

Macro Module 21 + 22 Readings

(The attached PDF file has better formatting.)

Chapter 15: Price Mis-perceptions model (Modules 21 and 22)

Chapters 15 and 16 present several alternatives to Barro's macroeconomic model. Barro says: "Many economists believe that monetary shocks have been a principal cause of economic fluctuations in the U.S. and other economies." Other macroeconomics textbooks explain how expansion or contraction of the monetary base affects GDP, unemployment, and interest rates. Barro does not agree with these analyses, and his last two chapters compare the pros and cons of various models.

One might wonder: "Economists have studied monetary policy for years. Don't they know how it affects the economy?" Follow the reasoning in these chapters. Each macroeconomic model implies pro- or contra-cyclical relations for various economic items; the relations can be compared to the empirical data. But the theoretical relations are affected by numerous secondary factors. Several models can agree with the empirical evidence.

Module 21: read pages 273-279. The price-misperceptions model says that people are fooled by government policies. At first, this seems reasonable: non-economists do not understand the effects of fiscal and monetary policies. The rational expectations school of thought says that expectations of inflation are (on average) unbiased. People get estimates of future inflation in newspapers and magazines. It is unclear if people can be fooled. Know the rational expectations implications for the final exam, as well as the differences in the price-mis-perceptions model.

Module 22: read pages 280-287. Focus the section "Rules vs Discretion" on pages 284-287. Politicians, including economists serving on the Federal Reserve Board, don't want strict rules. They say they want the discretion to adjust their policies to the perceived needs of the economy. But some politicians want to "spread the wealth" to their constituents before elections. The U.S. has an independent FED, to curb this populism.

Other economists, as Milton Friedman, believe central banks do more harm than good with their discretionary policies. They want central banks bound by rules relating the money supply to population growth and real GDP. Some countries now set explicit rules for the central bank, directing it to target low and stable inflation. Countries that had high inflation in past years are especially likely to set strict rules for the central bank.