

Prof. Bryan Caplan

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Econ 816

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Macro II Syllabus

Course Focus:

This course will try to fulfill two goals. First, it will expose students to a wide variety of influential ideas in academic macroeconomics. Second, it will focus on macro topics where GMU students have a comparative advantage in the production of new research.

Prerequisites:

I assume familiarity with the standard neoclassical toolkit of mathematical and econometric methods; more advanced techniques will be covered as necessary during class. You will also need to have completed graduate Macro I.

Texts:

The quantity of reading assigned is moderate, but you are expected to carefully read (and re-read) all of the readings. The readings will play an important role in lecture, homework, and exams.

The following texts are *required*. I suggest just ordering these online at e.g. <http://www.amazon.com> if you don't already own them.

David Romer. *Advanced Macroeconomic*

Milton Friedman and Anna Schwartz, *A Monetary History of the United States*

Lawrence White, *The Theory of Monetary Institutions*

There will also be a *required* reader available at the copy center. The reader contains all of the assigned articles that you cannot download and print from JSTOR (<http://www.jstor.org>).

A *recommended* additional text is Fisher Black, *Exploring General Equilibrium*. Many people find that it provides helpful intuition on real business cycle theory.

Grading and Exams:

There will be one midterm and a final exam. The midterm counts for 30%; the final exam is 50%; homework counts for the remaining 20%. These weights are fixed - improvement on later exams will not retroactively raise your grades on earlier exams.

There is no formal grade for participation, but if you are one of the students who (in my judgment) contributes most to the quality of class discussion you will be "bumped up" a fraction grade (e.g. B- to B).

Homework:

There will be four homework assignments during the semester. Depending upon how good a job you do, your homework will receive a check-plus (4 points), a check (3

points), or a check-minus (2 points) if you turn it in; otherwise you receive 0 points. Late homework loses one point. *Late homework is no longer accepted after I pass out my suggested answers for a given assignment.*

Office Hours

The best way to contact me is by email at bcaplan@gmu.edu. Many questions and requests can be satisfied by going to my homepage at <http://www.gmu.edu/departments/economics/bcaplan>. My office is in 8 Carow Hall; my office number is 3-2324. My official office hours are TT 3:00-4:30, but you can also schedule an appointment or just drop by and see if I'm available.

Tentative Schedule:

My proposed schedule for the semester follows. If it proves too ambitious, I will try to *simply say less about each topic* rather than cut the topics for the final weeks.

Articles marked with a * are available on JSTOR (<http://www.jstor.org>), so they won't be in the reader. They are of course still required reading. Pieces to be handed out in class are marked with a +.

Part 1: Macroeconomic Fluctuations and Policy

Weeks 1-2: Competing Theories of Macro Fluctuations

- Preview and background: Real Business Cycle theory (RBC) and New Keynesianism as the descendants of Friedman=s critique of dinosaur Keynesianism
- Typology #1: Classical/Keynesian: {standard RBC models; New Keynesian models with either real or nominal rigidities}
- Typology #2: Real/Nominal: {standard RBC models, New Keynesian models with real rigidities; New Keynesian models with nominal rigidities}
- Immediate questions:
 - What does monetary policy do?
 - What does fiscal policy do?
- Underlying questions:
 - Why does output fluctuate around its trend?
 - Why does employment fluctuate?
 - What determines nominal and real interest rates?
 - What determines the price level and the inflation rate?
- Applications:
 - The Great Depression?

- Oil shocks

- Implications for efficient policy and efficient institutions

Readings:

* Friedman, Milton. "The Role of Monetary Policy," American Economic Review, volume 58, issue 1, March 1968, pp. 1 - 17.

* Lucas, Robert. "Unemployment Policy," American Economic Review, volume 68, issue 2, May 1978, pp. 353 - 357.

* Long, John, and Charles Plosser. "Real Business Cycles," Journal of Political Economy, volume 91, issue 1, Feb. 1983, pp. 39 - 69.

* Mankiw, N. Gregory. "Real Business Cycles: A New Keynesian Perspective," Journal of Economic Perspectives, volume 3, issue 3, Summer 1989, pp. 79 - 90.

Sheffrin, Steven. "Have Economic Fluctuations Been Dampened?," Journal of Monetary Economics, volume 21, 1988, pp. 73 - 83.

* Romer, D. "The New Keynesian synthesis," Journal of Economic Perspectives, volume 7, 1993, pp. 5-22.

Summers, Lawrence. "Why Is the Unemployment Rate So Very High near Full Employment?," Brookings Papers on Economic Activity, volume 2, 1986, pp. 339 - 396.

* Carmichael, Lorne. "Can Unemployment Be Involuntary? Comment," American Economic Review, volume 75, issue 5, Dec 1985, pp. 1213 - 1214.

* Shapiro, Carl, and Joseph Stiglitz. "Can Unemployment Be Involuntary? Reply," American Economic Review, volume 75, issue 5, Dec 1985, pp. 1215 - 1217.

* Olson, Mancur. "The Productivity Slowdown, the Oil Shocks, and the Real Cycle," Journal of Economic Perspectives, volume 2, issue 4, 1988, pp. 43 - 69.

Week 3: Basics of Monetary Economics

- The monetary base vs. broader money supply measures and money substitutes
- Money in the utility function
- Price level, nominal interest rates, real income, real wealth, substitute assets and money demand
- The equation of exchange
- Velocity and money demand
- Cash-in-advance models of money demand

Readings:

Romer, 9.2

White, chapter 1

Friedman, Milton. "Quantity Theory of Money," in: The New Palgrave, Macmillan Press Ltd, pp. 3 - 20.

Azariadis, Intertemporal Macroeconomics. Cambridge, MA: Blackwell, 1993, pp. 377-392.

Week 4: Rational Expectations

- Rational expectations and perfect foresight equilibria
- Rational expectations with uncertainty (real or nominal)
- Solving simple RE models
- The short-run and the long-run Phillips curve
- When is RE rational?
- Models with both rational and naive agents

Readings:

Romer, 6.1-6.4

+ Caplan, "Rational Ignorance vs. Rational Irrationality," unpub. ms.

+ Caplan, "Systematically Biased Beliefs About Economics," unpub. ms.

Haltiwanger and Waldman, "Rational Expectations in the Aggregate," Economic Inquiry, volume 27, Oct. 1989, pp.619-636.

Fremling and Lott, "The Bias Towards Zero in Aggregate Perceptions," Economic Inquiry, volume 34, April 1996, pp.276-295.

Week 5: Monetary vs. Fiscal Policy in Real Models

- Benchmark: policy in the standard RBC model
- Supply shocks and RBC
- Sectoral shifts and RBC
- Seasonal cycles and RBC

- The neutrality of money

- The neutrality and the non-neutrality of inflation
- Endogeneity of broader money supply measures
- Real channels for fiscal policy transmission
- Spending shocks: temporary vs. permanent
- Tax shocks: temporary vs. permanent
- Unemployment and search; the optimal vs. natural rate of unemployment
- Adding a fixed employment cost to the standard RBC model
- Adding New Keynesian real rigidities

Readings:

Romer, 4.1-4.10

* Hamilton, James. "Oil and the Macroeconomy since World War II," *Journal of Political Economy*, volume 91, issue 2, April 1983, pp. 228 - 248.

* Lilien, David. "Sectoral Shifts and Cyclical Unemployment," *Journal of Political Economy*, volume 90, issue 4, Aug. 1982, pp. 777 - 793.

* Barsky, Robert, and Jeffrey Miron. "The Seasonal Cycle and the Business Cycle," *Journal of Political Economy*, volume 97, issue 3, Jun. 1989, pp. 503 - 534.

* Barro, Robert. "Output Effects of Government Purchases," *Journal of Political Economy*, volume 89, issue 6, Dec. 1981, pp. 1086 - 1121.

* Aschauer, D. "The equilibrium approach to fiscal policy," *Journal of Money, Credit, and Banking*, volume 20, issue 1, Feb. 1988, pp. 41-62.

* King, Robert and Plosser, Charles. "Money, Credit, and Prices in a Real Business Cycle," *American Economic Review*, June 1984, pp. 363-379.

Braun, R., and E. McGrattan. "The macroeconomics of war and peace," *NBER Macroeconomics Annual 1993*, 197-247.

Rogerson, Richard. "Indivisible Labor, Lotteries, and Equilibrium," *Journal of Monetary Economics*, volume 21, 1988, pp. 3 - 16.

Weeks 6-7: Monetary vs. Fiscal Policy with Nominal Rigidities

- Nominal vs. real rigidities; nominal price vs. nominal wage rigidity
- RE models with nominal rigidities
- The ADP model
- An abbreviated monetary history
- The liquidity effect: theory and evidence
- The standard ISLM transmission mechanism

- Alternative transmission mechanisms
- Fiscal policy and the equation of exchange
- The standard ISLM transmission mechanism
- Alternative transmission mechanisms?
- The quantity theory of money as a theory of money demand
- The quantity theory of money as a theory of velocity
- Empirical performance of the quantity theory

Readings:

Romer, 6.5-6.8

Akerlof, G. A., Dickens, W. T. and Perry, G. L. "The Macroeconomics of Low Inflation," *Brookings Papers on Economic Activity*, volume 1, 1996, pp. 1-76.

Friedman and Schwartz, *A Monetary History of the United States*, chapter 7 (required); chapters 5-9 (recommended)

Boschen, J., and L. Mills. "The relation between narrative and money market indicators of monetary policy," *Economic Inquiry*, volume 33, 1995, pp. 24-44.

Leeper, E., and D. Gordon. "In search of the liquidity effect," *Journal of Monetary Economics*, volume 29, 1992, pp. 341-369.

* Bernanke, Ben, and Alan Blinder. "The Federal Funds Rate and the Channels of Monetary Transmission," *American Economic Review*, volume 82, issue 4, 1992, pp. 901 - 921.

Mishkin, F. "Symposium on the monetary transmission mechanism," Journal of Economic Perspectives, volume 9, issue 4, Fall 1995, pp. 3-10.

+ Caplan, "War as a Natural Macro Experiment: Did Fiscal Policy Ever Matter?," unpub. ms.

Week 8: MIDTERM

Part 2: Macroeconomic Regimes and Optimality

Week 9: Optimal Policy; Endogenous Policy Theory, I: Time Consistency

- Central banking after RE
- Interest, money, inflation, and nominal GDP targeting
- The optimal rate of inflation
- The case for Friedman's deflation rule, zero inflation, the productivity norm, and moderate inflation
- Time consistency problems and reputation
- Rules vs. discretion
- Rules and time consistency
- Central bank independence and time consistency

Readings:

Romer, 9.4-9.6, 9.8

White, chapters 4, 5 (pp. 105-116), 10, 11

Eichenbaum, M. "Some thoughts on practical stabilization policy," American Economic Review Papers and Proceedings, volume 87, issue 2, May 1997, pp. 236-239.

* Alesina, A. and Summers, L. "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," Journal of Money, Credit and Banking, May 1993, pp. 151-162.

* Rogoff, Kenneth. "The Optimal Degree of Commitment to an Intermediate Monetary Target," Quarterly Journal of Economics, 1985, pp. 1169-1190.

Week 10: Endogenous Policy Theory, II: Public Choice and Macro Policy

- Fiscal theories of money supply: seigniorage and the unpleasant monetarist arithmetic
- Hyperinflation, seigniorage, and expectations
- The central bank as bureaucracy
- Political business cycles

Readings:

Romer, 9.7

White, chapters 7-9

Mankiw, Gregory. "The Optimal Collection of Seigniorage: Theory and Evidence," *Journal of Monetary Economics*, volume 20, 1987, pp. 327-341.

* Alesina, Alberto, and Jeffrey Sachs. "Political Parties and the Business Cycle in the United States, 1948-1984," *Journal of Money, Credit and Banking*, volume 20, issue 1, Feb. 1988, pp. 63 - 82.

Week 11: Privatization of Money, I: Commodity Standards

- 100% reserve standards
- Fractional reserve standards
- The gold standard era in perspective

Readings:

White, chapter 2

Rothbard, Murray N. "The Case for a 100 Per Cent Gold Dollar." In *In Search of a Monetary Constitution*, ed. by Yeager, Leland B. Cambridge, MA: Harvard University Press, 1962, pp. 94-136.

Bordo, M. "The Gold Standard, Bretton Woods, and Other Monetary Regimes: A Historical Appraisal," NBER Working Paper 1818, March/April 1993.

Friedman and Schwartz, *A Monetary History of the United States*, chapters 3-4.

Bordo, M. and Kydland, F. "The Gold Standard as a Rule: An Essay in Exploration," *Explorations in Economic History*, October 1995, pp. 423-464.

Week 12: Privatization of Money, II: Free Banking and Alternatives

- A working definition: Freedom of banknote issue; unregulated reserves; unregulated portfolios, and uninsured banks
- How the market determines banks' reserve ratio
- Banks' optimal response to shifts in money demand
- Advantages and disadvantages of free banking
- Multi-commodity standards, competing fiat currencies, and legal restrictions theories

Readings:

White, chapters 3, 5 (pp.88-105, 116-119), 6 (pp.121-123, 128-135), 12

Selgin, G. A. and White, L. W. "How Would the Invisible Hand Handle Money?," Journal of Economic Literature, volume 32, Dec. 1994, pp. 1718-1749.

Week 13: The Great Depression and European Unemployment

- The monetary explanation triumphant: from Friedman and Schwartz to Eichengreen and Bernanke
- The aggregate supply puzzle
- Government intervention and the Great Depression
- European unemployment as an aggregate supply puzzle
- Government intervention and European unemployment

- Great Depression and European unemployment compared

Readings:

Bernanke, Ben. "The World on a Cross of Gold: A Review of 'Golden Fetters,'" Journal of Monetary Economics, volume 31, 1993, pp. 251 - 267.

Bernanke, Ben. "The Macroeconomics of the Great Depression: A Comparative Approach," Journal of Money, Credit and Banking, volume 27, issue 1, Feb. 1995, pp. 1-28.

Bordo, Michael, Choudhri, Ehsan U. and Schwartz, Anna J. "Could Stable Money Have Averted the Great Contraction?," Economic Inquiry, volume 33, July 1995, pp. 484-505.

Rothbard, Murray. "Herbert Hoover and the Myth of Laissez-Faire," in: Radosh, Ronald, and Murray Rothbard, A New History of Leviathan (NY: Dutton, 1972), pp.111-145.

Siebert, Horst. "Labor Market Rigidities: At the Root of Unemployment in Europe," Journal of Economic Perspectives, volume 11, issue 3, Summer 1997, pp. 37-54.

Nickell, Stephen. "Unemployment and Labor Market Rigidities: Europe versus North America," Journal of Economic Perspectives, volume 11, issue 3, Summer 1997, pp. 37-54.

Week 14: Comparative Systems and Macro Performance

- The logic (?) of efficiency
- Reality vs. optimality: Some evidence on free lunches
- Why are some countries rich and others poor?

- Obvious explanations
- Economic policy explanations
- The growth of government
- The decline of socialism

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Readings:

* Wittman, Donald. "Why Democracy is Efficient," Journal of Political Economy, 1989.

Olson, Mancur. "Bill Bills Left on the Sidewalk: Why Some Nations are Rich and Others are Poor," Journal of Economic Perspectives, volume 10, issue 2, Spring 1996, pp. 3 - 24.

+ Caplan, Bryan. "The Logic of Collective Belief," unpub. ms.

+ Caplan, Bryan. "Sociotropes, Systematic Bias, and Political Failure," unpub. ms.

Higgs, Robert. "Crisis, Bigger Government, and Ideological Change: Two Hypotheses on the Ratchet Phenomenon," Explorations in Economic History, volume 22, 1985, pp. 1-28.

Murrell, Peter. "How Far Has the Transition Progressed?," Journal of Economic Perspectives, volume 10, issue 2, Spring 1996, pp. 25 - 44.

FINAL EXAM
