Lecture Notes in Macroeconomics

Christian Groth

October 1, 2017
Contents

Preface xvii

I THE FIELD AND BASIC CATEGORIES 1

1 Introduction 3
  1.1 Macroeconomics 3
  1.1.1 The field 3
  1.1.2 The different “runs” 5
  1.2 Elements of macroeconomic analysis 8
  1.2.1 Model elements 8
  1.2.2 From input to output 11
  1.3 Macroeconomic models and national income accounting 15
  1.4 Some terminological points 15
  1.5 Brief history of macroeconomics 16
  1.6 Literature notes 17

2 Review of technology and firms 19
  2.1 The production technology 19
  2.1.1 A neoclassical production function 20
  2.1.2 Returns to scale 23
  2.1.3 Properties of the production function under CRS 29
  2.2 Technological change 32
  2.3 The concepts of representative firm and aggregate production function 38
  2.4 The neoclassical competitive one-sector setup 40
  2.4.1 Profit maximization 41
  2.4.2 Clearing in factor markets 45
  2.5 More complex model structures* 50
  2.5.1 Convex capital installation costs 50
  2.5.2 Long-run versus short-run production functions 51
5.1.4 Discussion . . . . . . . . . . . . . . . . . . . . . . . . . . . 181

5.2 Endogenous labor supply . . . . . . . . . . . . . . . . . . . . . 183
  5.2.1 The intensive margin: A simple one-period model . . . . . 183
  5.2.2 Endogenous labor supply in an extended Diamond model . 190

5.3 Early retirement with transfer income . . . . . . . . . . . . . . 194

5.4 Intertemporal substitution of labor supply . . . . . . . . . . . . 205

5.5 Concluding remarks . . . . . . . . . . . . . . . . . . . . . . . . 211

5.6 Literature notes . . . . . . . . . . . . . . . . . . . . . . . . . . 211

5.7 Appendix: The extended Slutsky equation . . . . . . . . . . . . 212

6 Long-run aspects of fiscal policy and public debt 215
  6.1 An overview of government spending and financing issues . . . 216
  6.2 The government budget . . . . . . . . . . . . . . . . . . . . . 217
  6.3 Government solvency and fiscal sustainability . . . . . . . . . . 222
    6.3.1 The critical role of the growth-corrected interest factor . 223
    6.3.2 Sustainable fiscal policy . . . . . . . . . . . . . . . . . . 226
  6.4 Debt arithmetic . . . . . . . . . . . . . . . . . . . . . . . . . . 227
    6.4.1 The required primary budget surplus . . . . . . . . . . . 228
    6.4.2 Case study: The Stability and Growth Pact of the EMU . 235
  6.5 Solvency, the NPG condition, and the intertemporal government
    budget constraint . . . . . . . . . . . . . . . . . . . . . . . . . 243
    6.5.1 When is the NPG condition necessary for solvency? . . . 243
    6.5.2 Equivalence of NPG and GIBC . . . . . . . . . . . . . . . 246
  6.6 A proper accounting of public investment* . . . . . . . . . . . . 250
  6.7 Ricardian equivalence? . . . . . . . . . . . . . . . . . . . . . . 253
    6.7.1 A small open OLG economy with a temporary budget deficit255
    6.7.2 A one-off tax cut . . . . . . . . . . . . . . . . . . . . . . 260
    6.7.3 Widening the perspective . . . . . . . . . . . . . . . . . 264
  6.8 Concluding remarks . . . . . . . . . . . . . . . . . . . . . . . . 266
  6.9 Literature notes . . . . . . . . . . . . . . . . . . . . . . . . . . 267
  6.10 Appendix A . . . . . . . . . . . . . . . . . . . . . . . . . . . . 268
  6.11 Exercises . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 269

7 Bequests and the modified golden rule 271
  7.1 Bequests . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 271
  7.2 Barro’s dynasty model . . . . . . . . . . . . . . . . . . . . . . . 272
    7.2.1 A forward-looking altruistic parent . . . . . . . . . . . . 273
    7.2.2 Case 1: the bequest motive operative (\(b_{t+1} > 0\) optimal) . 276
    7.2.3 Case 2: the bequest motive not operative (\(b_{t+1} = 0\) optimal) 282
    7.2.4 Necessary and sufficient conditions for the bequest motive
      to be operative . . . . . . . . . . . . . . . . . . . . . . . . . . . 283
# CONTENTS

7.3 Bequests and Ricardian equivalence ............................................ 286  
7.4 The modified golden rule when there is technological progress* ........ 292  
7.5 Concluding remarks ................................................................. 297  
7.6 Literature notes ........................................................................ 298  
7.7 Appendix ..................................................................................... 299  
7.8 Exercises ..................................................................................... 303  

8 Optimal capital accumulation .......................................................... 305  
8.1 Command optimum ................................................................. 305  
8.1.1 A social planner ................................................................. 306  
8.1.2 The modified golden rule of the command optimum ................. 315  
8.1.3 The turnpike property ......................................................... 316  
8.2 Optimal control theory and the social planner’s problem* ............. 318  
8.2.1 Decomposing the social planner’s problem ............................. 318  
8.2.2 Applying the Maximum Principle ........................................... 322  
8.3 The overtaking and catching-up criteria* ..................................... 334  
8.4 Concluding remarks ................................................................... 338  
8.5 Literature notes ......................................................................... 339  
8.6 Appendix ..................................................................................... 340  
8.7 Exercises ..................................................................................... 356  

9 The intertemporal consumption-saving problem in discrete and continuous time ................................................................. 357  
9.1 Market conditions ....................................................................... 358  
9.2 Maximizing discounted utility in discrete time .............................. 360  
9.3 Transition to continuous time analysis .......................................... 371  
9.4 Maximizing discounted utility in continuous time ....................... 377  
9.4.1 The saving problem in continuous time ................................... 377  
9.4.2 Solving the saving problem ................................................... 380  
9.4.3 The Keynes-Ramsey rule ...................................................... 386  
9.4.4 Mangasarian’s sufficient conditions ....................................... 389  
9.5 The consumption function ......................................................... 389  
9.6 Concluding remarks ................................................................... 394  
9.7 Literature notes ......................................................................... 394  
9.8 Appendix ..................................................................................... 395  
9.9 Exercises ..................................................................................... 403  

10 The basic representative agent model: Ramsey ................................ 405  
10.1 Preliminaries ............................................................................ 406  
10.2 The agents ............................................................................... 407  
10.2.1 Households ........................................................................ 407  

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.2.2</td>
<td>Firms</td>
<td>413</td>
</tr>
<tr>
<td>10.3</td>
<td>General equilibrium and dynamics</td>
<td>414</td>
</tr>
<tr>
<td>10.4</td>
<td>Comparative analysis</td>
<td>426</td>
</tr>
<tr>
<td>10.4.1</td>
<td>The role of key parameters</td>
<td>426</td>
</tr>
<tr>
<td>10.4.2</td>
<td>Special case: Solow’s growth model*</td>
<td>428</td>
</tr>
<tr>
<td>10.5</td>
<td>A social planner’s problem</td>
<td>429</td>
</tr>
<tr>
<td>10.5.1</td>
<td>The equivalence theorem</td>
<td>430</td>
</tr>
<tr>
<td>10.5.2</td>
<td>Ramsey’s original zero discount rate and the overtaking criterion*</td>
<td>433</td>
</tr>
<tr>
<td>10.6</td>
<td>Concluding remarks</td>
<td>436</td>
</tr>
<tr>
<td>10.7</td>
<td>Literature notes</td>
<td>437</td>
</tr>
<tr>
<td>10.8</td>
<td>Appendix</td>
<td>438</td>
</tr>
<tr>
<td>10.9</td>
<td>Exercises</td>
<td>446</td>
</tr>
<tr>
<td>11</td>
<td>The Ramsey model in use</td>
<td>447</td>
</tr>
<tr>
<td>11.1</td>
<td>Fiscal policy and announcement effects</td>
<td>447</td>
</tr>
<tr>
<td>11.1.1</td>
<td>Public consumption financed by lump-sum taxes</td>
<td>448</td>
</tr>
<tr>
<td>11.1.2</td>
<td>Income taxation</td>
<td>453</td>
</tr>
<tr>
<td>11.1.3</td>
<td>Effects of shifts in the capital income tax rate</td>
<td>456</td>
</tr>
<tr>
<td>11.1.4</td>
<td>Ricardian equivalence</td>
<td>462</td>
</tr>
<tr>
<td>11.2</td>
<td>Learning by investing and investment-enhancing policy</td>
<td>465</td>
</tr>
<tr>
<td>11.2.1</td>
<td>The common framework</td>
<td>466</td>
</tr>
<tr>
<td>11.2.2</td>
<td>The arrow case: ( \lambda &lt; 1 )</td>
<td>469</td>
</tr>
<tr>
<td>11.2.3</td>
<td>Romer’s limiting case: ( \lambda = 1, n = 0 )</td>
<td>475</td>
</tr>
<tr>
<td>11.3</td>
<td>Concluding remarks</td>
<td>482</td>
</tr>
<tr>
<td>11.4</td>
<td>Literature notes</td>
<td>482</td>
</tr>
<tr>
<td>11.5</td>
<td>Appendix</td>
<td>483</td>
</tr>
<tr>
<td>11.6</td>
<td>Exercises</td>
<td>487</td>
</tr>
<tr>
<td>12</td>
<td>Overlapping generations in continuous time</td>
<td>489</td>
</tr>
<tr>
<td>12.1</td>
<td>Introduction</td>
<td>489</td>
</tr>
<tr>
<td>12.2</td>
<td>The model of perpetual youth</td>
<td>491</td>
</tr>
<tr>
<td>12.2.1</td>
<td>Households</td>
<td>491</td>
</tr>
<tr>
<td>12.2.2</td>
<td>Aggregation</td>
<td>500</td>
</tr>
<tr>
<td>12.2.3</td>
<td>The representative firm</td>
<td>502</td>
</tr>
<tr>
<td>12.2.4</td>
<td>Dynamic general equilibrium (closed economy)</td>
<td>503</td>
</tr>
<tr>
<td>12.3</td>
<td>Adding retirement</td>
<td>515</td>
</tr>
<tr>
<td>12.4</td>
<td>The rate of return in the long run</td>
<td>521</td>
</tr>
<tr>
<td>12.5</td>
<td>National wealth and foreign debt</td>
<td>525</td>
</tr>
<tr>
<td>12.6</td>
<td>Concluding remarks</td>
<td>534</td>
</tr>
<tr>
<td>12.7</td>
<td>Literature notes</td>
<td>535</td>
</tr>
</tbody>
</table>

CONTENTS

12.8 Appendix .................................................. 536
12.9 Exercises ................................................. 546

13 General equilibrium analysis of public and foreign debt 547
  13.1 Reconsidering the issue of Ricardian equivalence ............... 547
  13.2 Dynamic general equilibrium effects of lasting budget deficits .. 555
  13.3 Public and foreign debt: a small open economy ................. 570
  13.4 Government debt when taxes are distortionary* ................. 582
  13.5 Public debt policy ....................................... 589
  13.6 Credibility problems due to time inconsistency ................. 589
  13.7 Literature notes ......................................... 590
  13.8 Appendix ................................................. 590
  13.9 Exercises ................................................. 592

III MODELING FIXED CAPITAL INVESTMENT 593

14 Fixed capital investment and Tobin’s q 595
  14.1 Convex capital installation costs .............................. 597
     14.1.1 The decision problem of the firm ......................... 599
     14.1.2 The implied investment function ......................... 604
     14.1.3 A not implausible special case .......................... 605
  14.2 Marginal q and average q .................................. 608
  14.3 Applications .............................................. 609
  14.4 Concluding remarks ....................................... 617
  14.5 Literature notes ......................................... 619
  14.6 Appendix ................................................. 619
  14.7 Exercises ................................................. 629

15 Further applications of adjustment cost theory 631
  15.1 Oil price shock in a small oil-importing economy ............... 631
     15.1.1 Three inputs: capital, labor, and raw material .......... 632
     15.1.2 General equilibrium and dynamics ....................... 637
     15.1.3 National income accounting for an open economy with cap-
             ital installation costs .................................. 641
     15.1.4 Household behavior and financial wealth ................. 644
     15.1.5 General aspects of modeling a small open economy ...... 648
  15.2 Housing market dynamics ................................... 649
     15.2.1 The housing service market and the house market ....... 650
     15.2.2 Residential construction ................................ 653
     15.2.3 Dynamics under perfect foresight ........................ 658
### CONTENTS

15.2.4 Discussion ........................................ 663
15.3 Literature notes .................................... 665
15.4 Appendix ............................................. 665
15.5 Exercises ............................................ 670

### IV MODELING MONEY

#### 16 Money in macroeconomics 673

16.1 What is money? ...................................... 673
  16.1.1 The concept of money ......................... 673
  16.1.2 Historical remarks ............................. 675
  16.1.3 The functions of money ....................... 676
16.2 The money supply .................................... 677
  16.2.1 Different measures of the money stock .... 677
  16.2.2 The money multiplier ......................... 679
16.3 Money demand ....................................... 682
16.4 What is then the "money market"? ............... 683
16.5 Key questions in monetary theory and policy .. 687
16.6 Literature notes ..................................... 688
16.7 Exercises ............................................ 689

#### 17 Inflation and capital accumulation: The Sidrauski model 691

17.1 The agents .......................................... 692
17.2 Equilibrium and evolution over time ............ 699
17.3 Theoretical implications ........................... 702
  17.3.1 Money neutrality and superneutrality ...... 702
  17.3.2 Milton Friedman’s zero interest rate rule 706
  17.3.3 Discussion ...................................... 708
17.4 Are inflation and deflation bubbles possible? 710
17.5 Miscellaneous notes ............................... 716
17.6 Literature notes ..................................... 717
17.7 Appendix ............................................ 717
17.8 Exercises ............................................ 721

#### 18 Wider perspectives on monetary economies 723

18.1 Money growth and inflation in the long run .... 723
18.2 Are neutrality and superneutrality of money theoretically robust properties? .......... 727
18.3 Inflationary public finance ....................... 730
  18.3.1 The seigniorage Laffer curve ................. 731

## CONTENTS

20.3 General equilibrium ........................................ 828  
  20.3.1 The case with flexible wages and prices .......... 828  
  20.3.2 The case with sticky wages and prices ........ 833  
20.4 Spillover complementarity and multiple equilibria .... 840  
20.5 Concluding remarks ...................................... 842  
20.6 Literature notes ........................................ 843  
20.7 Appendix ................................................ 843  
20.8 Exercises ............................................... 843  

21 The IS-LM model ............................................. 845  
  21.1 The building blocks .................................... 846  
    21.1.1 The output market ................................ 846  
    21.1.2 Asset markets .................................... 850  
  21.2 Keynesian equilibrium ................................ 851  
  21.3 Alternative monetary policy regimes ................. 854  
    21.3.1 Money stock rule ................................ 854  
    21.3.2 Fixed interest rate rule ......................... 860  
    21.3.3 Contra-cyclical interest rate rule ............ 869  
  21.4 Further aspects ....................................... 870  
    21.4.1 A liquidity trap ................................ 870  
    21.4.2 The loanable funds theory of the interest rate 872  
  21.5 Some robustness checks ............................... 873  
    21.5.1 Presence of an interest rate spread (banks’ lending rate = \( i + \omega > i \)) ........................................ 873  
    21.5.2 What if households are infinitely-lived? .... 874  
  21.6 Concluding remarks .................................. 875  
  21.7 Literature notes ...................................... 876  
  21.8 Appendix ............................................. 877  
  21.9 Exercises ............................................ 877  

22 IS-LM dynamics with forward-looking expectations .... 879  
  22.1 A dynamic IS-LM model ................................. 880  
  22.2 Monetary policy regimes ............................... 885  
    22.2.1 Policy regime \( m \): Money stock rule .......... 885  
    22.2.2 Policy regime \( i \): Fixed short-term interest rate 898  
    22.2.3 Policy regime \( i' \): A contra-cyclical interest rate rule 902  
  22.3 Discussion ............................................ 904  
  22.4 Literature notes ................................... 905  
  22.5 Appendix ........................................... 905  

## CONTENTS

### 23 The open economy and alternative exchange rate regimes

- 23.1 The Mundell-Fleming model
  - 23.1.1 The basic elements
  - 23.1.2 Fixed exchange rate
  - 23.1.3 Floating exchange rate
  - 23.1.4 Perspectives
- 23.2 Dynamics under a fixed exchange rate
- 23.3 Dynamics under a floating exchange rate: overshooting
  - 23.3.1 The model
  - 23.3.2 Unanticipated rise in the real money supply
  - 23.3.3 Anticipated rise in the money supply
  - 23.3.4 Monetary policy tightening
- 23.4 Concluding remarks
- 23.5 Literature notes
- 23.6 Appendix
- 23.7 Exercises

### 24 A closer look at the labor market

- 24.1 Introduction
- 24.2 Themes
- 24.3 Problems

### VI UNCERTAINTY AND EXPECTATIONS

### 25 Uncertainty, rational expectations, and staggered wage setting

- 25.1 Simple expectation formation hypotheses
- 25.2 The rational expectations hypothesis
  - 25.2.1 Two model classes
  - 25.2.2 Rational expectations
  - 25.2.3 Solving a simple RE model
- 25.3 Wage setting in advance
- 25.4 A benchmark model with synchronous wage setting
  - 25.4.1 Wage setting one period in advance
  - 25.4.2 Solving the benchmark model
- 25.5 Asynchronous wage setting for several periods: Fischer’s approach
  - 25.5.1 The original Fischer model
  - 25.5.2 A modified Fischer model
- 25.6 Asynchronous wage setting with constant wage level for several periods: Taylor’s model
- 25.7 Conclusion

25.8 Appendix .................................................. 982
25.9 Exercises ................................................. 989

26 Forward-looking rational expectations .................................. 991
26.1 Expectational difference equations .................................. 991
26.2 Solutions when $|a| < 1$ .................................... 994
   26.2.1 Repeated forward substitution .......................... 994
   26.2.2 The fundamental solution .............................. 995
26.2.3 Bubble solutions ........................................ 998
26.2.4 When rational bubbles in asset prices can or can not be ruled out ..... 1005
26.2.5 Time-dependent coefficients ................................ 1010
26.2.6 Three classes of bubble processes .......................... 1011
26.3 Solutions when $|a| > 1$ .................................... 1013
26.4 Concluding remarks ......................................... 1014
26.5 Literature notes ............................................ 1015
26.6 Appendix .................................................. 1016
26.7 Exercises ................................................. 1020

27 Applications to New Classical and Keynesian models ............. 1025
27.1 New Classical Macroeconomics .................................. 1026
   27.1.1 The New Classical school .............................. 1026
   27.1.2 An NCM model ........................................ 1026
   27.1.3 Weak and strong policy ineffectiveness .................. 1036
   27.1.4 Alternative specifications and extensions ............... 1042
   27.1.5 Discussion ............................................ 1047
27.2 The Lucas critique of econometric policy evaluation ............. 1048
27.3 Paper money and hyperinflation ................................ 1051
27.4 Announcement effects ...................................... 1054
27.5 Is increased wage flexibility stabilizing? ......................... 1057
   27.5.1 Dynamic AD-AS model with uncertainty and nominal rigidities ........................................ 1058
   27.5.2 Dynamic responses .................................... 1061
27.6 Depression economics ........................................ 1063
27.7 Conclusion ................................................ 1063
27.8 Appendix ................................................ 1064

28 Can rational bubbles be ruled out in general equilibrium? ...... 1067
28.1 Introduction .............................................. 1067
28.2 Finite number of agents .................................... 1069

28.3 Infinite number of agents: OLG models ......................... 1070
  28.3.1 No bubbles ........................................ 1070
  28.3.2 The Diamond-Tirole model ........................... 1072
  28.3.3 Stochastic bubbles .................................. 1078
28.4 Concluding remarks ........................................ 1079
28.5 Notes on the literature ..................................... 1079
28.6 Appendix ................................................ 1079
28.7 Problems ................................................ 1082

VII FITTING THE PARTS TOGETHER: THE MEDIUM RUN 1083

29 Business fluctuations ......................................... 1085
  29.1 Some business cycle facts ................................. 1085
  29.2 Key terms from the business cycle vocabulary .......... 1087
  29.3 A quick glance at the Great Recession and its aftermath .. 1088
  29.4 Conclusion ............................................ 1091
  29.5 Literature notes ....................................... 1091
  29.6 Exercises .............................................. 1091

30 The real business cycle theory ............................... 1093
  30.1 A simple RBC model ................................... 1094
  30.2 A deterministic steady state* ............................ 1102
  30.3 On the approximate solution and numerical simulation* . 1104
    30.3.1 Log-linearization .................................. 1105
    30.3.2 Numerical simulation ................................ 1107
  30.4 The two basic propagation mechanisms .................... 1109
  30.5 Limitations ............................................ 1110
  30.6 Technological change as a random walk with drift ...... 1112
  30.7 Concluding remarks .................................... 1113
  30.8 Literature notes ....................................... 1114
  30.9 Exercises .............................................. 1114

31 Keynesian perspectives on business cycles .................. 1115
  31.1 A minimalist Keynesian medium-run model in discrete time .. 1116
  31.2 Vicious and virtuous circles ............................ 1119
  31.3 Precautionary saving ................................... 1122
    31.3.1 Consumption/saving under alternative forms of uncertainty 1122
    31.3.2 Precautionary saving in a macroeconomic perspective ... 1129
  31.4 On the distinction between risk aversion and prudence* . 1130
