

Economics 320: Macroeconomic Theory II

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I. What is Macroeconomics?

“Macroeconomic theory focuses on the determinants of ... (aggregate) economic activity.” — Michl (2002)

This is an extremely vague statement. Yet, it may be appropriate.

Notice that the focus is something called “**economic activity**”.

- This is a general term which implies **aggregation**.

The basic idea of macroeconomics as a discipline is that it is possible to study directly the determination and behaviour of economic aggregates.

A number of questions immediately present themselves:

1. What are these aggregates (*i.e* what is *economic activity*)?
2. What is the appropriate time dimension over which to consider them?
 - economic growth vs. “the business cycle”
 - the importance of saving/investment and/or search behaviour

3. How do we treat expectations about the future?

4. To what extent should we abstract from the *individual* behaviour that is *aggregated* to generate economic activity?

This is the issue of “micro-foundations”.

5. How do we expect aggregates to react to policy actions?

There are many other questions that one might ask. I have chosen these because we will take up each of them in this course. Also, I have put them in the order that they have come to the forefront of economic debates.

Over time, economists have approached these issues in different ways and designed models to address particular issues.

In this course we will focus on a modern approach that has been developed over the past forty years. I will refer to this as the “neo-classical” approach (as does David Andolfatto).

To begin with, however, I will be more explicit about the relevant “macroeconomic issues”...

1. Long-term economic growth vs. short-term aggregate fluctuations.
2. Co-movements among aggregates over the “business cycle”.

Figure 1: Canadian Gross Domestic Product

1961–2008, Annual

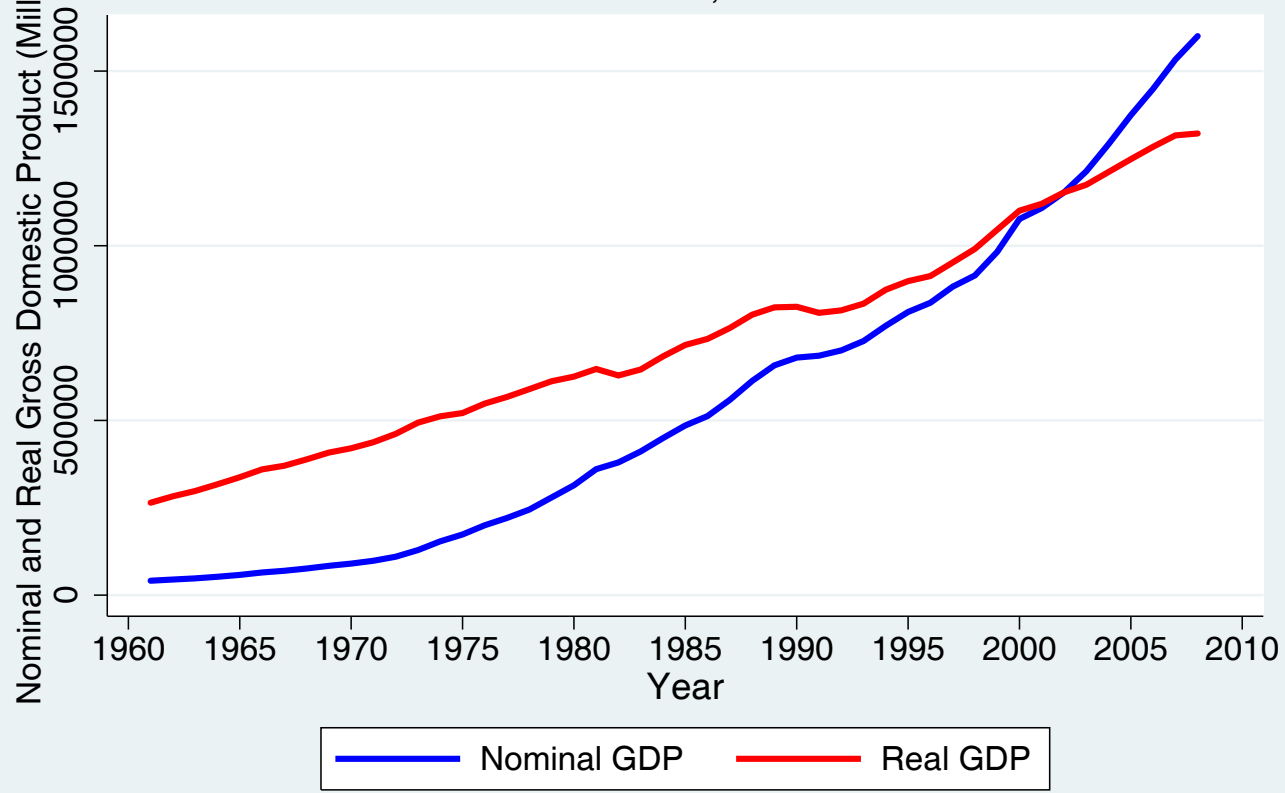


Figure 2: Canadian Real Gross Domestic Product

1961.Q1–2009.Q2, Quarterly

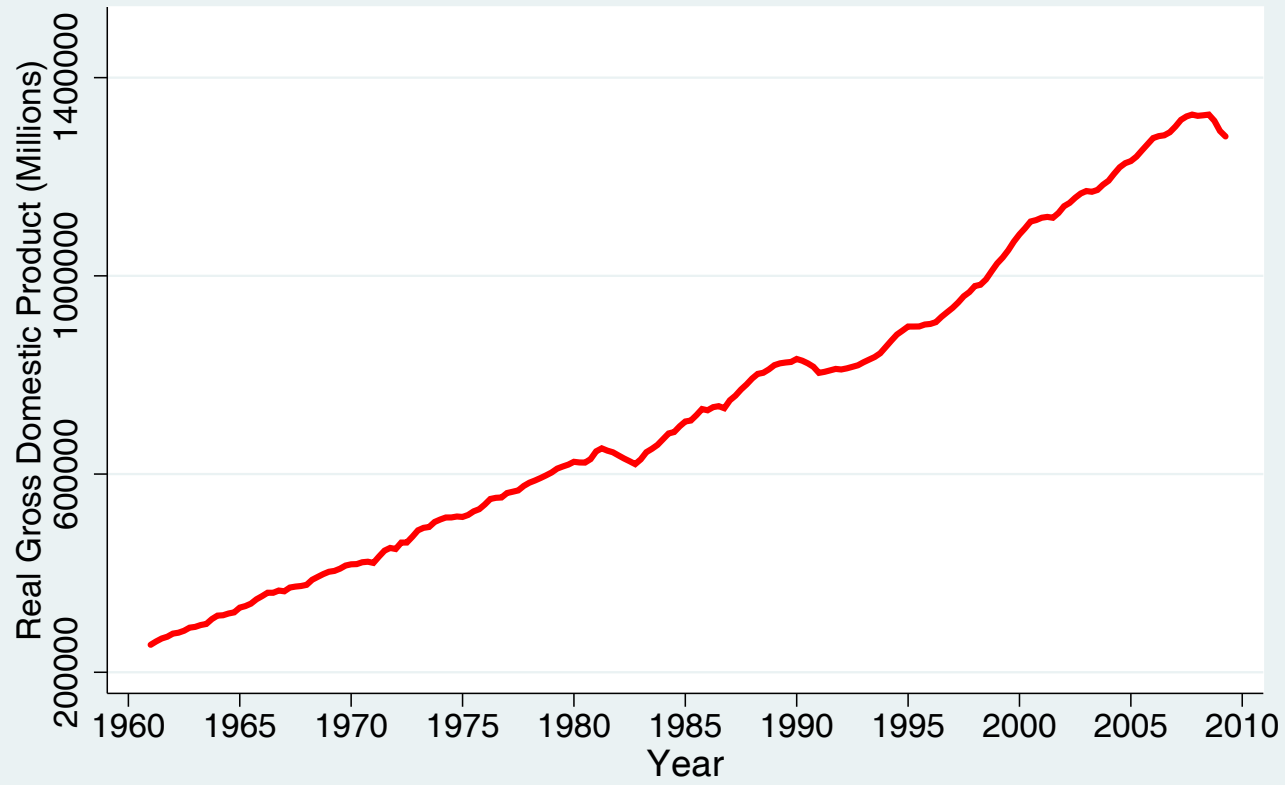


Figure 3: Logarithm of Canadian Real Gross Domestic Product
1961.Q1–2009.Q2, Quarterly

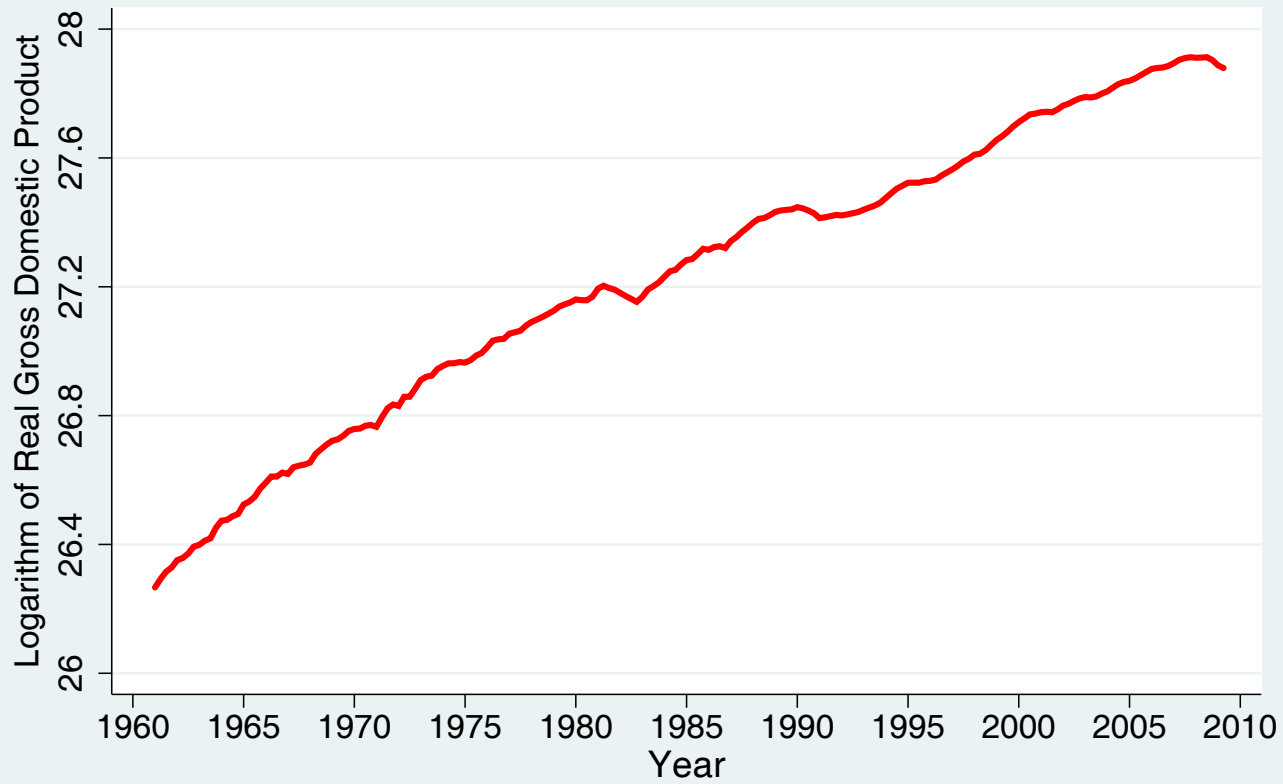


Figure 4: Growth Rate of Canadian Real GDP

1961.Q1–2009.Q2, Quarterly

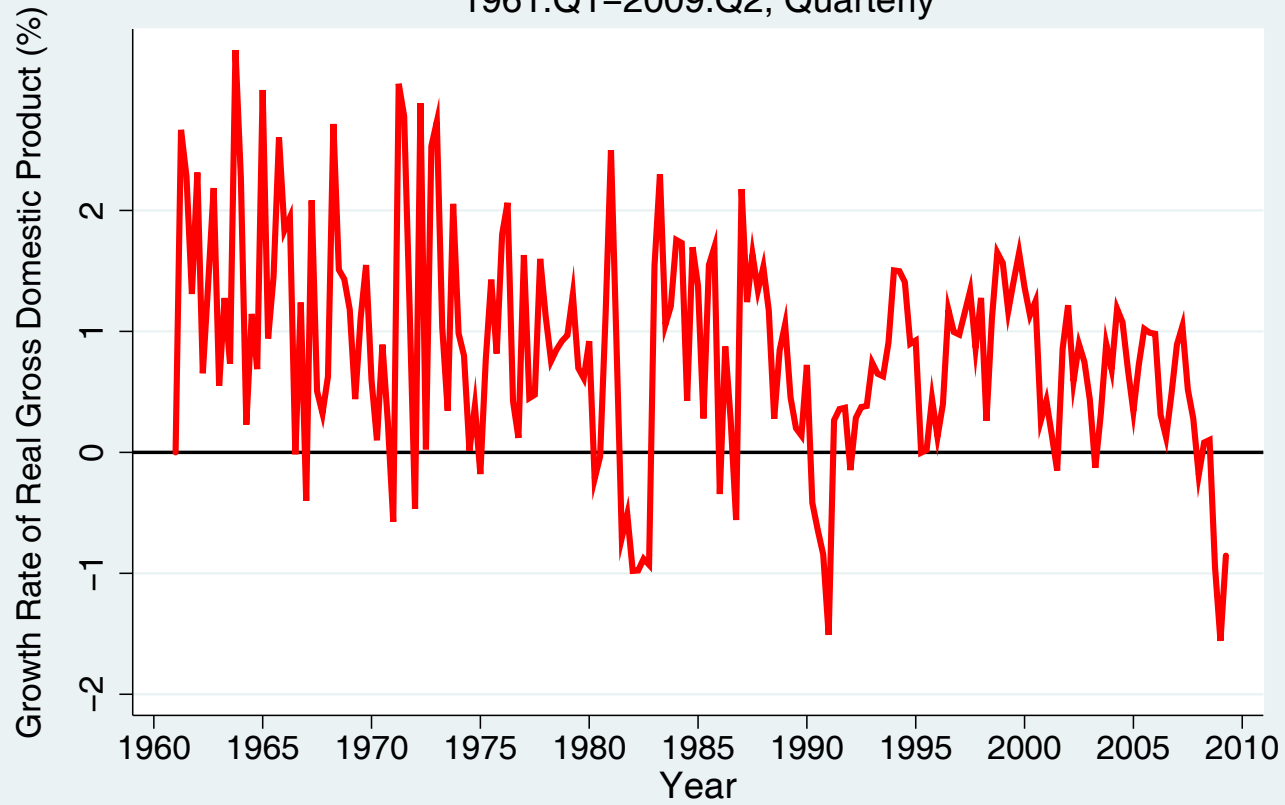


Figure 5: Trend Deviations of Canadian Real GDP

1961.Q1–2009.Q2, Quarterly

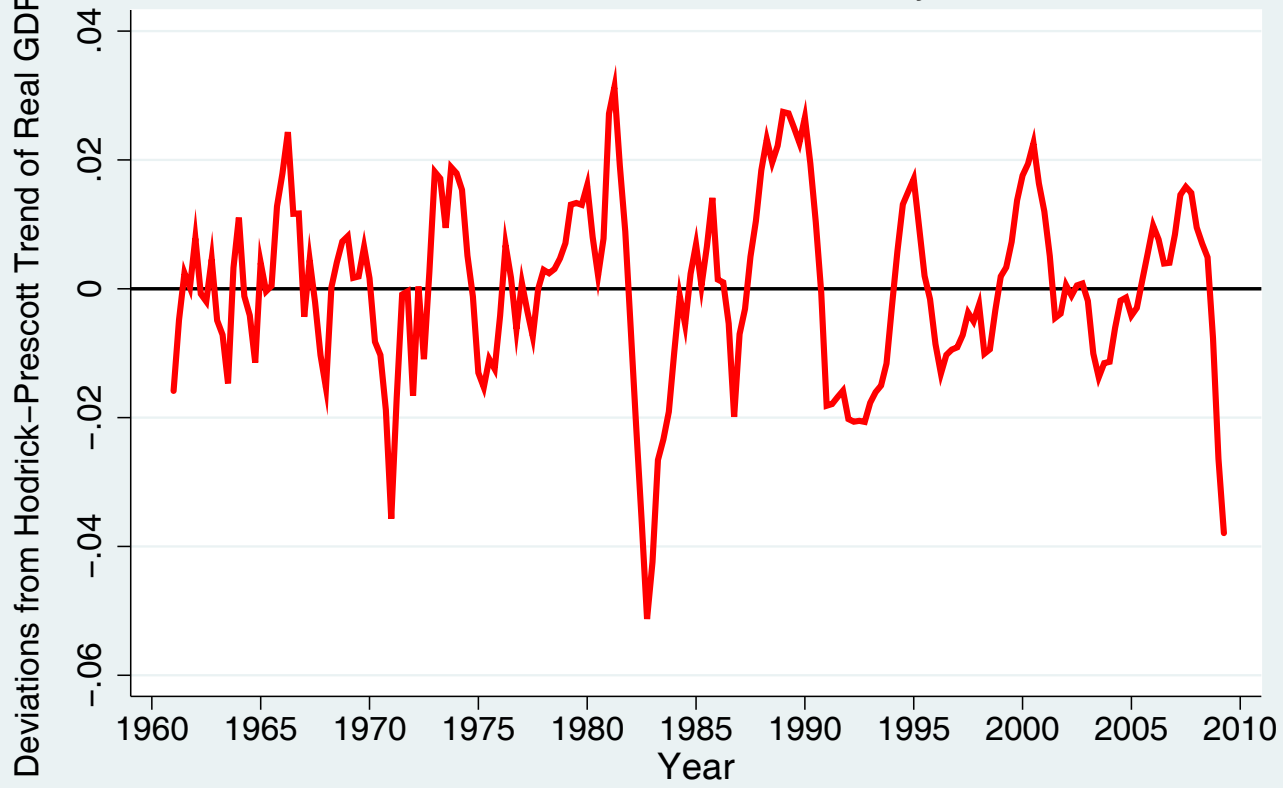


Figure 6: Canadian Real GDP Components

1961.Q1–2009.Q2, Quarterly

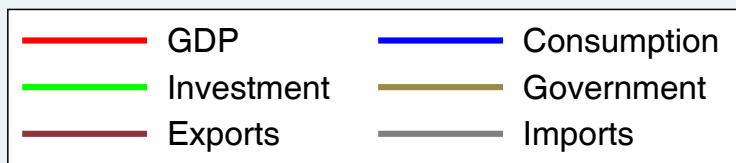
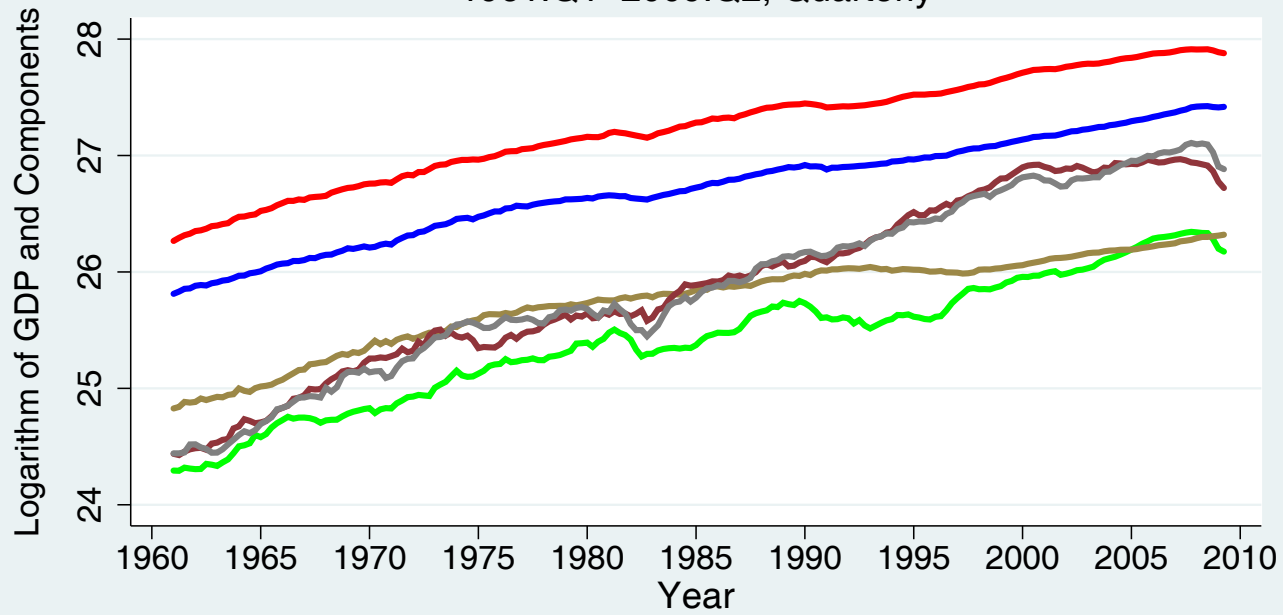


Figure 7: Canadian Real GDP Closed Economy Components

1961.Q1–2009.Q2, Quarterly

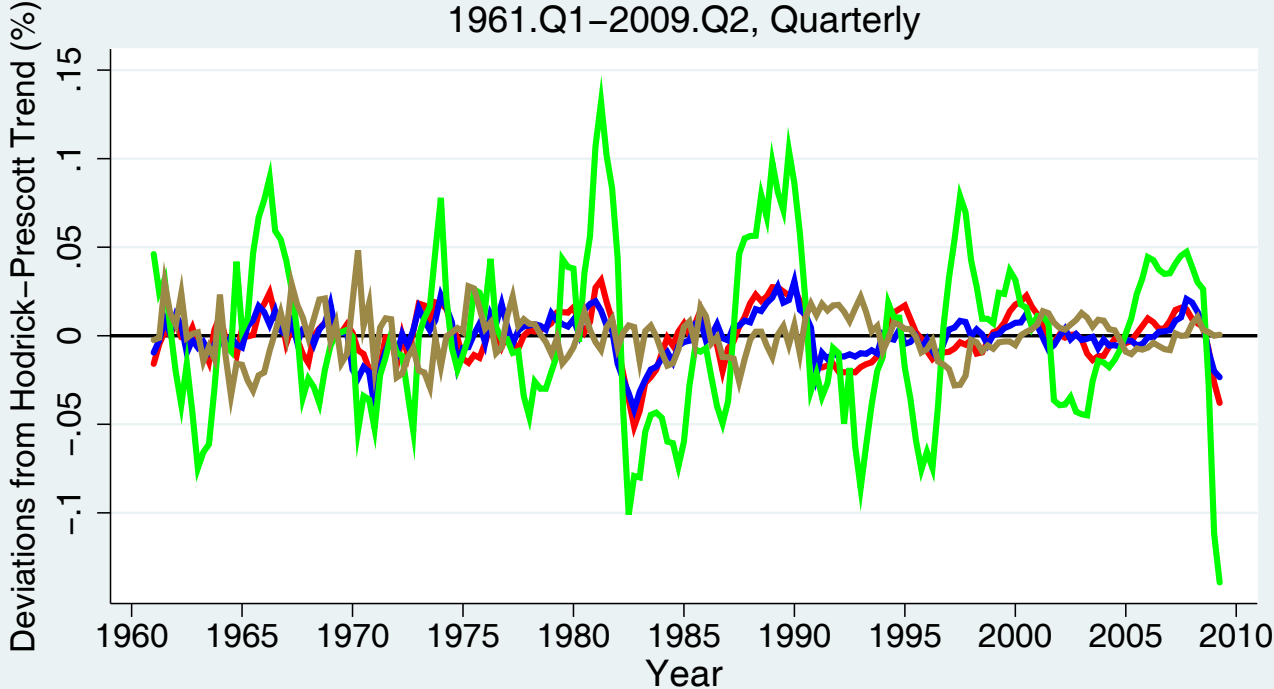


Figure 8: Canadian Real GDP and Consumption

1961.Q1–2009.Q2, Quarterly

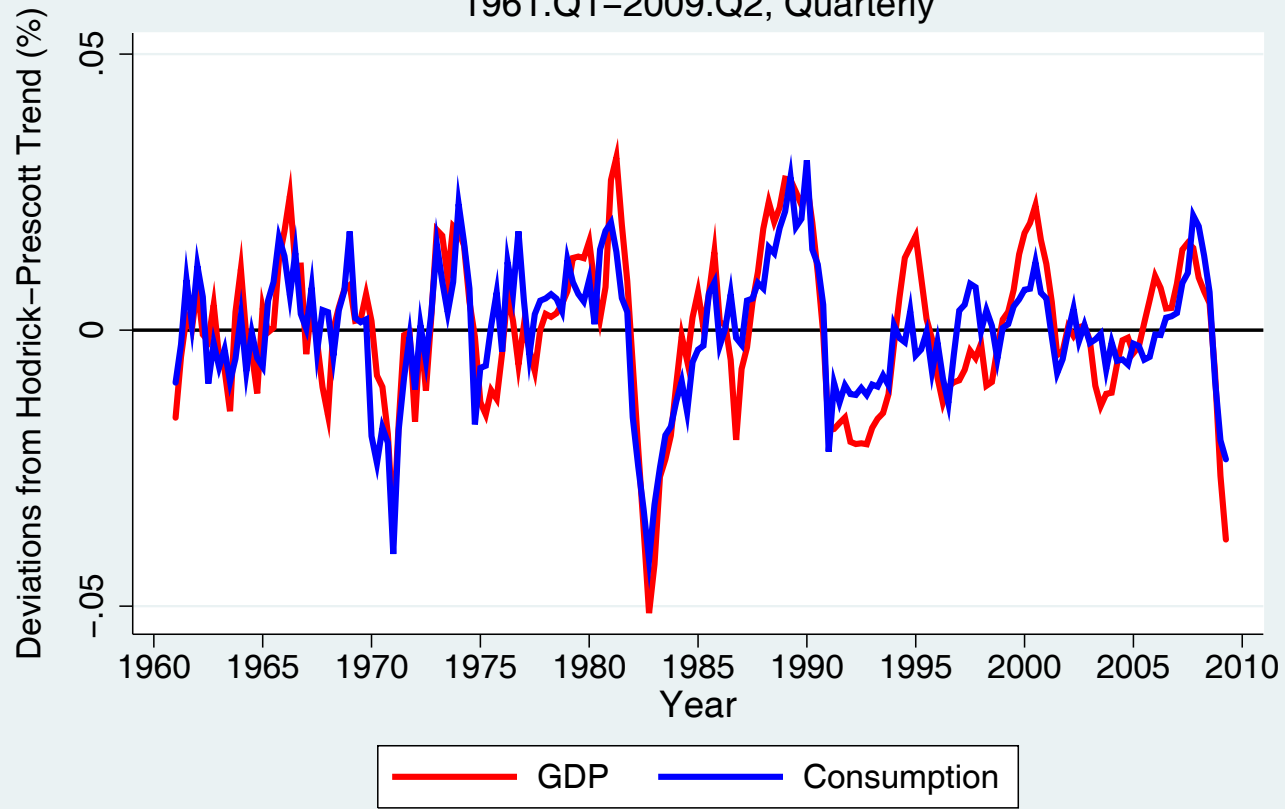


Figure 9: Canadian Real GDP and Investment

1961.Q1–2009.Q2, Quarterly

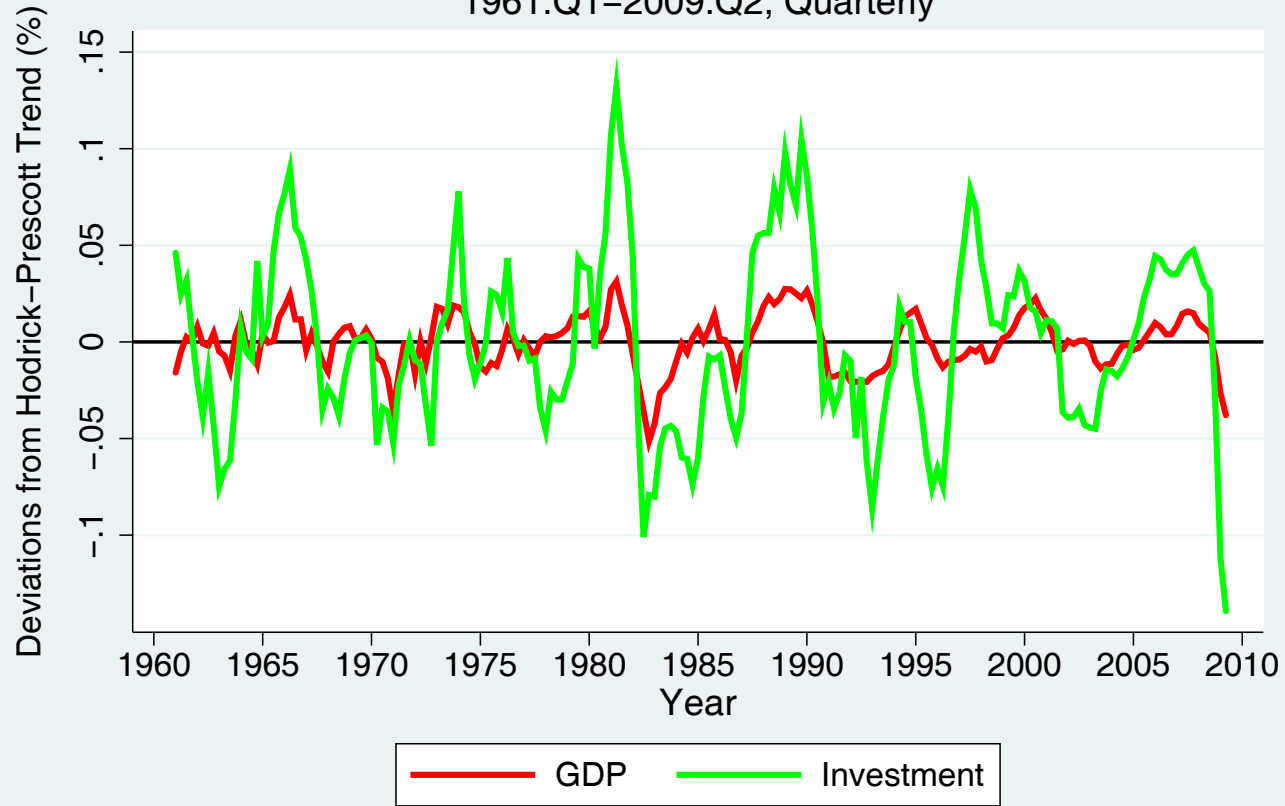


Figure 10: Canadian Real GDP and Government Expenditure

1961.Q1–2009.Q2, Quarterly

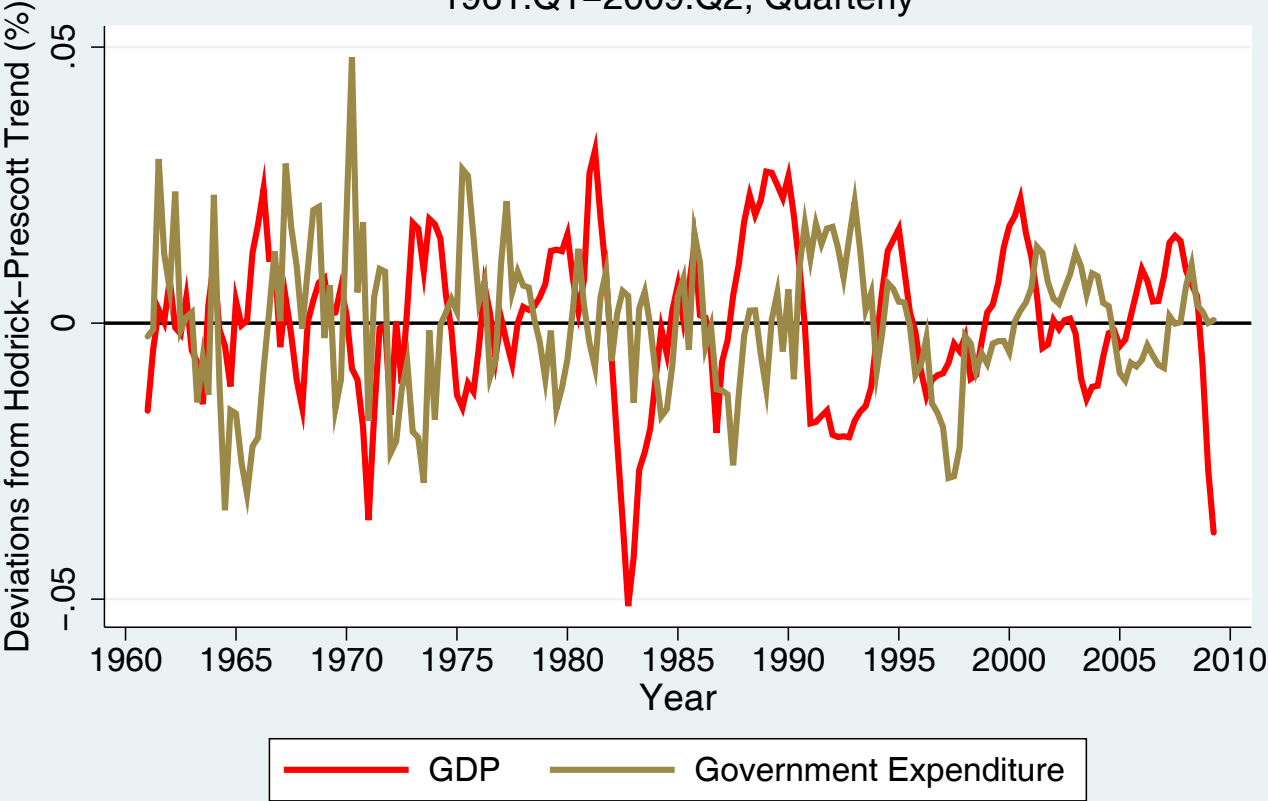


Figure 11: Canadian Real GDP and Exports

1961.Q1–2009.Q2, Quarterly

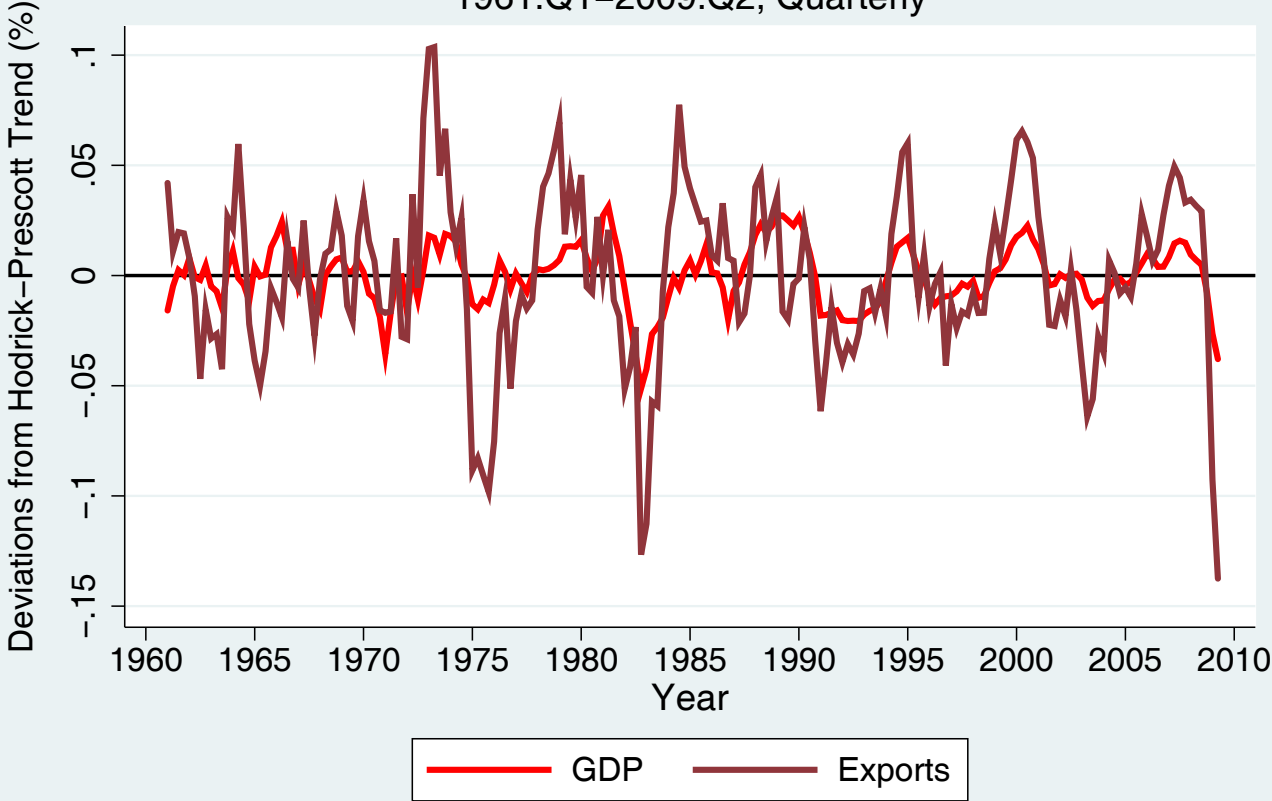


Figure 12: Canadian Real GDP and Imports

1961.Q1–2009.Q2, Quarterly

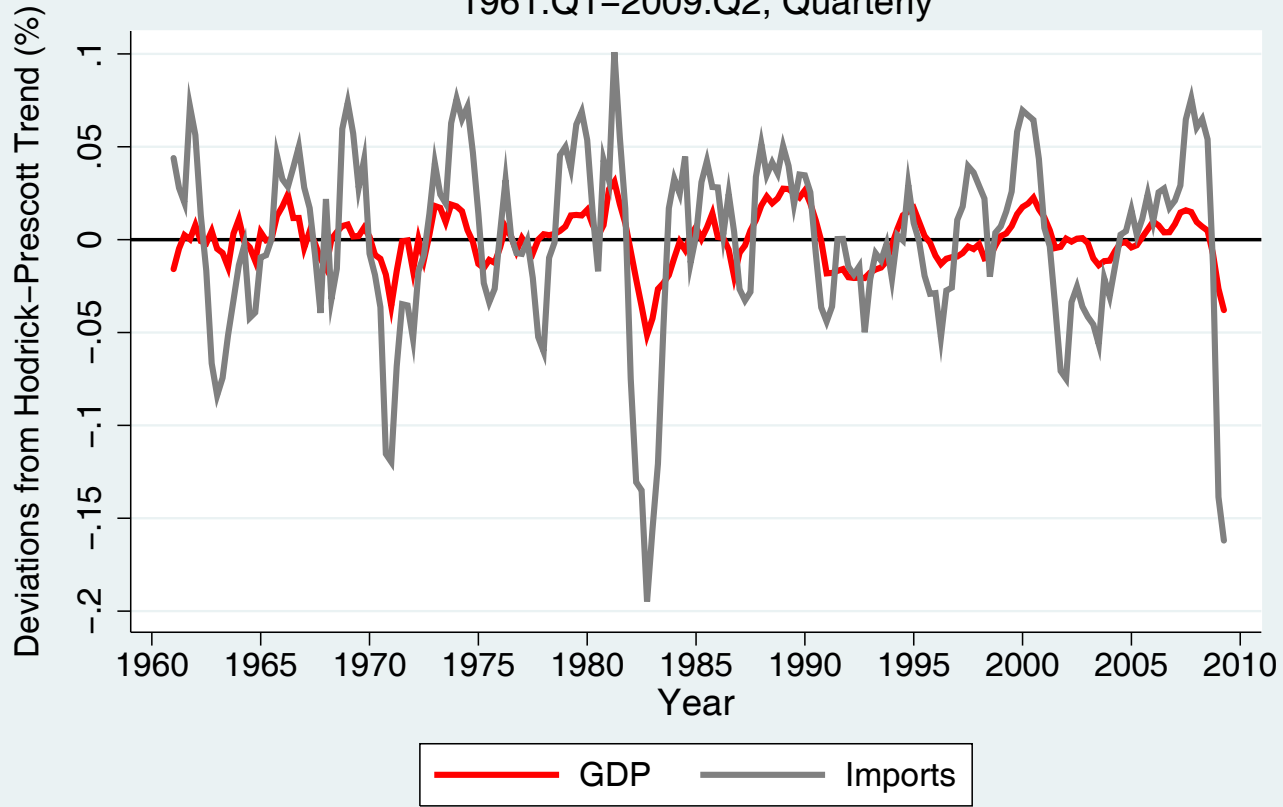


Figure 13: Canadian Real GDP and Employment

1976.Q1–2009.Q2, Quarterly

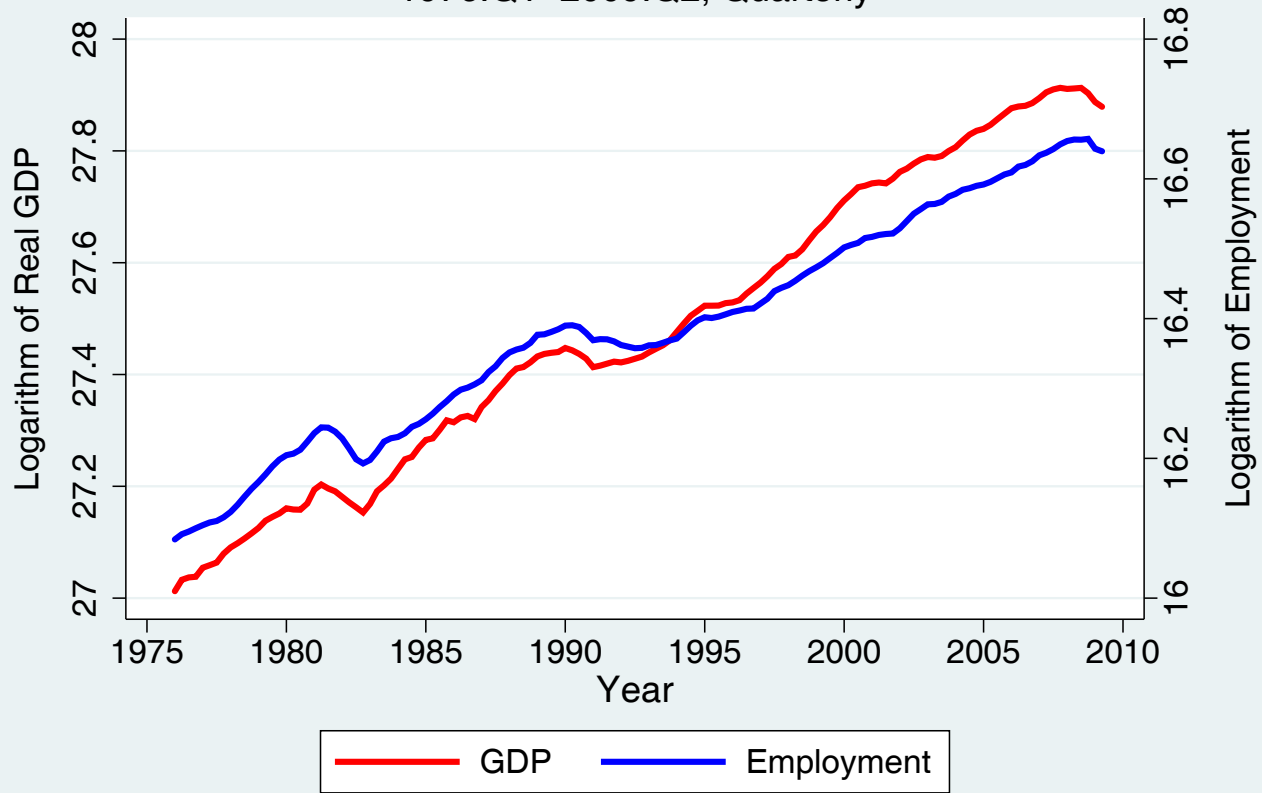


Figure 14: Deviations of Canadian Real GDP and Employment
1976.Q1–2009.Q2, Quarterly

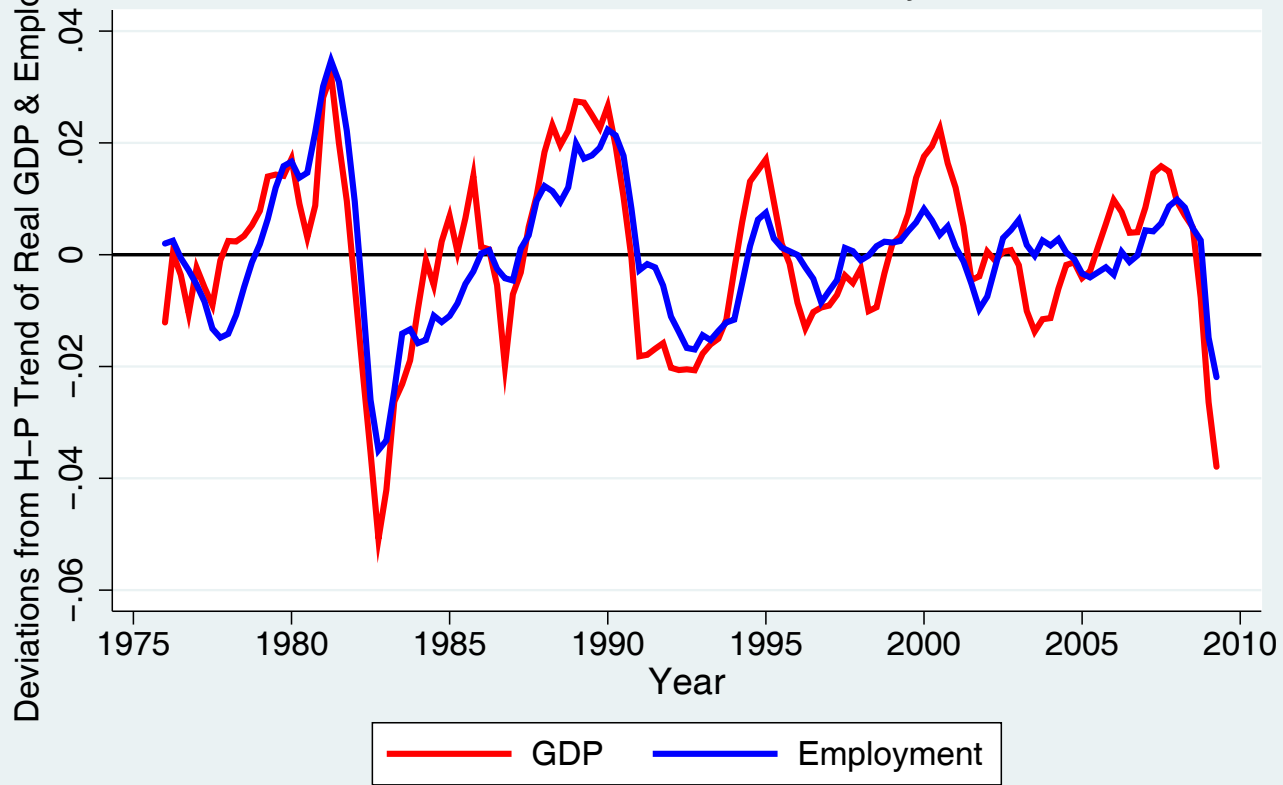


Figure 15: Canadian Real GDP and Hours Worked

1976.Q1–2009.Q2, Quarterly

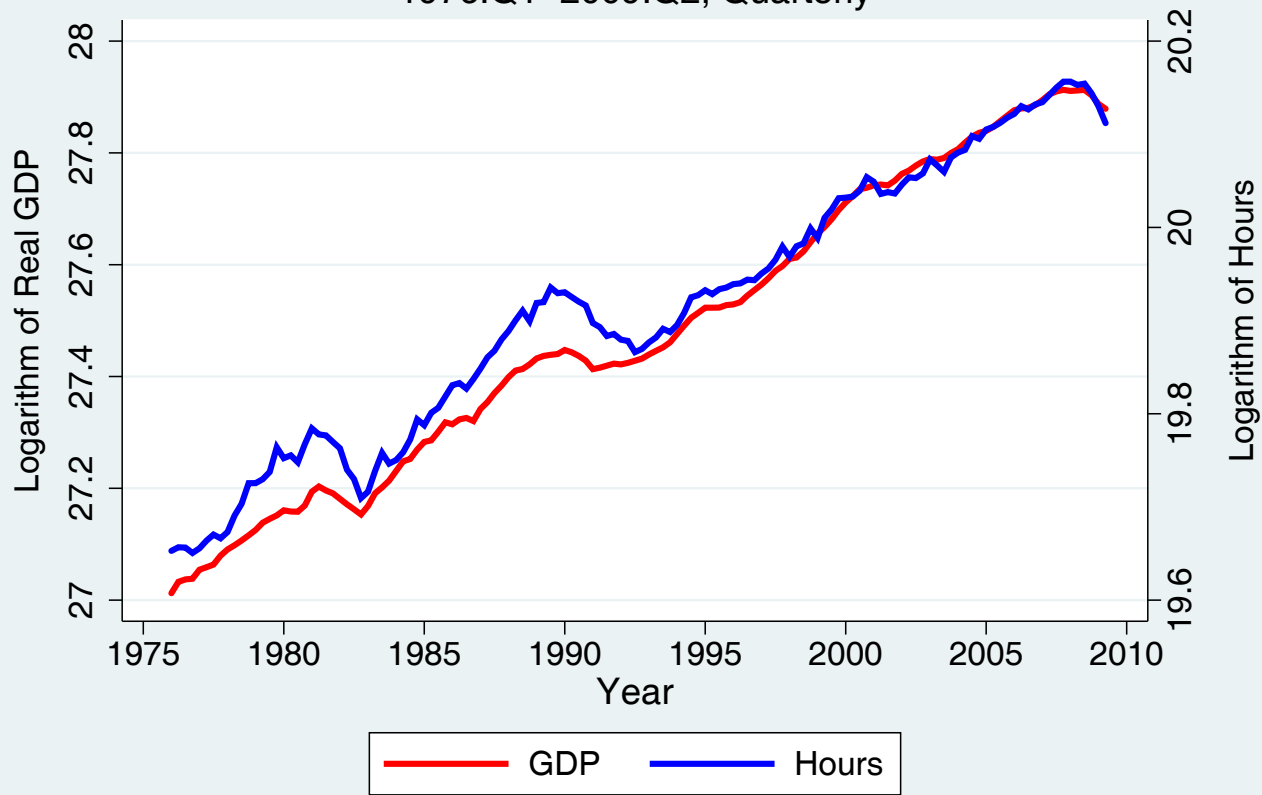


Figure 16: Deviations of Canadian Real GDP and Hours

1976.Q1–2009.Q2, Quarterly

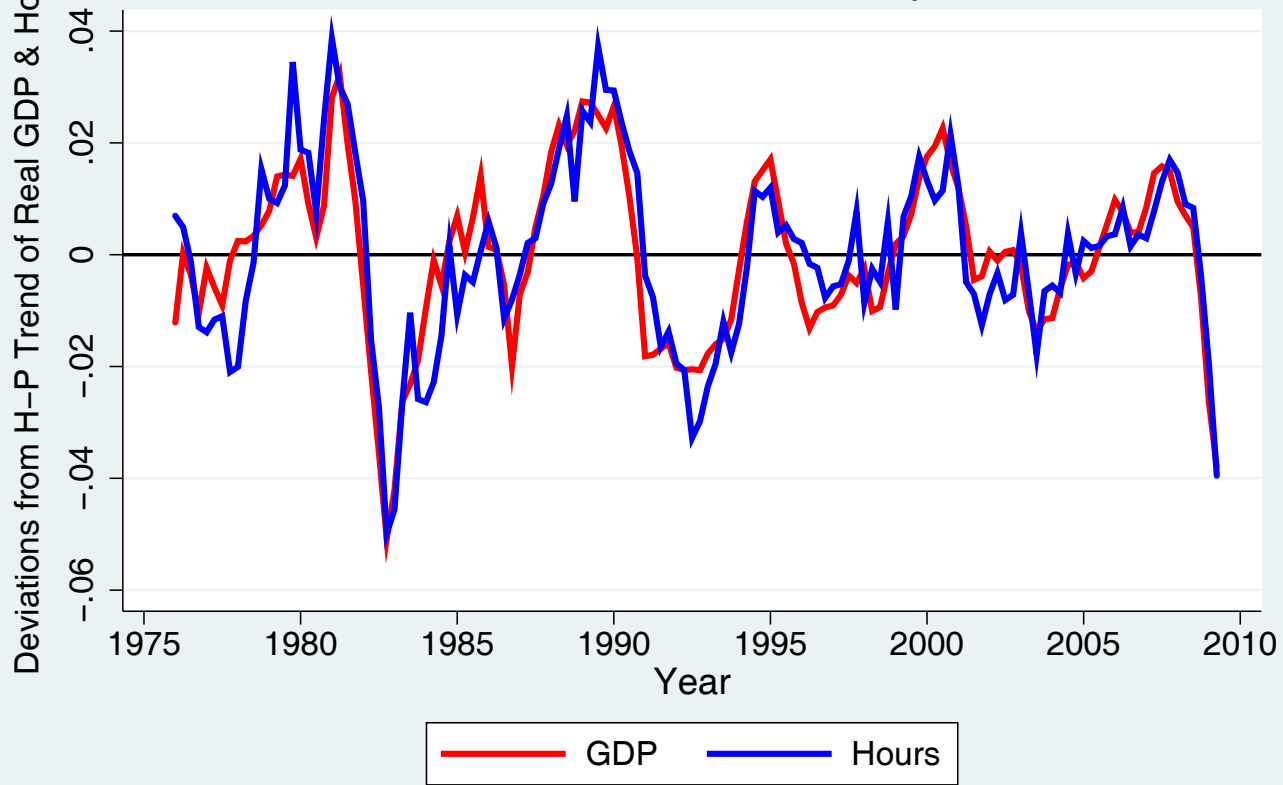


Figure 17: Canadian Real GDP and the Unemployment Rate

1976.Q1–2009.Q2, Quarterly

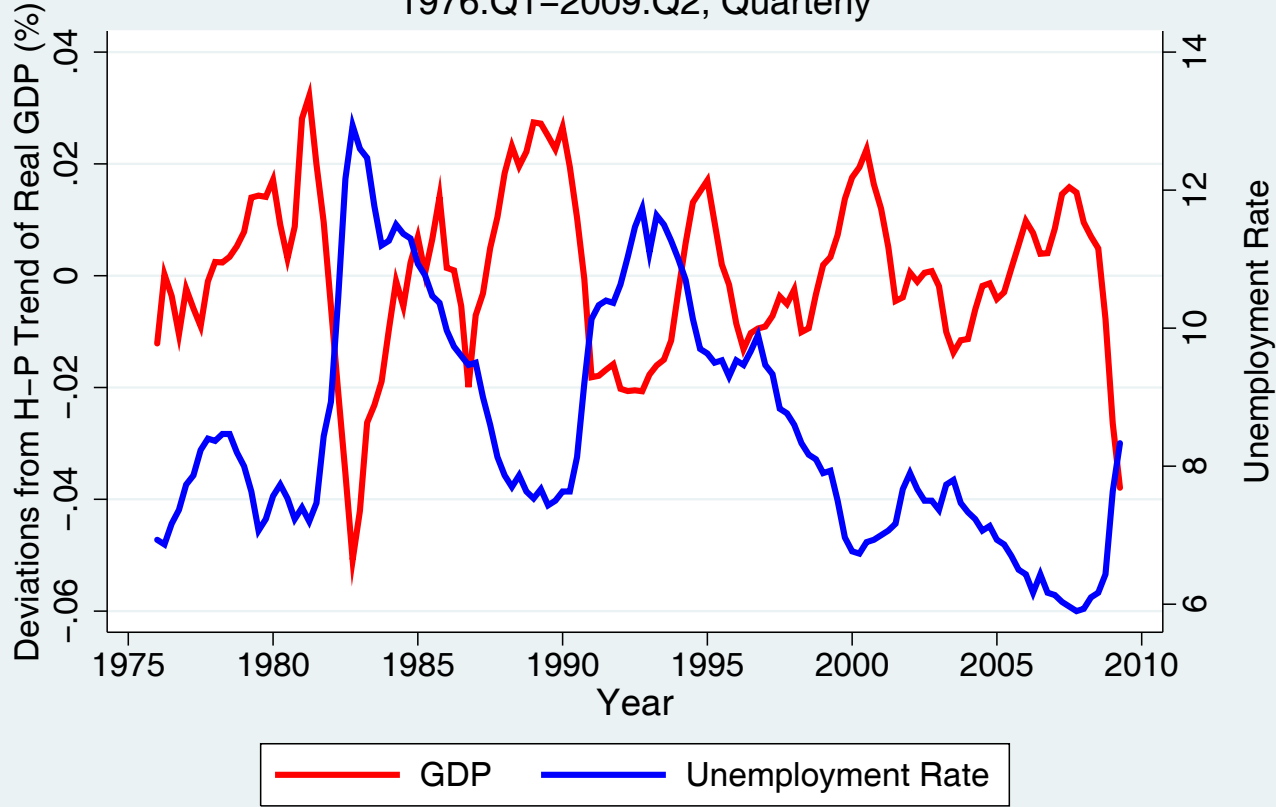


Figure 18.2: Canadian Prices: 1986–2008

1986–2008, Annual

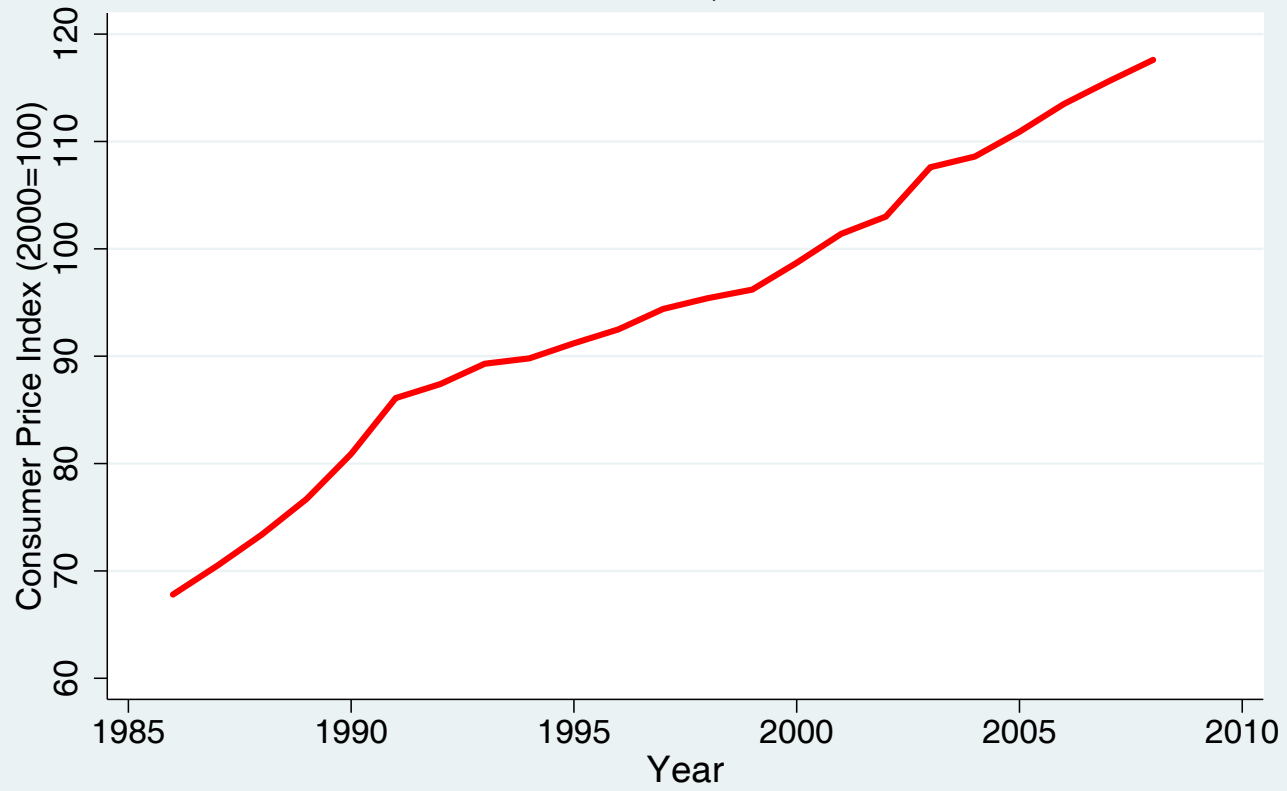


Figure 19.2: Canadian CPI Inflation: 1987–2008

1987–2008, Annual

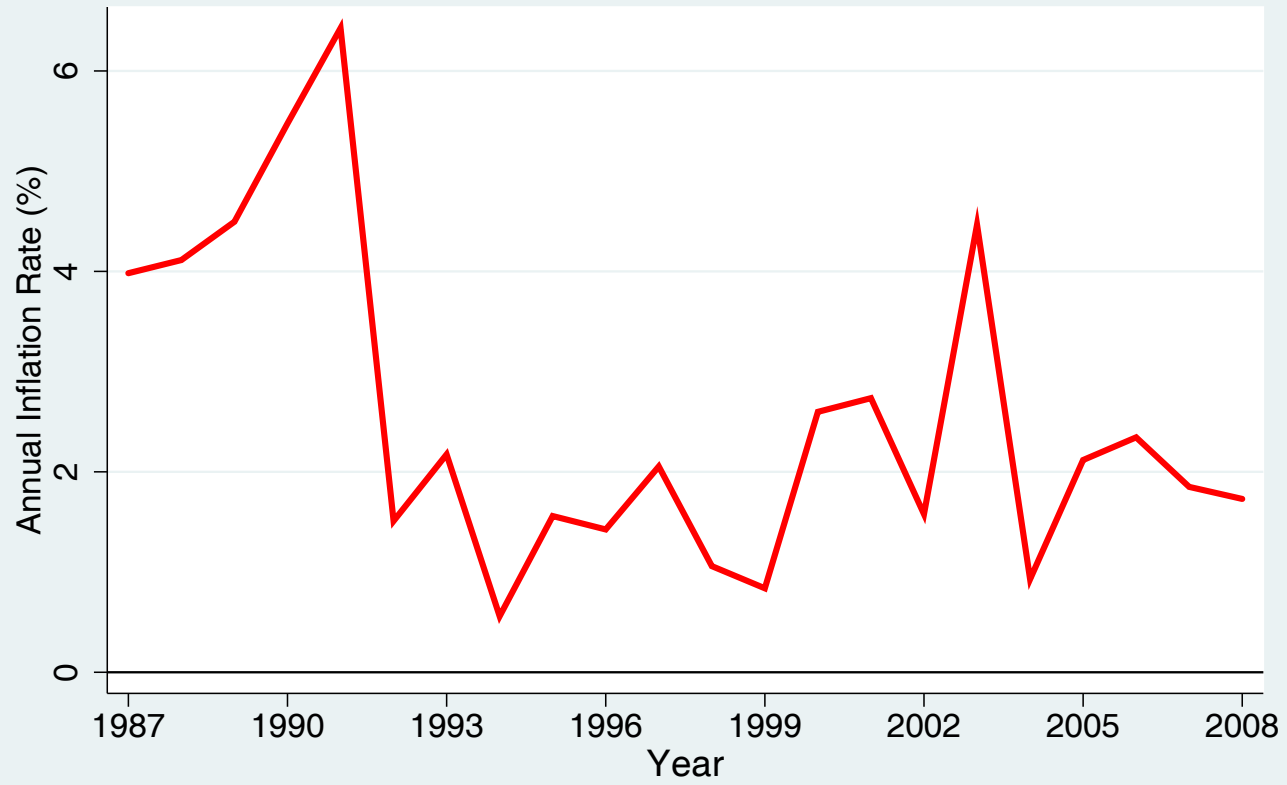
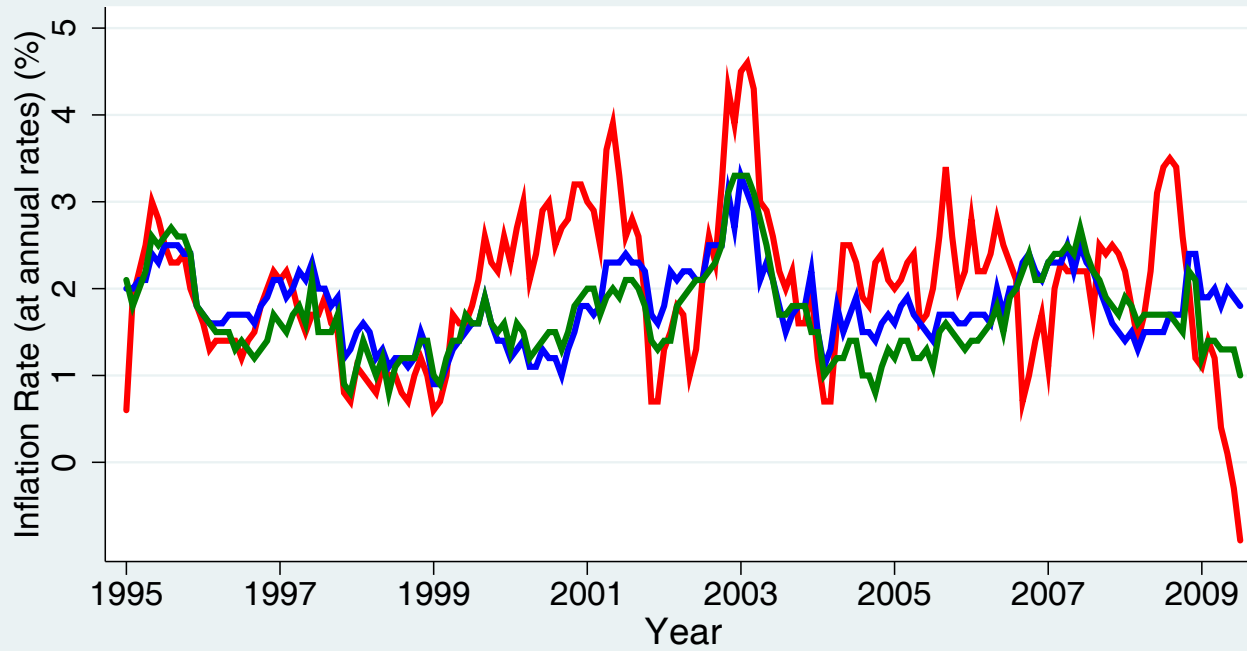


Figure 20: Canadian Inflation

1995M1–2009M7, Monthly



A brief and extremely simplified chronology of business cycle theory

1. **Early twentieth century:** Identification of the “reference cycle”

Economists noted and documented that many industries tend to go through highly synchronized cycles of expansion and contraction.

2. **1930's:** Keynes's *General Theory*

Focus on the role of aggregate demand in determining the level of economic activity at a point in time.

3. **Late 1930's until mid-1970's:** Policy based on Keynes's theory

Very active fiscal and monetary policies to alleviate the problems associated with the business cycle. Limits on international financial transactions and capital flows. Fixed exchange rates.

4. **1970's:** Stagnation, Inflation, Oil shocks and Lucas's critique.

Renewed interest in microeconomic behaviour and incentives.

5. **1980's to present:** "Micro-founded" dynamic macroeconomics
(neo-classical)

"New Classical" vs. "New Keynesian" approaches.

- Importance of **frictions** in the economy.
- Aggregate Demand vs. Productivity