

Economics 137
Macroeconomic Policy

Course Description: This course will study the theory of macroeconomic policy. First we will examine some issues in the conduct of fiscal policy and then turn our attention to the theory and practice of modern monetary policy. The focus of the course will be on relatively recent developments; in several cases, the economists associated with these ideas were awarded the Nobel prize in Economics for their scientific contributions. Recently proposed monetary policy rules will be the topic for the final part of the course.

Note: Several of the topics will be presented at an advanced undergraduate level – it will be assumed that you have had (and remember) the necessary prerequisites. Moreover, calculus and probability will be used in developing the theory. The reason for this emphasis on rigor is to bridge the gap between undergraduate economic education and what economists actually do.

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Office Hours:

Professor Salyer: SSH 1120, Monday 3:30-5:30pm or by appointment.

Paul Gaggl: TBA

Grading: There will be one midterm exam (worth 35%) and a cumulative final exam (55%). The remaining 10% will be determined by performance on homework assignments and class participation.

Note the dates of the midterm and final – there will be no alternate exams given!!

Readings: All articles (see below) are available from the class web site:

<http://www.econ.ucdavis.edu/faculty/kdsalyer/LECTURES/ecn137.html>

Schedule of Topics

1. Review Material (to be covered in Section)

Reading: Math Handout, Stats Handout, Bond Pricing, Term Structure of Interest Rates

2. Fiscal Policy – the optimal path of taxes. (3/29 – 4/16)

We will first examine the fiscal implications of the current Social Security and Medicare policies. Then, we will begin our study of optimal policy within dynamic economies. Our focus will be on the optimal path of taxes and the effects of deficits on interest rates.

Readings:

Hakkio, C.J. and E.J. Wiseman, “Social Security and Medicare: The Impending Fiscal Challenge,” Federal Reserve Bank of Kansas City *Economic Review* (2006), p. 7-41.

Auerbach, A., “American Fiscal Policy in the Post-War Era,” *The Macroeconomics of Fiscal Policy*, R. Kopcke, G. Tootell, R. Triest, MIT Press, 2006.

Blinder, A., “The Case Against the Case Against Fiscal Policy,” *The Macroeconomics of Fiscal Policy*, R. Kopcke, G. Tootell, R. Triest, MIT Press, 2006.

Sims, C., “Comment on Blinder,” *The Macroeconomics of Fiscal Policy*, R. Kopcke, G. Tootell, R. Triest, MIT Press, 2006.

Barro, R., “The Stimulus Evidence One Year On,” WSJ Op-Ed, Feb.23, 2010.

Taylor, J. V. Wieland, et al., “New Keynesian versus Old Keynesian Government Spending Multipliers,” Stanford Economics Dept. Working Paper, 2010.

Doepke, M., A. Lehnert, A. Sellgren, *Macroeconomics*, Chapter 14.

3. Time Inconsistency – The case of the benevolent, dissembling government (4/19 – 4/26)

The 2004 Nobel Prize was awarded to Ed Prescott and Finn Kydland in large part for their 1977 article on time inconsistency. We explore this concept within the context of optimal taxation of capital and labor.

Readings:

S. Fischer, “Dynamic Inconsistency, Cooperation, and the Benevolent, Dissembling Government,” *Journal of Economic Dynamics and Control* (1980), 93-107.

4. Monetary Policy: History and Evidence (4/28 – 5/05)

Readings:

Romer, C., “Changes in Business Cycles: Evidence and Explanations,” *Journal of Economic Perspectives*, Spring 1999, 23-44.

Goodfriend, M., “Monetary Policy Comes of Age: A 20th Century Odyssey, The Federal Reserve Bank of Richmond *Quarterly Review*, Winter 1997.

Goodfriend, M., “The Monetary Policy Debate Since October 1979: Lessons for Theory and Practice,” The Federal Reserve Bank of St. Louis *Review*, March-April 2005, p. 243-262.

MIDTERM FRIDAY MAY 7

5. Rational Expectations and Policy Evaluation: The Lucas Critique (5/10 – 5/17)

Robert Lucas won the 1995 Economic Nobel Prize in part because of his critique of policy evaluation. We look at this in detail.

Reading:

Lucas, R.E., Jr., “Econometric Policy Evaluation: A Critique,” *Carnegie-Rochester Conference Series on Public Policy* Volume 1, (*The Phillips Curve and Labor Markets*, K. Brunner and A. Meltzer, eds, Amsterdam, 1976.

6. Rational Expectations and the Policy Invariance Proposition: The Lucas Supply Curve (5/19 – 5/26)

Robert Lucas forcefully demonstrated that the Phillips curve does not necessarily imply a policy trade-off between inflation and output. This contribution was another reason for his winning the Nobel prize.

Reading:

Romer, D, *Advanced Macroeconomics*, Chapter 6 excerpt.

7. The Science of Monetary Policy (5/28 – 6/02)

We examine the modern formulation of monetary policy in a stochastic general equilibrium model with rational expectations. We also discuss inflation targeting and Taylor rules.

Readings:

Blinder, Alan, *Monetary Policy in Theory and Practice*, MIT Press, 1998. Chapter 1.

Poole, W., “Optimal Choice of Monetary Policy Instruments in a Simple Stochastic Macro Model,” *Quarterly Journal of Economics* (1970), p. 197-216.

McCallum, B., “Recent Developments in the Analysis of Monetary Policy Rules,” *St. Louis Federal Reserve Review* (1999), p. 3-12.

Walsh, C., “Teaching Inflation Targeting: An Analysis for Intermediate Macro,” *Journal of Economic Education*, Fall 2002, 333-345.

FINAL, SATURDAY JUNE 5, 8AM