
# Lecture 1: Schools of Macroeconomic Thoughts

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# Introduction

- Instructor: Dr. Lei Pan
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  - Office hours: Monday 10:00am-12:00pm
- Lecture Times
  - Friday 8:00-11:00am, Room 213, Bld 407

# Topics

- Topic 1: Schools of Macroeconomic Thoughts
- Topic 2: Solow-Swan Model
- Topic 3: The Diamond Model
- Topic 4: The Ramsey Model
- Topic 5: New Growth Theory
- Topic 6: An Overview of Fiscal Policy
- Topic 7: Effects of Government Debt on Capital and Saving
- Topic 8: An overview of Money and Monetary Policy
- Topic 9: Transmission Mechanisms of Monetary Policy
- Topic 10: An OLG Model with Growing Money Supply

# Textbooks and Journal Articles

- Advanced Macroeconomics, 5th Edition, By David Romer: It is useful for growth theories and RBC models (real business cycle model)
- We use some chapters from other books and notes.
- Journal articles: will be posted on Blackboard

# Assessments

- Seminar Presentation (20% of your grade)
  - Seminar presentation topic will be posted on 2026-Mar-15th (Week 4).
  - The presentation sessions will take place on 2026-Apri-24th (Week 10).
- Major Essay (40% of your grade)
  - Due on 2026-May-10th @ 5:00pm AWST (Week 12).
- Online Case Study (40% of your grade)
  - 2026-Jun-1st from 10:00am-11:59pm

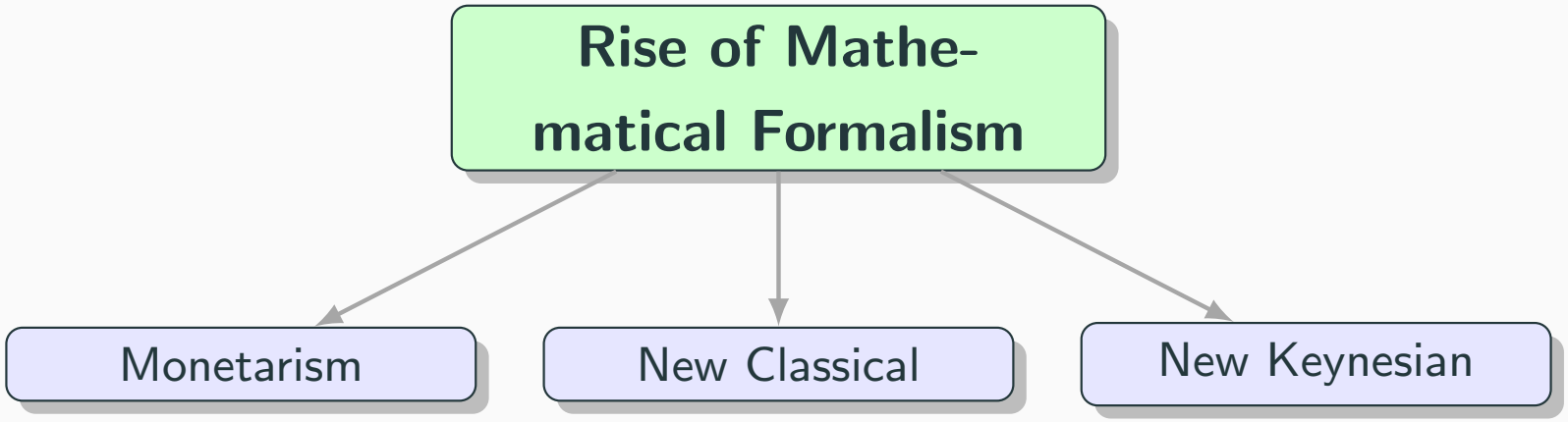
# This Lecture: Schools of Macroeconomic Thought (1 of 2)

- To give a historical view
  - Classical economics
    - Say's law
  - Keysian economics
    - quantities adjust instead prices
  - Neoclassical economics
    - microeconomic foundations


(Response to 1930s, the "Great Depression")

# This Lecture: Schools of Macroeconomic Thought (2 of 2)

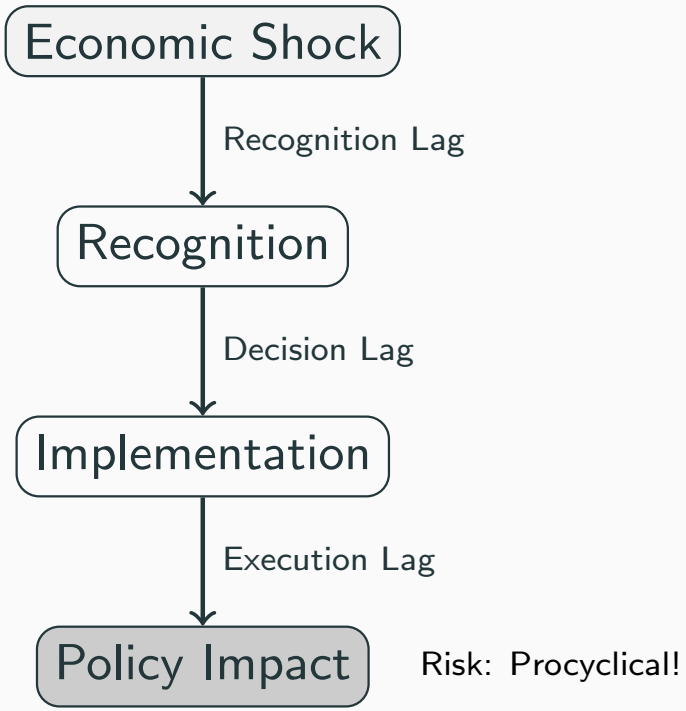
- After mathematical formalism became more common place, the main schools of modern macroeconomic thought
  - Monetarism
  - New classical
  - New Keynesian



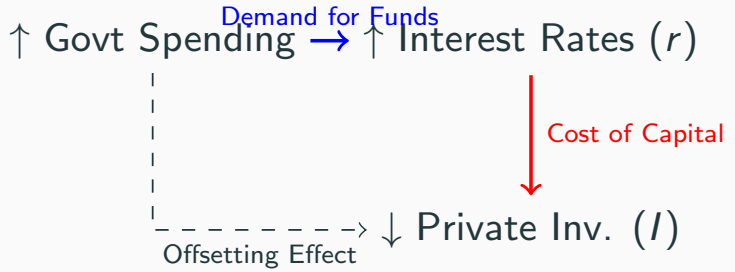

- Useful reading: "Modern macroeconomic models as tools for economic policy" by Narayana Kocherlakota, 2010.

# Monetarist Scepticism of Activist Fiscal Policy (1 of 2)

## 1. Long & Variable Lags




## 2. Crowding Out Effect



# Monetarist Scepticism of Activist Fiscal Policy (2 of 2)

**3. Inflationary Consequences**

- Persistent deficits $\rightarrow$ Debt Monetisation.
- "Inflation is always and everywhere a monetary phenomenon."

**4. Uncertainty & Credibility**

- Anticipation of future taxes (Ricardian Equivalence).
- Discretion creates noise; Rules create stability.

**The Monetarist Conclusion**

Activist fiscal policy is unreliable due to lags, crowding out, and inflation bias. Preference: Steady, rule-based monetary policy.

# The Evolution of the Phillips Curve (1 of 23)

**1. The Empirical Era (1958–1960s)**

- Phillips (1958): A statistical regularity in UK data.
- *Interpretation:* A stable "menu" of policy choices (lower $u$ for higher $\pi$).

**2. The Expectations Critique (1970s)**

- **Stagflation:** High $\pi$ and high $u$ simultaneously broke the simple trade-off.
- **Friedman & Phelps:** Agents care about *real* wages.
- If $\pi > \pi^e$, $u$ falls temporarily.
- Once $\pi^e$ adjusts, curve shifts up (Point B $\rightarrow$ C).

## 3. The Structural Era (Modern)

- **Lucas critique:** Correlations break when policy exploits them.
- **Insight:** We need micro-foundations (sticky prices), not just history.
- **The modern New Keynesian specification:**
  $\pi_t = \beta E_t \pi_{t+1} + \kappa(y_t - y_t^n)$
  (Forward-Looking)

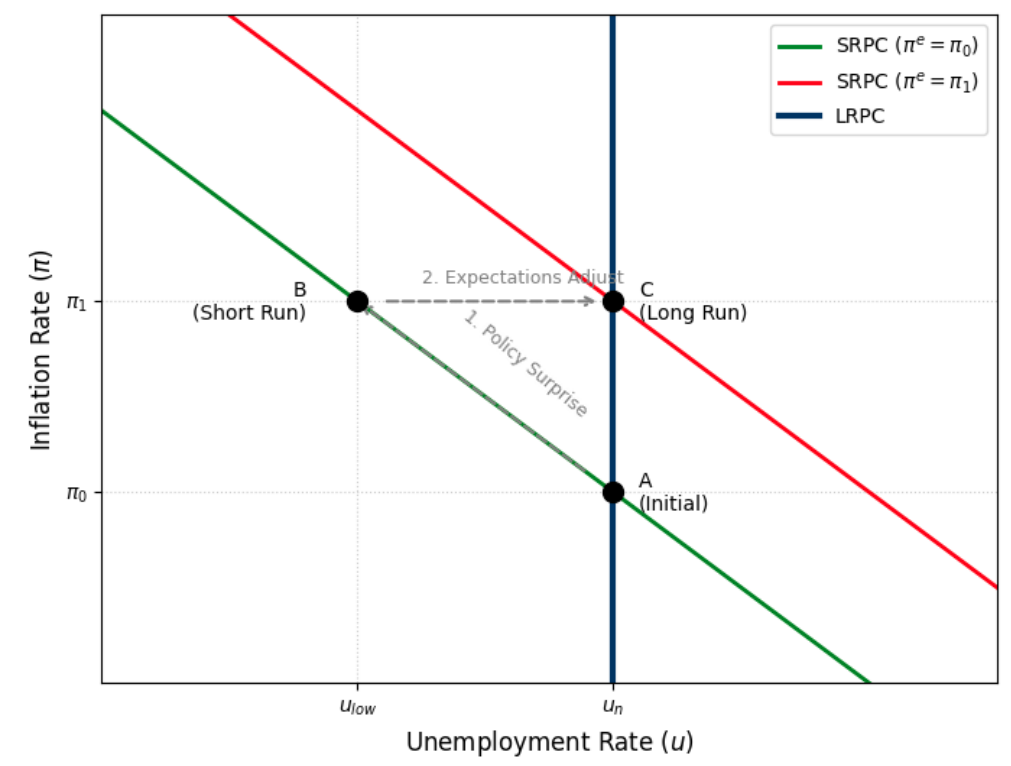


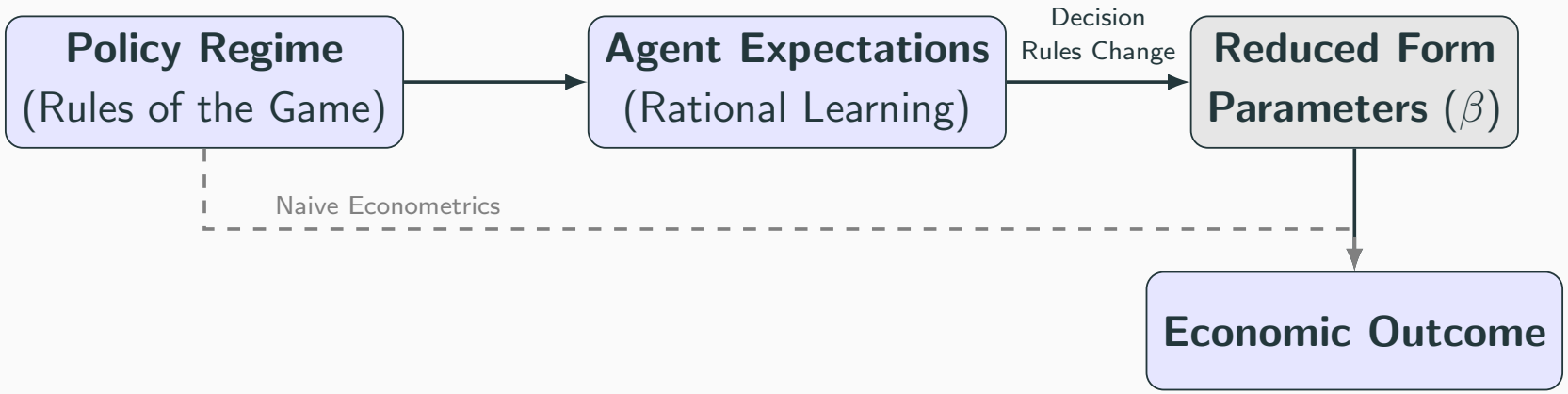

**Figure 1:** Friedman-Phelps critique: the expectations-augmented Phillips curve

# The Lucas Critique (1976) (1 of 2)

## The Fundamental Insight

Historical correlations (e.g., the Phillips Curve) are not structural. They are equilibrium outcomes of a specific policy regime.

- Naive view: Parameters remain fixed when policy changes.
- Lucas View: Agents are active optimisers. If policy rules change, optimal decision rules change $\rightarrow$ Model parameters shift.



# The Lucas Critique (1976) (2 of 2)

**The Naive Model (Old)** Assumes behavior is fixed:

$$C_t = \alpha + \beta Y_t$$

Here, $\beta$ is estimated from history.
*Critique:* If tax policy changes, consumers save differently. $\beta$ is unstable!

**The Structural Model (New)**
Derived from optimization:

$$U'(C_t) = \beta E_t[R_{t+1} U'(C_{t+1})]$$

*Solution:* Parameters depend on "Deep" factors (Preferences, Tech) which are **invariant** to policy.

**Key Takeaway**

To predict the effects of a policy experiment, we must model the deep parameters (preferences & technology), not the superficial correlations.