



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

- ▶ 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-April-24th (Week 10).
- ▶ Major Essay (40% of your grade)
 - ▶ Due on 2026-May-10th @ 11:59pm AWST (Week 12).
- ▶ Online Case Study (40% of your grade)
 - ▶ 2026-Jun-1st from 10:00am-11:59pm

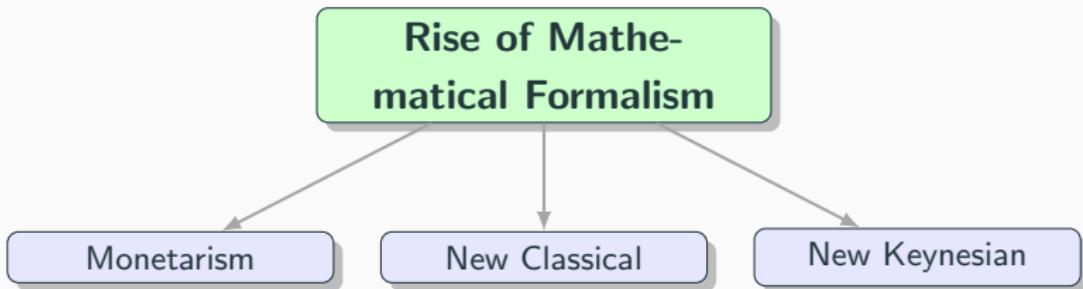
This Lecture: Schools of Macroeconomic Thought (1 of 2)

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



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

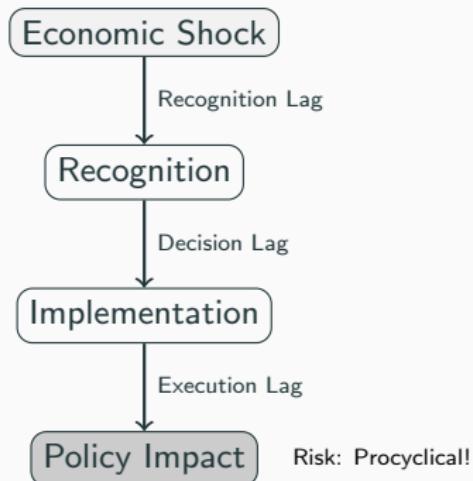
- ▶ After mathematical formalism became more common place, the main schools of modern macroeconomic thought
 - ▶ Monetarism
 - ▶ New classical
 - ▶ New Keynesian



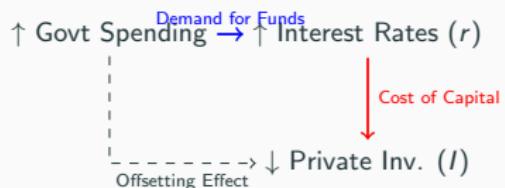
- ▶ Useful reading: “Modern macroeconomic models as tools for economic policy” by Narayana Kocherlakota, 2010.

Monetarist Scepticism of Activist Fiscal Policy (1 of 2)

1. Long & Variable Lags



2. Crowding Out Effect



3. Inflationary Consequences

- ▶ Persistent deficits → 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 2)

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 π).

2. The Expectations Critique (1970s)

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

The Evolution of the Phillips Curve (2 of 2)

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)

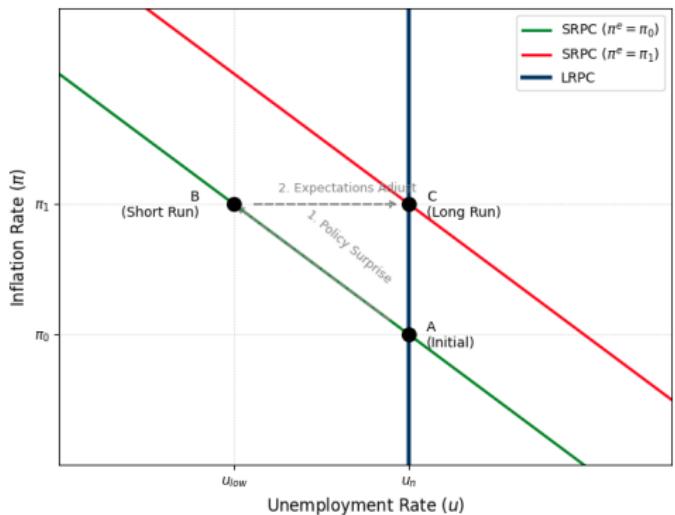
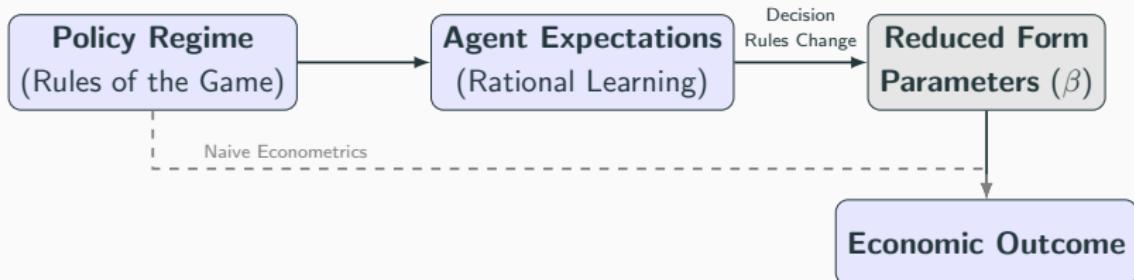


Figure 1: Friedman-Phelps critique: the expectations-augmented Phillips curve

The 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 → **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, β is estimated from history.

Critique: If tax policy changes, consumers save differently. β 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.