

Macroeconomics II

<https://nikhildamodaran.github.io/teaching/macro2-fall2020.html>

Fall 2020

Jindal School of Government and Public Policy

O.P. Jindal Global University

Course Synopsis

This is the second course in macroeconomics at an undergraduate level. We presume a basic knowledge of the separate markets which comprise of a general equilibrium system from the previous course. We venture into an examination of macroeconomic policy in this model to shed light contemporary real world economic issues. Can the central bank help us get out of this slump? What are its limits? Is there a role for the government? Can government spending hurt us instead? What are the textbook answers and what do we observe in real life?

In the first part of the course, we then initiate an analysis of short run economic fluctuations in output using a simple macroeconomic model. We examine a simple static model with product and factor markets and build a general equilibrium model with micro-foundations. This is a version of the textbook IS-LM model. We use this model to explore Classical and Keynesian explanations of output fluctuations and the differences therein. We look at the early chronological wave of explanations for temporary fluctuations in economic activity and gradually work towards a more realistic depiction of the world. We illustrate a possible mechanism of how our economies might work and what happens after it is hit by a shock.

The second part focuses on what can policymakers do after they witness this shock. We introduce two policy institutions into our model who try to precariously balance and attain a level of employment and inflation. How and why do these institutions work? We understand the logic of government policy and of governance by analyzing issues of government spending, taxation and debt which come under the ambit of fiscal policy. We also examine the objectives of central bank and its policy options in printing money and managing its balance sheet.

We conclude the course by taking a snapshot of what we have missed and where new directions of research is taking the analysis of macroeconomics. What are the missing pieces of the puzzle which makes policy making challenging. Why can't we answer old questions and why do we keep repeating our exercises to answer the same old questions in macroeconomics?

Course Goals (Learning Outcomes)

Participants who successfully complete the course are expected to:

1. Build a basic model and understand its main mechanisms of transmission i.e. how macroeconomic variables are interconnected in the complex economic web,
2. Distinguish between Classical and Keynesian interpretations of the model economy as parallel, not necessarily competing strands of explanation,
3. Integrate IS-LM and our basic model as two methods of formulating a model economy,
4. Examine policy alternatives in the model and contrast it with the role of policymakers in the real world,
5. Gain insights into functioning of the two key economic policy institutions i.e. the government and central bank,
6. Understand common methods of policy stimulus to counteract temporary cyclical downturns and the need to do so.

We will try and mix economic theories with empirical realities to understand how far can simple models explain what we as macro economists observe in any economy. At the end of this course, you should be able to start thinking like a macro economist, and even hopefully inch closer to being one.

Class Timing

Wednesday 4:20 pm – 05:50 pm Room: T2-F37

Friday 11:20 am – 12:50 pm Room: T2-F37

Pre-requisites

Principles of Economics, Macro Economics I

Instructors and Office Hours

Instructor	Nikhil Damodaran
Preferred Contact	ndamodaran@jgu.edu.in
Office Hours	Wednesday 12:30 pm – 1:30 pm or by appointment Cabin #6, T4, Academic Block, OP Jindal Global University

Readings

- Required Textbook: [Macroeconomics](#)
Andrew B. Abel , Ben Bernanke, Dean Croushore [ABC]
Pearson; 8th ed. 2015 edition
- Additional Text: [Macroeconomics](#)
Olivier Blanchard [OB]
Pearson; 7th edition (2017)
- Blogs and Popular Resources: There are plenty of Blogs/Popular writings which will help you understand and contribute to the in-class discussions. To simplify matters further, the American Economic Association has compiled a [list of resources available online](#) and updates this list frequently.

Assessment

Assessments for the remaining semester are given below. We adopt this in light of the recent COVID-19 pandemic closures.

- Quiz 1 and 2 are 10% each, out of which only one will be considered for the final grade.
 - We adopt a continuous assessment for the remainder of the course. There will be 3 more assignments which would be 30% each instead of a mid-semester and an end-semester examination.
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Course Contents

Important: This syllabus is intended to give the student guidance in what may be covered during the semester and will be followed as closely as possible. However, the instructor reserves the right to modify, supplement and make changes as the course needs arise.

1. Introduction to Short Run Macroeconomics

- ABC, Chapter 8: Business Cycles
 - 8.1 Business Cycle Introduction
 - India's Business Cycle History
 - 8.2 US Business Cycle History
 - 8.3 Business Cycle Stylized Facts
- Static Toy RBC Model (Lecture notes)
- 8.4 Business Cycle Analysis Preview
- ABC Chapter 9: The IS–LM/AD–AS Model: A General Framework for Macroeconomic Analysis
 - 9.1 The Full Employment Line: Labor Market Equilibrium
 - 9.2 The IS Curve: Goods Market Equilibrium
 - 9.3 The LM Curve: Asset Market Equilibrium
 - Portfolio adjustment refresher
 - 9.4 General Equilibrium
 - 9.5 Price Adjustments in Attainment of General Equilibrium
 - Money Neutrality
 - 9.6 Aggregate Demand and Supply as a version of IS-LM
 - 9.A. Numerical and Algebraic Versions of IS-LM/AD-AS models

2. Classical Business Cycle Model under Flexible Prices

- ABC Chapter 10: Classical Business Cycle Analysis: Market Clearing
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- 10.1 Business cycles in classical model
 - Productivity shocks
 - Solow Residual and Omitted Variable Bias
- 10.2 Fiscal Shocks in Classical Model
 - Wealth Effects
 - Crowding Out: A version
- 10.3 Unemployment in Classical Model
- 10.4 Money in Classical Model
 - Non neutrality of money under flexible prices
- 10.5 Price Expectations and Money Non-neutrality

3. Keynesian Business Cycle Model under Sticky Prices

- ABC Chapter 11: Keynesianism: The Macroeconomics of Wage and Price Rigidity
 - 11.1 Real Wage Rigidity
 - Theory of Efficiency Wage and the effort curve: [Akerlof \(1982\)](#), [Yellen \(1984\)](#), [Wadhvani and Wall \(1991\)](#)
 - 11.2 Price Stickiness
 - Monopolistic competition: [Blanchard and Kiyotaki \(1987\)](#), Notes by [Sanjay Chugh](#), [Startz \(1989\)](#) [Svensson and Wijnbergen \(1989\)](#)
 - Menu Cost
 - Empirical evidence on sticky prices
 - 11.3 Monetary and Fiscal Policy in Keynesian Model
 - Short run non-neutrality in monetary expansions
 - Government spending and short run expansions: [Haavelmo \(1945\)](#)
 - Tax cuts vs. government spending
 - 11.4 Keynesian theory of macroeconomic stabilization
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- Oil price shocks and stagflation
- 11.B and 11.C Keynesian multiplier
- Introducing monopolistic competition in the static model (LN)**

4. Unemployment and Inflation

- ABC Chapter 12: Unemployment and Inflation
 - 12.1 Phillips Curve Trade-off
 - Friedman-Phelps Expectations Augmented Phillips Curve
 - Shifts in Phillips curve
 - Reconciliation of Phillips curve and post 1960 evidence
 - 12.2 Macroeconomic Policy and Phillips Curve
 - Menu for policymakers
 - Classical and Keynesian disagreements, and agreements
 - 12.3 Unemployment
 - Estimating the loss of output on account of unemployment (Okun's Law)
 - Natural Rate and its measurement error
 - 12.4 Inflation
 - US Inflation Era and Oil Prices
 - Cost of anticipated inflation : Shoe Leather and Menu Cost
 - Cost of unanticipated inflation
 - Hyperinflation and Money
 - 12.5 Inflationary Expectations
 - Managing inflationary expectations: Gradualism vs. Cold Turkey
 - Institutional Measure to Inflationary expectations
 - Credibility, Reputation and Monetary Policy
 - Natural rate of unemployment (8.2–8.3, OB).
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- India's unemployment problem (LN)

5. Monetary Policy and the Central Bank

- ABC, Chapter 14: Monetary Policy and the Federal Reserve System
 - 14.0 Role of Monetary Policy and Independence of Central Banks
 - 14.1 Principles of Money Supply Determination
 - Understanding the Balance Sheet of a Central and Commercial Bank
 - * RBI's balance sheet and monetary policy (LN)
 - Reserve deposits, monetary base and high powered money
 - Open Market Operations
 - * RBI and its open market operations (LN),
 - The Money Multiplier Process
 - Fractional reserve system and Banks Runs
 - 14.2 Monetary Control in India and the US
 - The RBI History Project
 - Fed Balance Sheet and Open Market Operations
 - Other Ways of Controlling the Money Supply
 - Discount Window Lending
 - Reserve Requirements
 - Fed Funds rate
 - Interest on Reserves
 - 14.3 Setting Monetary Policy Target through the Federal Funds Rate
 - 14.4 Making Monetary Policy in Practice
 - Lags in Monetary Policy Transmission
 - Monetary Policy Under Uncertainty
 - Monetary Policy and The Recent Recession
 - * Zero Lower Bound and the Liquidity Trap
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- * Credit Easing
- * Quantitative Easing
- 14.5 The Conduct of Monetary Policy: Rules Versus Discretion
 - The Monetarist Case for Rules
 - Rules and Central Bank Credibility
 - The Taylor Rule, The Taylor's principle (14.3, OB 23.2)
- 14.6 Extending the basic model to include money in utility: money demand (LN)
- The optimal inflation (OB, 23.3) and Unconventional monetary policy (OB, 23.4)

6. Fiscal Policy: Government Spending and Its Financing

- ABC Chapter 15: Government Spending and Its Financing
 - 15.1 The Government Budget: Some Facts and Figures
 - Components, Trends and Composition
 - * Government Spending Types
 - * Types of Taxes and its Relative Importance
 - Devolution and Federalism
 - Deficit Definitions: Primary, Current and Total Deficit
 - 15.2 Macroeconomic Effects of Fiscal Policy
 - Automatic Stabilizers
 - Full Employment Deficit
 - Spending: consumption vs investment spending
 - Average and Marginal Tax Rates
 - 15.3 Government Deficits and Debt
 - Debt-GDP Ratio
 - Debt as burden on future generations
 - Ricardian Equivalence
 - 15.4 Deficits and Inflation
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- Monetizing of Deficit and Seignorage Revenue
 - Are deficits inflationary?
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Tentative Weekly Plan

This is contingent upon class participation, evaluations and other tutorials

- Week 1: The IS-LM Framework
 - Week 2: Basic static model into the IS-LM framework
 - Week 3: Classical RBC, unemployment and money neutrality
 - Week 4: Basic static model with monopolistic competition
 - Week 5: The Keynesian rigidities and macroeconomic policy
 - Week 6: Distinguishing between Classical and Keynesians
 - Week 7: Revision + Mid Term
 - Week 8: Unemployment and Inflation
 - Week 9: Monetary Policy and the RBI (static model with money)
 - Week 10: Inflation Targeting and Unconventional monetary policy
 - Week 11: Basis static model with government spending
 - Week 12: Ricardian equivalence and Effectiveness of Fiscal Policy
 - Week 13: Review
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References

- Akerlof, G. A. (1982). Labor contracts as partial gift exchange. *The quarterly journal of economics*, 97(4):543–569.
- Blanchard, O. J. and Kiyotaki, N. (1987). Monopolistic competition and the effects of aggregate demand. *The American Economic Review*, pages 647–666.
- Haavelmo, T. (1945). Multiplier effects of a balanced budget. *Econometrica: Journal of the Econometric Society*, 13(4):311–318.
- Startz, R. (1989). Monopolistic competition as a foundation for keynesian macroeconomic models. *The Quarterly Journal of Economics*, 104(4):737–752.
- Svensson, L. E. and Wijnbergen, S. v. (1989). Excess capacity, monopolistic competition, and international transmission of monetary disturbances. *The Economic Journal*, 99(397):785–805.
- Wadhvani, S. B. and Wall, M. (1991). A direct test of the efficiency wage model using uk micro-data. *Oxford Economic Papers*, 43(4):529–548.
- Yellen, J. L. (1984). Efficiency wage models of unemployment. *The American Economic Review Papers and Proceedings*, 74(2):200–205.
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