

**MACQUARIE UNIVERSITY**



Division of Economic and Financial Studies

**ECON201 MACROECONOMIC ANALYSIS**

<http://www.econ.mq.edu.au/courses/econ201>

**UNIT OUTLINE**

**2006**

## 1. AIMS AND NATURE OF THIS UNIT

ECON201 builds on the 100-level economics program. As a unit in macroeconomic theory, it provides a deeper understanding of how the economy works. We follow a model-based approach emphasising the common core of theory accepted by most economists. The syllabus develops concepts and tools necessary for the study of more applied areas in economics and provides insight into the macroeconomic environment of business.

### The Economics Major

This unit is a stepping-stone in training to become an economist. Professional economists follow sound rules and must be good at thinking logically and consistently. They must also acquire analytical skills for the application of macroeconomic theory to real world issues.

In ECON201, the focus is on developing skills in the interpretation of macroeconomic data. Rigorous and logical thinking is encouraged through the analysis of policy issues. A variety of techniques including conceptual questions, numerical problems and analytical questions to test understanding of theory, tutorial presentations to encourage group-work skills, and a major research essay, assist in promoting these skills.

### Students Taking a Few Courses in Economics

For many ECON201 students, the objective is to learn how different parts of the economy fit together, to understand economic issues and participate in macroeconomic debates. We motivate the use of theory by reference to real world factual examples, by linking models to policy issues, by focusing on international experience and by analysing how different countries interact within this system.

### Broad Aims of this Unit

There are four broad objectives:

#### 1. Build a picture of how the economy works

This unit extends the model of goods and money markets, adding a labour market and an external sector, and refining the consumption and investment relations. We introduce bonds and equities to show the relation between short and long-term interest rates and the role of expectations in macroeconomics. Dynamic models are constructed to explore key policy issues such as inflation, unemployment, and economic growth. All models are related and we learn to select an appropriate model to analyse a particular problem.

#### 2. Show the relevance of institutions to macro performance

This unit also shows the relevance of institutions to the performance of the economy. Economists attribute the sustained growth, low inflation, and falling unemployment of the Australian economy since the early 1990's to structural reform, improved socio-economic institutions and better management of the economy.

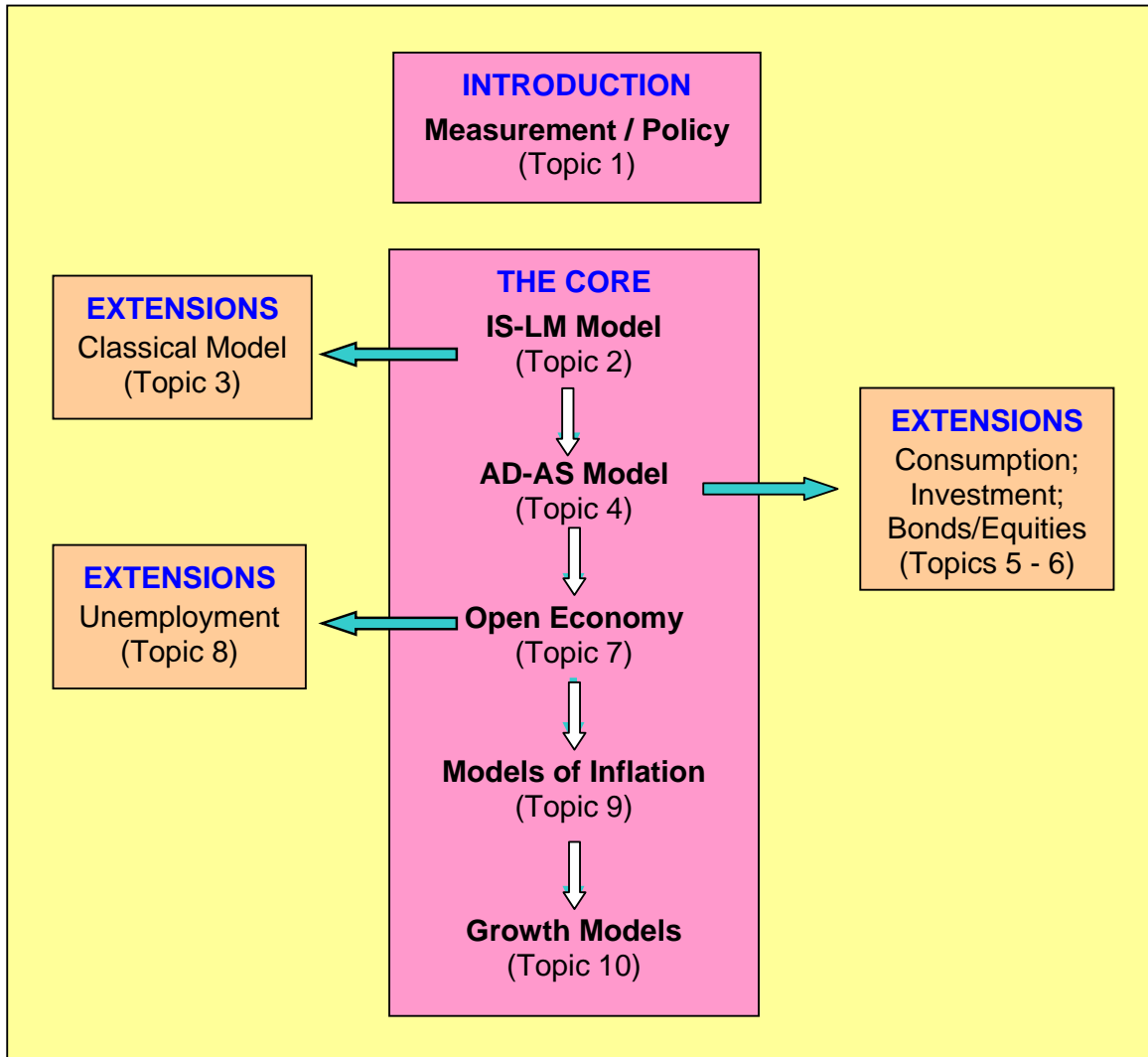
#### 3. Encourage critical thinking about the major policy debates

To promote critical thinking, website resources are used to provide explanations for why the Australian economy continued to expand strongly in times of adversity (eg during the Asian crisis of 1997, and in 2001, when many of our trading partners were in recession). Notwithstanding recent policy successes, economists believe Australia's future prospects will largely be governed the strength of major trading partners such as the USA and China.

#### 4. Provide a foundation for a more detailed study of macroeconomic policy

Although this is not a policy unit, we wish to know why the government pursues policy goals such as maintaining inflation in the 2%-3% range and balancing the budget over the business cycle. Policies to improve the performance of the economy are explored in greater depth in ECON311 Macroeconomic Policy.

## 2. ROAD MAP TO THE SYLLABUS



The topics included in ECON201 are:

- 1. Measurement and Policy:** Here we survey policy problems confronting Europe, the United States, Japan, and Asia. We clarify relationships among macroeconomic variables by presenting the key concepts and procedures involved in measuring GDP.
- 2. The IS-LM Model:** The spirit of Keynes' General Theory is captured by the IS-LM model. This fixed-price model describes the interaction of goods and financial markets and illustrates much of what happens in the economy in the short run.

**3. The Classical Model:** This was the dominant school of thought prior to Keynes. The classical model distinguishes labour, capital and money markets to explain changes in employment, output, wages, prices and interest rates. Although classical ideas are useful for explaining economic growth and provide a rationale for inflation targeting, most economists believe they cannot explain short-run fluctuations in output and employment.

**4. Models of Aggregate Demand and Supply:** We use the AD-AS framework to study economic fluctuations. Assuming an interest rate rule, the central bank will reduce interest rates as prices fall. Thus the AD curve slopes downward. We examine the sticky wage, imperfect-information and new-Keynesian models to derive an AS curve that is positively sloped, and allow price expectations to adjust with a lag to reconcile the short and long run effects of policy. Recent versions of these models incorporate rational expectations.

**5. Micro-Foundations of Consumption and Investment:** The permanent-income model allows the multiplier to be small for temporary rather than permanent changes, and the life-cycle model recognises the influence of demography and wealth. If borrowing constraints apply or expectations are uncertain, consumption and income are closely related as proposed by Keynes. Investment is a more volatile element of demand and an understanding of investment theory is crucial for short and long run analysis.

**6. Financial Markets: Bonds and Equities:** Here we use expectations to explore the relation between short and long-term interest rates. We also learn how stock prices are determined, why they move, and how they influence aggregate demand. On distinguishing short-term and long-term bonds and equities, we amend the IS-LM approach to re-evaluate the way in which monetary and fiscal policy affect the economy.

**7. The Open Economy:** The Mundell-Fleming model provides a useful framework for exploring important issues such as policy in the small and large open economy and the role played by the exchange rate system. We examine interest rate shocks, exchange-rate expectations, overshooting and currency crises. We are also interested in why some countries prefer a floating to a fixed exchange rate system or vice versa.

**8. Wages and Unemployment:** Business economists often conclude that a policy of wage cuts will increase employment. By concentrating upon the macroeconomic effects of wage cuts, we demonstrate that output may fall rather than rise.

**9. Models of Inflation:** On deriving the Phillips curve from an aggregate supply relation, we explore policy options for dealing with inflation. We also examine the conflict model which is able to generate a range of inflation and unemployment outcomes. This model provides insight into the effects of reform of the industrial relations system.

**10. Theories of Growth:** The neo-classical growth model identifies the forces determining the growth rate of an economy over long periods. It attributes cross-country variation to differences in investment. To account fully for these differences, we focus on the role of human capital and institutions. Endogenous technological progress is introduced to show how rich countries may continue to enjoy persistent growth. Based on our extended model, we examine various policies that governments may use to influence the growth rate.

### 3. LECTURES

There are three one-hour lectures per week which you are expected to attend.

<b>Day:</b>	Monday 9-11am	X5BT1
	Thursday 1-2pm	Mason Theatre
<b>Evening:</b>	Wednesday 6-8pm	Price Theatre
	Thursday 6-7pm	C5CT1

Day and evening lectures are given in parallel and students may attend a combination of either to suit their timetable. Lectures will be digitally recorded through the University's iLecture system and links to the recordings will appear on the unit website.

### 4. TUTORIALS

Class lists will be posted on the Website Bulletin Board late in week 2. To change tutorials, apply by e-mail to the Economics Department Teaching Assistant, giving your name and student number and two preferences. Contact details will be provided in the first lecture

There are eight tutorials in total. The tutorial schedule is given below:

No	Week	Topic	No	Week	Topic
1	3	IS-LM Model	5	9	Open Economy
2	4	Classical Model	6	11	Unemployment
3	6	AD-AS Model	7	12	Inflation
4	7	Consumption	8	13	Growth Theory

**Tutorial Format:** The tutorials comprise numerical problems and analytical questions and the program will be circulated separately in advance. There should be the opportunity to explore issues raised in lectures and to ask questions. The tutorials aim to improve understanding of macroeconomic theory and of the policy debates.

**Tutorial Presentations:** In the first tutorial, students will be placed into groups of 3 - 4. Each group will be allocated a tutorial question and must make a presentation to the class. Your tutor may require a group report (max of 1000 words) to be submitted for grading. To facilitate discussion, we suggest groups circulate a summary to members of the class. The presentation component of tutorials will count for 5% of your final mark.

**Tutorial Attendance:** To pass ECON201, students must attend and participate in at least six tutorials. You may be excluded from the unit for non-participation if this requirement is not satisfied. If unforeseen circumstances cause you to miss a tutorial, you may attend another group on a once-off basis without notification.

### 5. PEER ASSISTED LEARNING (PAL) SUPPORT

PAL is a FREE program that is offered to all students in ECON201. It is a great way to improve your understanding of the course, help with your study skills, to get better grades and to have the opportunity to meet other people in your unit.

PAL offers a weekly 1 hour class led by a student leader who has previously succeeded in ECON201. PAL leaders are fully trained and qualified. They help to facilitate your learning and provide examples, activities, case studies and assist with exam preparation.

To sign up for PAL please come to ERIC (E4B106) in Weeks 1 and 2 of the semester.

## 6. ECON201 ON THE WEB

The unit website is important in communicating with students and can be found at:

<http://www.econ.mq.edu.au/courses/econ201>

The first section of the unit website provides the information contained in this guide. The second section is password-protected and includes contact details and consultation hours of teaching staff. Select the notes icon for tutorial/essay guides and lecture slides. Access the bulletin board to ask questions, or to see the questions/answers of other students.

Your username is your Student ID Number. Your password should have been changed for security reasons and is confidential. If you forget your current password or if your account has been disabled, it can be reset by the Library IT Customer Support Desk (ITCSD).

### Student Services Website

A wide range of information for Economics students has been collected at:

<http://www.efs.mq.edu.au/services/index.htm>

Under 'student resources', there is a Resources Directory.

## 7. ASSESSMENT

The components of assessment in this unit are as follows:

One Class Test	15%
One Essay	15%
Tutorial Participation	5%
Final Examination	65%
<b>Total Assessment</b>	<b>100%</b>

**Class Test:** This will be conducted on Thursday 05 October, 1pm (day) or 6pm (evening). Lecture topics 1 to 7 are examinable. Students should attend unless medically unfit. If serious misadventure is experienced, advise the Economics Department Teaching Assistant within 48 hours. It may be possible to arrange a catch-up test. You should also submit an Advice of Absence form to the Student Centre.

**Essay:** The essay is due by Tuesday 27 September. Details of topics, suggested readings and requirements, will be provided in the essay guide to be distributed separately.

**Final Examination:** The examination paper is in two parts:

- Part A: Multiple-Choice Questions (approximately 25% of exam marks)
- Part B: Three Essay Questions (approximately 75% of exam marks)

To pass ECON201, students must satisfy **two separate requirements:**

- (1) Accumulate sufficient marks from all assessment tasks and the final examination to justify a passing grade; **AND**
- (2) Pass the final exam.

**It is Economics Department policy that failure in the final examination means automatic course failure notwithstanding any other circumstances.**

## 8. ENQUIRIES

There are two lecturers in ECON201:

- ◇ Mr Trevor Whitehead (Lecturer-in-charge)      Weeks 1-9  
(Room E4A 442, Phone 9850-8499)
- ◇ Professor Rod O'Donnell                              Weeks 9-13  
(Room E4A 435, Phone 9850-8493)

For administrative matters, contact the Economics Department Teaching Assistant. For clarification of points in lectures, consult the relevant lecturer. Other academic enquiries should be directed to your tutor. Contact details and consultation times will be released on the Unit Home Page. Members of staff also display consultation times on their doors.

When tutors/lecturers are not available for consultation, it is best to telephone or email them, leaving a message with your name and contact details. If your question is of general interest, post it online on the Bulletin Board and it will be answered. Other students can then also benefit from your question and the posted response.

## 9. SPECIAL CONSIDERATION - FINAL EXAMINATION

In cases of illness or misadventure, you may apply for special consideration. Requests must clearly identify the circumstances - illness, accident or other unavoidable disruption - that justify any special concession. In every case, students should submit a professional authority form that can be accessed on the web:

<http://www.reg.mq.edu.au/Forms/APSCons.pdf>

All requests must be lodged in writing with the Registrar within 5 working days of the exam including full supporting documentation.

### Supplementary Examinations

No student affected by illness or misadventure will be offered a supplementary examination unless they have scored a minimum of 50% in the in-course assessments.

If you request and are granted special consideration, you will be required to sit the supplementary examination regardless of your grade on the final examination. The grade awarded will be the grade you receive in the supplementary.

Students should note that the Economics Department does not adjust grades on the basis of illness or misadventure affecting performance on the final examination. If you apply for special consideration, the only option available is the supplementary exam.

### Notification of Supplementary Examinations

To check if you are offered a supplementary, consult a list to be posted on the web at:

<http://www.efs.mq.edu.au/supexams.htm>

Students must make themselves available for an examination normally held in December.

### Student Appeal

Any query or difficulty concerning the final grade in the unit should be resolved by following the process explained on the ECON201 website. For full details, select the [exam info link](#).

## 10. CHEATING AND PLAGIARISM

For details of the policy on plagiarism approved by Academic Senate, please refer to:

<http://www.student.mq.edu.au/plagiarism>

Also refer to the document on the home page for the Division of Economic and Financial Studies: [www.efs.mq.edu.au/ugrad.html](http://www.efs.mq.edu.au/ugrad.html) and click on “Cheating and Plagiarism”.

## 11. USEFUL REFERENCES

There is NO compulsory textbook for the unit. A two-part package comprising course notes (Topics 1 to 7) and readings (Topics 8 to 10) can be purchased from the Bookshop. Lecture slides will be available for all topics and can be downloaded from the website.

The following texts are cited frequently in the list of readings for each lecture topic.

Blanchard, O and Sheen, J. (2004), *Macroeconomics*, Prentice-Hall, Australian edition.

This Australian edition of a US text gives increased emphasis to expectations in macroeconomics. It is the most important reference for Topics 4, 6 and 7.

Dornbusch, R, Bodman, P, Crosby, M, Fischer, S, and Startz, R. (2006), *Macroeconomics*, McGraw-Hill, (2nd edition).

This text uses Australian examples and data. It offers straightforward explanations of more difficult material and incorporates state-of-the-art research.

Gartner, M. (2006), *Macroeconomics*, Prentice-Hall, 2<sup>nd</sup> edition.

This text provides a streamlined, no-frills introduction to the macroeconomic concepts essential to understanding the issues and challenges facing the world economy and individual countries. It emphasises applications of the theory in the form of case studies.

Mankiw, N.G. (2003), *Macroeconomics*, Worth Publishers, 5th edition.

This text provides a balanced coverage between short and long run issues, and integrates Keynesian and classical ideas. It also offers web-based, interactive software.

Sachs, J.D. and Larrain, F.B. (1993), *Macroeconomics in the Global Economy*, Harvester.

This advanced text emphasises the role of expectations, inter-temporal choices of households, firms and government, and the implications of time consistency.

### Official Australian Publications

The Reserve Bank Bulletin: This contains media releases, speeches and useful articles. The February, May, August and November issues publish detailed statements on monetary policy. All these resources are available on the Reserve Bank's website. Click on the RBA's Chart Pack for graphs of the latest economic statistics.

Australian Treasury: For a detailed analysis of the Australian economy, refer to the 2005-2006 Commonwealth Budget, Paper No.1, Budget Strategy and Outlook, (May). The budget papers can be viewed at the Treasury's website.



## 12. READING GUIDE

### MEASUREMENT AND POLICY ISSUES

(1 hour)

The concerns of macroeconomists - Policy issues confronting the United States, Japan, and Europe - Australia's macroeconomic performance - Problems in measuring economic aggregates - Sources of macroeconomic data in Australia.

Blanchard, ch1,2

Gartner, ch1

Dornbusch et al, ch1,2

### THE IS - LM MODEL

(3 hours)

Equilibrium in goods and financial markets - Derivation and properties of the IS and LM curves - Policy analysis with IS-LM - Using IS-LM to analyse the Great Depression.

Dornbusch et al, ch7,8,9

Mankiw, ch9,10

Gartner, ch2,3

Sachs and Larrain, ch12

### THE CLASSICAL MODEL

(3 hours)

The classical system: labour, capital and money markets - Disturbances in the classical model - Keynes' critique of the classical model.

Sachs and Larrain, ch3

Trevithick, ch1-5 \*

\* Trevithick, J. A. (1992), *Involuntary Unemployment: Macroeconomics from a Keynesian Perspective*, Harvester Wheatsheaf. This text offers a comprehensive analysis of the classical model.

### THE AD-AS MODEL

(4 hours)

Deriving the AD relation using an interest rate rule - Alternative models of aggregate supply - 'Sticky-Wages' - 'Imperfect Information' - New-Keynesian - Macroeconomic policies and supply shocks in the AD-AS framework.

Blanchard, ch5,6 \*

Gartner, ch6,7

Dornbusch et al, ch5,6

Sachs and Larrain, ch3,16

\* Blanchard, ch5,6 is compulsory reading for the new-Keynesian model and policy using the AD-AS model.

### MICRO-FOUNDATIONS: CONSUMPTION AND INVESTMENT

(3 hours)

Consumption: Traditional versus inter-temporal approaches - Life cycle and permanent income models - Borrowing constraints, uncertainty, and bequests - Demographic trends and saving - Strategies to increase national saving

Investment: Neo-classical theory and accelerator models of investment

Dornbusch et al, ch12,13

Sachs and Larrain, ch4,5 \*

Mankiw, ch16,17

\* Sachs and Larrain is the most comprehensive reference. It is highly recommended for this topic.

### FINANCIAL MARKETS: MONEY, BONDS AND EQUITIES

(3 hours)

(We examine the role of expectations in financial markets and extend the analysis of the IS-LM model to take another look at the role and the limits of policy in an economy in which expectations play a major role).

The yield curve linking short and long-term interest rates - Stock prices and wealth effects - Policy in an expectations-amended IS-LM model

Blanchard, ch15,17 \*

Dornbusch et al, ch14,16

\* Blanchard, ch17, extends the IS-LM model to examine the policy implications of expectations.

## THE OPEN ECONOMY

(5 hours)

(We consider issues such as policy under fixed and floating exchange rates, role of expectations in triggering exchange rate crises, and how the exchange rate adjusts in the long run).

Exchange rate concepts - Interest rate parity relation - 'J' Curve - Australia's current account deficit - Mundell-Fleming model - Policy under fixed and floating exchange rates - Large country case - Allowing for exchange rate risk - Open-economy AD-AS model - Expectations, overshooting and exchange rate crises.

Blanchard, ch18-21 \*

Gartner, ch4,5,12

Dornbusch et al, ch10,11

Sachs and Larrain, ch10,13,14

\* Blanchard, ch21, is important for exchange rate risk and advanced policy issues.

## UNEMPLOYMENT: MACROECONOMICS AND THE LABOUR MARKET

(3 hours)

(Based on the work of Keynes, we ask if output may fall rather than rise if there is a policy of wage cuts).

Aggregate demand, wages and unemployment in Neoclassical and Keynesian theory - Can unemployment be reduced by cutting wages?

Davidson, ch11 \*

Trevithick, ch5

Keynes, *General Theory*, ch19

\* Davidson, P. (1984), *Post Keynesian Macroeconomic Theory*, Elgar, Aldershot

## INFLATION: DEMAND AND CONFLICT

(5 hours)

(We examine the policy options for dealing with inflation based on the Phillips curve and conflict models).

Theories of inflation, the Phillips curve and anti-inflation policies - Conflict models and the behaviour of inflation under alternative policy regimes

### (a) Orthodox/Neoclassical Models of Phillips Curve

Blanchard, ch8-9

Gartner, ch8,13

Dornbusch et al, ch17

Sachs and Larrain, ch15

### (b) Conflict Model

Palley, T. (1996), *Post Keynesian Macroeconomics: Debt, Distribution and the Macroeconomy*, Macmillan, ch11.

## GROWTH THEORY

(6 hours)

(We examine the facts of growth and policies to influence the growth performance of economies).

Sources of growth - Harrod model - Basic Neoclassical (Solow) model - Endogenous growth theory - Explanations of cross country variation in growth performance - Neo Institutional approaches.

Dornbusch et al, ch3,4

Gartner, ch9,10

Jones, C. (2002), *Introduction to Economic Growth*, 2nd edition, W.W. Norton, ch2,3.2,7,8

Jones, H. G. (1975), *An Introduction to Modern Theories of Economic Growth*, Van Nostron Rheinhold, ch3.

Thirlwall, A.P. (1999), *Growth and Development*, 6th edition, Macmillan, London, ch4.

(NB: Jones, H, and Thirlwall deal with the Harrod model. The references by C. Jones and Gartner are highly recommended).

## 13. UNIT DIARY

WEEK	TOPICS	CLASS WORK
31 July (1)	Measurement and Policy (1) IS-LM Model (2)	<a href="#">Register for PAL in E4B106 *</a>
07 August (2)	IS-LM Model (1) Classical Model (2)	<a href="#">Register for PAL in E4B106 *</a>
14 August (3)	Classical Model (1) AD-AS Model (2)	Tutorial 1: IS-LM Model
21 August (4)	AD-AS Model (2) Consumption (1)	Tutorial 2: Classical Model
28 August (5)	Consumption and Investment (2) Bonds and Equities (1)	
04 Sept (6)	Bonds and Equities (2) The Open Economy (1)	Tutorial 3: AD-AS Model
11 Sept (7)	The Open Economy (3)	Tutorial 4: Consumption
<b>18 Sept to 02 Oct</b>	<b>Mid-Semester Break (2 Weeks)</b>	<b>Essay: Tues 27 September</b>
03 Oct (8)	<b>Class Test: Thurs 05 October, Day: Mason, 1pm, Evening: C5C T1, 6pm.</b> No lectures Mon 02 Oct and Wed 04 October. **	
09 Oct (9)	The Open Economy (1) Unemployment and the Labour Market (2)	Tutorial 5: Open Economy
16 Oct (10)	Unemployment and the Labour Market (1) Inflation: Demand and Conflict (2)	
23 Oct (11)	Inflation: Demand and Conflict (3)	Tutorial 6: Unemployment
30 Oct (12)	Growth Theory: Basics (3)	Tutorial 7: Inflation
06 Nov (13)	Growth Theory: Extensions (3)	Tutorial 8: Growth Theory

\* PAL is offered to all students in ECON201. It is a great way to improve your understanding of the course, help with your study skills, to get better grades and to have the opportunity to meet others. It offers a weekly 1 hour class led by a student leader who has previously succeeded in ECON201. Leaders help to facilitate your learning and provide examples, activities, case studies and assist with exam preparation. To sign up for PAL please come to ERIC (E4B106) in Weeks 1 and 2 of the semester.

\*\* Due to the Public Holiday, lectures on Monday 02 October, 9-11am, are cancelled. To keep lectures in sequence, lectures on Wednesday 04 October, 6-8pm are also cancelled.