5 (Friday, May 23): Understanding money: Money & the Price level

Expected and unexpected inflation have different effects, but “inflation is always and everywhere a monetary phenomenon.”

Lecture 6 (Friday, May 30): **Mid term Exam**

Lecture 7 (Friday, June 6): **Money & Output**

Mishkin: Chapter 3 *What is “Money?”* pp 94-107

Chapter 20 *Quantity Theory, Inflation, and the Demand for Money* pp534-550

Lecture 8 (Friday, June 13): **Business cycles**

What are business cycles? Are they avoidable? Could governments “fine tune”?
Role of econometric models; parameter estimates and economic *versus* statistical significance. The Lucas Critique. Rules *versus* Discretion.

Lecture 9 (Friday, June 20): **Money & Banking**

Chapter 11 *Banking and the Management of Financial Institutions* pp 265-280

Chapter 15 *The Money Supply Process* pp 379-408

Tobin (1964) “Banks as Creators of Money”

Fama (1977) “Banking and the Theory of Finance”

Mishkin: Chapter 17 *The Conduct of Monetary Policy: Strategy & Tactics* pp 434-473 (a bit US-centric)

Lecture 10 (Friday, June 27): **Banking and Financial Crises**

The Great Recession of 2008: were markets to blame or policies?

Chapter 9 *Financial Crises in Advanced Economies* pp 227-244

Chapter 25 *The Role of Expectations in Monetary Policy* pp 643-646

Lecture 11 (Friday, July 4): **International Trade & Capital flows**

Must trade balance? Capital flows and the balance of payments.

Mishkin: Chapter 18 *The Foreign Exchange Market* pp 476-499 (Interest Parity Conditions in the Chapter appendix)

Chapter 19 *The International Financial System* pp 500-533

Lecture 12 (Friday, July 11): **The Balance of Payments & Exchange rate regimes**

How exchange rates affect trade and capital flows. Fixed *versus* floating exchange rates; the choice. The Euro zone: is it really that different?

Lecture 13 (Friday, July 18): **Residual Topics (e.g. Capital Controls: their rationale & effectiveness)**

Lecture 14 (Friday, July 25): **Review.**

Final Examination (*Date* to be determined)