ECON10003
Introductory Macroeconomics

SUBJECT GUIDE

Semester 2, 2014

Adam Smith          Maynard Keynes          Milton Friedman        Robert Lucas

Prepared by
Dr. Graham Richards
Subject Coordinator

Department of Economics
Faculty of Business and Economics
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Introduction

Welcome to ECON10003 Introductory Macroeconomics.

You have chosen to study macroeconomics at a most exciting time in the history of both the Australian and the world economy. The failure of investment banks and the associated sub-prime mortgage crisis in the United States provided for the global financial crisis which in turn caused recession in much of the world. Even now, much of Europe and the United States are still experiencing sluggish or negative economic growth rates and associated high rates of unemployment. As a result the European Central Bank has recently adopted a more expansionary monetary policy which has included providing for a negative nominal interest rate on deposits with it held by commercial banks. And the United States Federal Reserve continues with “quantitative easing” which provides for an expansion of the money supply to lower longer term interest rates.

The most recent official data for the March quarter 2014 show that the United States is experiencing economic contraction or negative growth in real GDP at an annualised rate of 2.9 per cent. In Europe, the Eurozone economies are expanding, but with an annual growth rate of only 0.9% (March quarter 2014). With such a low rate of economic growth, it is not surprising that the unemployment rate experienced in the Eurozone economies is 11.7% (April 2014).

However, local students should be aware, and international students may know, that the Australian economy was described by overseas commentators as the “miracle economy.” This view was based on the failure of the Australian economy to experience a recession as a result of the global financial crisis, and on its alleged far superior growth and labour market performance. In turn, much of this performance was attributed to the strong demand for Australia’s commodity based exports from China.

But can this continue? Slower rates of economic growth experienced in China recently and evidenced in the much lower international price of iron ore, and the poor performance of the European economies, provide for concern that the outlook for the Australian economy is deteriorating. However, the latest GDP growth rate for Australia in the March quarter 2014 was an annual rate of 4.5%, well in excess of most market commentators’ predictions, and the Treasury forecast provided in the Australian Government budget for 2014-15.

Another issue of debate observed through the media is that of “austerity programs” being pursued in Great Britain and some other European economies designed to reduce their budget deficits and public sector debt. At a time of recession is this the appropriate policy to pursue? While some economists support the approach, others
of a Keynesian persuasion strongly disagree. The Australian Government certainly seems to be persuaded by the need for debt reduction.

These issues influence all of us, but understanding the relationship between the wide range of economic variables and the way in which governments seek to impact on these variables and influence outcomes is not an easy task. I look forward to leading you through a systematic discussion of these complex but exciting issues.

Graham Richards
Coordinator, ECON10003 Introductory Macroeconomics
Second Semester, 2014

Subject Aims

The overall aim of this subject is to provide an introduction to macroeconomic theory and policy, economic aggregates such as aggregate production and employment, the general level of prices and inflation, the exchange rate, the volume of money and the balance of payments. Analysis is particularly directed to models of an open economy and to current economic problems and policy issues.

Prerequisites
ECON10004 Introductory Microeconomics
Learning Outcomes

Subject Objectives

On successful completion of this subject you should be able to:

• explain the importance of the circular flow of income to macroeconomics
• interpret the meaning and measurement of macroeconomic aggregates such as Gross Domestic Product and Gross National Income
• explain and use the short and long run national income determination
• describe the roles of money and the financial system in the macro economy
• critically analyse macroeconomic policies appropriate to the achievement of macroeconomic objectives and to evaluate those policies
• explain and apply the aggregate demand/aggregate supply model
• explain and use the Solow-Swan model of economic growth
• analyse the factors influencing the balance of payments and the exchange rate

Generic Skills

In this subject you will have the opportunity to develop important generic skills. These include:

• written communication; collaborative learning; critical thinking; synthesis of data and other information.
• oral communication; problem solving; team work; application of theory to practice; interpretation and analysis; evaluation of data and other information; accessing data and other information from a range of sources; receptiveness to alternative ideas.
• statistical reasoning.

Awareness Issues

At a broader level, studying this subject will increase your awareness of issues such as:

• macroeconomic arguments and theories and how they can be used to understand the current state of the economy both in Australia and internationally
• the nature of competing macroeconomic theories
• how macroeconomics enables the assessment of government policies
• the disparity in living standards across countries
• the effects of globalisation on economic welfare
Code of Conduct

CODE OF CONDUCT – LECTURES AND TUTORIALS

Lectures and tutorials are an integral part of the teaching and learning in ECON10003 Introductory Macroeconomics. In is in the lectures that I will guide you through the material and give a detailed explanation of each topic. In the tutorials you will work with your peers under the supervision of your tutor to broaden and deepen your knowledge through the practical application of the macroeconomic concepts and theories presented in lectures. There is a strong correlation between attentiveness in lectures, participation in tutorials and success in this subject.

My commitment to you is to:
• Deliver well prepared and structured lectures that will assist you in mastering the material
• Be responsive to your learning needs
• Provide appropriate and timely lecture and support materials.

What I expect of you:
• Be attentive in lectures and tutorials.
• Do not disrupt others in lectures or tutorials in any way. Lectures and tutorials are not appropriate places for conversation, or any other activity that may prevent others from learning. If you feel that you are unable to attend and be quiet, please do not come. Lecture theatres have wonderful acoustic properties. If you whisper something in the back row, I will hear it, as will others.
• Arrive on time. Coming into a lecture or tutorial late is very disruptive. If, for example, you are running late for a lecture, perhaps come to one of the later streams. Likewise, do not leave early. Again, this is very disruptive.
• Switch mobile phones off

Graham Richards
Coordinator,
ECON10003 Introductory Macroeconomics
Contact Details

Lecturer Contact Details

The lecturer and subject coordinator for ECON10003 Introductory Macroeconomics is:

Dr. Graham Richards

Email: grahammr@unimelb.edu.au

Room: 416, Fourth Floor, FBE Building, 111 Barry Street.

Phone: 8344-9717

The Tutor Coordinator is Ms. Nahid Khan

Email: n.khan@unimelb.edu.au

Room: 336, Third Floor, FBE Building, 111 Barry Street.

Phone: 8344-3621

Email Protocol

Please note that we are only able to respond to student emails coming from a University email address. Please do not use personal email addresses such as Yahoo, Hotmail or even business email addresses. Emails from non-University email addresses may be filtered by the University’s spam filter, which means that we may not receive your email. All correspondence relating to this subject will only be sent to your University email address. Note that you must first activate your University email address before you can send or receive emails at that address. You can activate your email account at this link: http://accounts.unimelb.edu.au/.
Lectures and Tutorials

Lecture Times

Tuesday: 9.00 – 10.00am; 11.00am – 12.00noon; 2.15 - 3.15pm; 4.15 – 5.15pm
and

Thursday: 9.00 – 10.00am; 11.00am – 12.00noon; 2.15 - 3.15pm; 4.15 – 5.15pm

Most lectures will be in the Kathleen Fitzpatrick Theatre, basement, Arts West Building.

However, the lecture scheduled for 11.00am. – 12.00noon on Tuesday and Thursday will be held in the Copland Theatre, in the basement of the “The Spot”.

Students must attend only the lecture for which they are enrolled using the timetable system.

Textbook


Lecture Recording

An audio recording of lectures delivered in this subject will be made available for review each lecture. The lecture recorded will be that delivered at 11.00am – 12.00noon. Audio recordings of lectures allow you to revise lectures during the semester, or to review lectures in preparation for the end of semester exam.

Lecture recording via the EchoSystem will be used in this subject.

Please note that lecture recordings are not a substitute for attendance; rather they’re designed for revision.
### Lecture Outlines

This section provides a timetable of lectures for the entire semester.

<table>
<thead>
<tr>
<th>Week 1, Lecture 1: An Introduction to Macroeconomics and National Income Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>What are the main issues to be explored in this lecture?</strong></td>
</tr>
<tr>
<td>● The circular flow diagram.</td>
</tr>
<tr>
<td>● The concept of Gross Domestic Product.</td>
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<td>● The three different ways of measuring GDP.</td>
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<table>
<thead>
<tr>
<th>Further reading or resources to deep your understanding</th>
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The most recent National Accounts for Australia (March quarter 2014), can be found at: http://www.ausstats.abs.gov.au/ausstats/meisubs.nsf/0/1D45684501575F51CA257CEC001D0A30/$File/52060_Mar%202014.pdf |

<table>
<thead>
<tr>
<th>After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?</th>
</tr>
</thead>
<tbody>
<tr>
<td>● What is the circular flow diagram?</td>
</tr>
<tr>
<td>● What is meant by GDP? Make sure you can provide an accurate definition.</td>
</tr>
<tr>
<td>● How is GDP calculated?</td>
</tr>
<tr>
<td>● Why do the income, production and expenditure approaches give the same value for GDP?</td>
</tr>
<tr>
<td>● What is value added?</td>
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<tr>
<td>● What is the difference between final goods and intermediate goods/</td>
</tr>
</tbody>
</table>
**Week 1, Lecture 2: National Income Accounting – Continued**

| **What are the main issues to be explored in this lecture?** | • The main features of Gross Domestic Product including the distinction between real and nominal GDP  
• GDP and the standard of living.  
• International comparisons of GDP  
• The recent performance of The Australian and international economies with respect to GDP. |
| --- | --- |


<table>
<thead>
<tr>
<th><strong>Relevant textbook exercises</strong></th>
<th>Pages 42 – 43, Questions 1 - 4 (Fourth Edition)</th>
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<tr>
<td></td>
<td>Page 38, Questions 1 – 4 (Third Edition)</td>
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| **Further reading or resources to deepen your understanding** | • The Australian National Accounts for the March quarter 2014 were released on Wednesday 4 June 2014 (at 11.30am). You should download this release and consider the behaviour of the main aggregates.  
| --- | --- |

| **After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?** | • What has been Australia’s recent GDP experience?  
• Do I understand how and why nominal GDP is adjusted for price change?  
• Do I understand the limitations of the constant price method of adjusting for price change?  
• How does Australia adjust nominal GDP for price change?  
• What are the limitations of using GDP as a measure of living standards? |
| --- | --- | --- | --- | --- |
**Week 2, Lecture 3: The Aggregate Price Level and Inflation**

**What are the main issues to be explored in this lecture?**

The lecture will consider inflation, another key performance indicator for the economy. A large part of Reserve Bank policy is designed to ensure that low rates of inflation are “locked in” for the future. In this lecture we look at some of the practical issues surrounding the measurement of inflation.

|------------------|---------------------------|--------------------------|---------------------------|--------------------------|

**Relevant textbook exercises**

Pages 43 - 44, Questions 6 - 10 (Fourth Edition)

Pages 38-39, Questions 6 – 10 (Third Edition)

**Further reading or resources to deepen your understanding**

The Australian Bureau of Statistics publishes a very detailed guide to the consumer price index at: [http://www.abs.gov.au/AUSSTATS/abs@.nsf/PrimaryMainFeatures/6461.0?OpenDocument](http://www.abs.gov.au/AUSSTATS/abs@.nsf/PrimaryMainFeatures/6461.0?OpenDocument). There is much more information here than you need for the subject, but if you have questions about the construction or interpretation of CPI figures, then this is the place to go.

**After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?**

- What does the CPI measure?
- How is the CPI calculated?
- Why is the distinction between the “headline” rate and the “underlying” rate important?
- Why is the distinction between “tradeables” and “non-tradeables” important?
- What has been Australia’s inflation experience?
- Why might the CPI overstate the rate of inflation?
- What other measures of inflation are available?
**What are the main issues to be explored in this lecture?**

This lecture will focus on the costs and consequences of inflation. Why high inflation is seen as a problem for an economy and why central banks make it the target of monetary policy. What is meant by deflation? Why is deflation a concern?

|------------------|-----------------------------|---------------------------|-----------------------------|---------------------------|

**Relevant Textbook Exercises**

Pages 43 - 44, Questions 6 - 10 (Fourth Edition)


**After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?**

- What are the economic costs of inflation?
- What are the other likely consequences of inflation?
- What is deflation and why is it seen to be a problem?
### Week 3, Lecture 5: Saving, Wealth and Investment

<table>
<thead>
<tr>
<th>What are the main issues to be explored in this lecture?</th>
<th>In this lecture, we look at some key economic ideas relating to savings, wealth and investment and how these concepts are related.</th>
</tr>
</thead>
</table>
| **Textbook Reading** | **Fourth Edition** pp. 47 - 73  
Third Edition pp. 40 - 65  
Second Edition pp. 91 – 95 and pp. 104 - 127  
First Edition pp. 110 - 115 and pp. 120 - 134 |
| **Relevant textbook exercises** | Page 76, Questions 4 – 6 (Fourth Edition)  
Page 68, Questions 4 – 6. (Third Edition) |
| **Further reading or resources to deepen your understanding** | An important issue for many countries is the impact that their aging populations will have on savings and wealth accumulation (an older population is likely to run down its wealth to finance current needs). A country where the aging of the population is likely to be particularly dramatic over the coming years is Japan. |
| **After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?** |  
• Do I understand the distinction between the nominal and real rate of interest?  
• What is the relationship between saving and wealth?  
• What has happened to the household savings ratio in Australia?  
• What is national savings?  
• Do I understand the relationship between national savings and the outcome of the Australian Government budget?  
• What is the relationship between national savings and investment?  
• What sectors of the economy contribute to national savings?  
• Do I understand the demand and supply analysis of savings and investment? |
### What are the main issues to be explored in this lecture?

For many, if not most people, labour market experiences, including unemployment, are the key macroeconomic issues. Given that people’s living standards are so closely aligned with labour market developments, this is hardly surprising. The labour market is perhaps the most complex component of the economy to understand. What we will do in this lecture is develop the competitive model of the macroeconomic labour market. This remains the foundation for many key macroeconomic theories. But be aware that there are many other ways of analysing the labour market and these will be explored in later macroeconomics subjects.

### Textbook Reading

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<th>Edition</th>
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<th>Questions</th>
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<tbody>
<tr>
<td>Fourth</td>
<td>pp. 79 – 98</td>
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<td>Third</td>
<td>pp. 72 – 89</td>
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<tr>
<td>Second</td>
<td>pp. 135 – 150</td>
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<tr>
<td>First</td>
<td>pp. 140 – 155</td>
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</table>

### Relevant textbook exercises

- Pages 110 – 111 Questions 2 - 8 (Fourth Edition)
- Pages 100 - 102, Questions 2 - 8 (Third Edition)

### Further reading or resources to deepen your understanding


### After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?

- What factors influence the demand for labour?
- Why does the labour demand curve slope downwards?
- What factors influence the supply of labour?
- Why does the labour supply curve slope upwards?
- What will cause a shift to the right or left of each of these curves?
- What is meant by equilibrium employment?
- How is the equilibrium achieved?
- How might that equilibrium change?
### Week 4, Lecture 7: The Labour Market (continued)

| What are the main issues to be explored in this lecture? | Labour market indicators  
• The Australian Labour Market  
• Types of Unemployment  
• Impediments to Full Employment |
|---|---|

### Textbook Reading


### Relevant textbook exercises

- Pages 110 – 111, Questions 2 – 8 (Fourth Edition)
- Pages 100-102, Questions 2 – 8 (Third Edition)

### Further reading or resources to deepen your understanding

- What are the key indicators of labour market performance used by economists?
- What is the current rate of unemployment in Australia?
- Which States of Australia currently have the lowest rates of unemployment? Why?
- What are the different categories of unemployment based on cause?
- What is meant by the term “the natural rate of unemployment”?
- Why might wages be “sticky”?

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Week 4, Lecture 8: An Introduction to Short-Term Economic Fluctuations

<table>
<thead>
<tr>
<th>What are the main issues to be explored in this lecture?</th>
<th>Since the Great Depression of the 1930s, a great deal of macroeconomics has been concerned with understanding how economic fluctuations (expansions and contractions) can occur. This is an immensely complex topic and there are a wide range of views amongst macroeconomists concerning the primary causes of economic fluctuations. Over the next few weeks, we will be looking at some of the main theories in macroeconomics designed to answer the question as to why the economy seems to go through periods of expansion and contraction.</th>
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<td>Further reading or resources to deepen your understanding</td>
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<tr>
<td>After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?</td>
<td>• How do people define recessions? • What are the characteristics of recessions? • What are output gaps? • Do I understand the implications of Okun’s Law? • What assumptions do macroeconomists make about price adjustments in the SR and in the LR? • Why is this distinction important?</td>
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</table>
**Week 5, Lecture 9: Macroeconomics in the Short-Run: The Basic Keynesian Model**

What are the main issues to be explored in this lecture?

We begin in this lecture to develop the basic Keynesian model of *short-run economic fluctuations*. This model is a simplified analytical representation of the economy. Its purpose is to study the short-run (the period in which prices do not adjust to demand changes). It is usual (and healthy) for beginning students of macroeconomics to question the usefulness of studying such a gross simplification of reality. But in the same way that studying a paper airplane in flight teaches us something of the physics of what keeps a passenger airliner in the air, looking at a simplified model of the economy can help economists to learn something about the complexities of the real world. You will start to see in this lecture, just how useful this approach can be.

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<tr>
<td>Relevant textbook exercises</td>
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<td>Pages 162 - 163, Questions 1 and 2 (Third Edition)</td>
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<tr>
<td>Further reading or resources to deepen your understanding</td>
<td>The eclectic U.S. economist Paul Krugman has written a very informative introduction to a new edition of <em>The General Theory</em>, published to celebrate the 70th anniversary of Keynes’ great work. It a nice overview of how important <em>The General Theory</em> is in modern macroeconomics. You can read the introduction here: <a href="http://www.pkarchive.org/economy/GeneralTheoryKeynesIntro.html">http://www.pkarchive.org/economy/GeneralTheoryKeynesIntro.html</a></td>
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</table>
| After reviewing the lecture, textbook and tutorials, what questions should students be able to answer? | • What is meant by planned aggregate expenditure?  
• When is planned aggregate expenditure different from actual expenditure?  
• What is the consumption function?  
• Do I understand the concepts of autonomous consumption and the MPC?  
• Do I know how to derive an equation for PAE?  
• What are the conditions that define SR equilibrium?  
• How does the economy adjust in the SR if it is not in SR equilibrium? |                              |                              |                              |
## What are the main issues to be explored in this lecture?

In this lecture, we continue our analysis of the economy using the 45-degree diagram. This is an extraordinarily useful means of representing short-run equilibrium in the economy, and of demonstrating a surprising aspect of the economy, namely that exogenous changes in aggregate demand have a multiplied effect on GDP. Remember, that this analysis applies to the short-run i.e., prices are assumed to be unchanged in the face of a change in aggregate demand – all adjustment to the change in demand is achieved through varying the quantity produced. We will focus in detail on the multiplier process in a two and three sector economy.

## Textbook Reading

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<tr>
<td>Fourth</td>
<td>150 – 156</td>
<td>Third</td>
<td>146 – 148</td>
<td>Second</td>
<td>203 208</td>
</tr>
<tr>
<td></td>
<td>and pp. 165 - 167</td>
<td>Edition</td>
<td>157 - 159</td>
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<td>and pp. 213 - 215</td>
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<td>First</td>
<td>208 – 211</td>
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</table>

## Relevant textbook exercises

- Pages 170 – 171, Questions 3 - 5 (Fourth Edition)
- Page 162, Questions 3 – 5 (Third Edition)

## Further reading or resources to deepen your understanding

There is a fascinating account of the intellectual development of the multiplier at [http://epress.anu.edu.au/gp/mobile_devices/ch05.html](http://epress.anu.edu.au/gp/mobile_devices/ch05.html). This article highlights the role played by a very famous Professor of Economics at the University of Melbourne, L. F. Giblin. In 1930, Giblin gave a lecture in the Public Lecture Theatre (Old Arts Building) in which he clearly articulated the concept of the multiplier, well before the publication of the General Theory.

## After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?

- Do I understand the construction of the 45-degree line diagram?
- Can I identify equilibrium on the 45-degree line diagram?
- Do I understand how the economy gets to equilibrium?
- Can I illustrate equilibrium on a diagram featuring withdrawals (leakages) and injections?
- Can I use this diagram to describe how the economy achieves SR equilibrium?
- What is meant by the autonomous expenditure multiplier? Can I use numerical examples to explain it?
- Can I give an intuitive explanation for the existence of the expenditure multiplier?
### Week 6, Lecture 11: The Four Sector Model and Fiscal Policy

**What are the main issues to be explored in this lecture?**

In this lecture, we extend the simple Keynesian model to incorporate the government and overseas sectors. While more complex, the basic principles underlying the analysis are not too far removed from the two sector model. To illustrate the practical usefulness of the model, we will also consider the issue of whether fiscal policy can be used to manage the economy in the short-run. Fiscal policy played a key role in governments’ responses to the Global Financial Crisis of 2008/09.

### Textbook Reading

<table>
<thead>
<tr>
<th>Edition</th>
<th>Pages</th>
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<tbody>
<tr>
<td>Third Edition</td>
<td>149–150 and pp. 166–177</td>
</tr>
<tr>
<td>First Edition</td>
<td>-</td>
</tr>
</tbody>
</table>

### Relevant textbook exercises

- Pages 197 – 198, Questions 1 - 5 (Fourth Edition)
- Pages 188 – 189, Questions 1 – 5 (Third Edition)

### Further reading or resources to deepen your understanding


### After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?

- Can I explain how fiscal policy can be used to eliminate an output gap?
- What is meant by the balanced budget multiplier? Why does it hold?
- What is the difference between the cyclical and structural components of budgetary revenue and expenses?
- What are the problems associated with using fiscal policy as a tool of macroeconomic stabilisation?
## Week 6 Lecture 12: Money and Monetary Policy

**What are the main issues to be explored in this lecture?**

In this and the next lecture, we leave behind the short-run world of the simple Keynesian model. Now we extend the time frame of reference to allow for the possibility of price change. In this framework, inflation is an important macroeconomic consideration; and central banks (the Australian central bank is the Reserve Bank of Australia) have an important role in managing the economy.

|------------------|-------------------------------|-----------------------------|-------------------------------|---------------|

**Relevant textbook exercises**

- Pages 223 – 224, Questions 1 - 5 (Fourth Edition)

**Further reading or resources to deepen your understanding**


**After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?**

- What are the functions of money?
- What is the difference between M1, M3, Broad Money and Base Money (the monetary base)?
- How does the banking system create money?
- What is the relationship between money and inflation?
**Week 7, Lecture 13: Money and Monetary Policy (continued)**

<table>
<thead>
<tr>
<th>What are the main issues to be explored in this lecture?</th>
<th>Many central banks, including the Reserve Bank in Australia, now set their monetary policy to achieve a <strong>target rate</strong> of inflation. In other words, achieving a certain rate of inflation is the primary motivation behind monetary policy. They do this by targeting the interest rate. An important part of this lecture is to understand how the Reserve Bank targets the overnight cash interest rate and what is its objective in doing so?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Further reading or resources to deepen your understanding</strong></td>
<td>More detail about how the Reserve Bank sets the target interest rate is found in Glenn Otto, “Central Bank Operating Procedures: How the RBA Achieves Its Target for the Cash Rate” The <em>Australian Economic Review</em>, Volume 40, Number 2, June 2007, 216-224</td>
</tr>
</tbody>
</table>
| **After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?** | • Do I know the implications of the quantity theory of money?  
• Can I explain how the Reserve Bank of Australia sets a target rate of interest?  
• Can I explain why all interest rates move in line with the overnight cash interest rate?  
• Do I know what the RBA targets?  
• Do I know what is meant by the target rate of inflation?  
• Do I understand the distinction between the target cash rate and the actual cash rate?  
• Do I understand how Monetary Policy affects the economy in the Short Run? |
### Week 7, Lecture 14: Aggregate Demand and Aggregate Supply

**What are the main issues to be explored in this lecture?**

The AD/AS model is an indispensable part of any working macroeconomist’s toolkit. As you will see, it is a relatively simple analytical tool. Yet, it is extraordinarily powerful, enabling informed discussion of a host of important real world macroeconomic issues.

|------------------|--------------------------------|----------------------------|-----------------------------------------------|----------------------------------------|

**Relevant textbook exercises**

- Pages 283 – 284, Questions 3, 5, 7 and 9 (Fourth Edition)
- Pages 267 - 268, Questions 3, 5, 7 and 9 (Third Edition)

**Further reading or resources to deepen your understanding**

- Do I know why the AD curve slopes downwards?
- Can I derive the AD Curve?
- Can I distinguish the factors that cause the AD curve to shift from those that lead to a movement along the AD curve?
- Can I explain the concept of “inflation inertia”
- Can I explain how inflation responds to the output gap?
- Can I derive the AD/AS diagram?
## Week 8, Lecture 15: Aggregate Demand and Aggregate Supply in Practice

<table>
<thead>
<tr>
<th>What are the main issues to be explored in this lecture?</th>
<th>We will use the AD/AS Model to Explain Short-Run Fluctuations in Real GDP, Unemployment and Inflation.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Third Edition pp. 249 – 264</td>
</tr>
<tr>
<td></td>
<td>First Edition pp. 308 - 319</td>
</tr>
<tr>
<td><strong>Relevant textbook exercises</strong></td>
<td>Pages 283 – 284, Questions 3, 5, 7 and 9 (Fourth Edition)</td>
</tr>
<tr>
<td></td>
<td>Pages 267- 268, Questions 3, 5, 7 and 9 (Third Edition)</td>
</tr>
<tr>
<td><strong>Further reading or resources to deepen your understanding</strong></td>
<td>A lot of what is said (written or spoken) about the Global Financial Crisis relates to the U.S.A. A more global perspective can be found at <a href="http://www.pbs.org/wnet/wideangle/uncategorized/how-global-is-the-crisis/3543/">http://www.pbs.org/wnet/wideangle/uncategorized/how-global-is-the-crisis/3543/</a></td>
</tr>
</tbody>
</table>
| **After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?** | • Do I understand the various sources of inflation?  
• Can I use the AD/AS diagram to explain the sources of short-term fluctuations in the economy? |
### Week 8, Lecture 16: An Introduction to Economic Growth

**What are the main issues to be explored in this lecture?**

In this lecture, we begin our exploration of economic growth. Since the time of Adam Smith, economists have been trying to understand the factors that contribute to the "Wealth of Nations". Why are some countries poor and others rich and what can be done about it? As Nobel Laureate Robert E Lucas Jr. once famously wrote “The consequences for human welfare involved in questions like these are staggering; once one starts to think about them, it is hard to think about anything else.” This lecture canvases some of the basic issues concerning economic growth and introduces you to a key theme, the role of productivity improvements in promoting growth.

|------------------|------------------------------|-------------------------------|-----------------------------|-----------------------------|

**Relevant textbook exercises**

Pages 339 – 340 Questions 1 - 4 and 6 - 7 (Fourth Edition)

Pages 305 - 306, Questions 1 - 4 and 6 - 7 (Third Edition)

**Further reading or resources to deepen your understanding**


**After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?**

- What has been the world’s growth experience over the last 1000 years?
- What regions of the world have grown relatively quickly?
- What regions of the world have grown relatively slowly?
- How do we illustrate LR growth in the AD/AS framework?
- What are the implications of small differences in growth rates for material living standards?
- What are the two basic factors that influence a nation’s growth performance?
- What factors impact on average labour productivity?
- What are some of the costs of economic growth?
- What can be done to encourage economic growth?
**Week 9, Lecture 17: The Production Function Approach to Economic Growth and Growth Accounting**

### What are the main issues to be explored in this lecture?

This lecture introduces a key building block of economists' analytical approach to understanding economic growth. This is the concept of the production function. The growth experiences of a variety of countries are examined to determine whether there are any systematic factors that have aided good growth performance. This lecture looks at *growth accounting*, a very powerful means of dissecting a country's growth experience to see what have been the relative contributions of the various factors that influence economic growth.

### Textbook Reading

|----------------|---------------|----------------|---------------|

### Relevant textbook exercises

- Page 364, Questions 1 – 5, 8 and 9 (Fourth Edition)
- Pages 330 - 331, Questions 1 – 5, 8 and 9 (Third Edition)

### Further reading or resources to deepen your understanding

- There is a fantastic 3-D interactive guide to the Cobb-Douglas production function at [http://www.fgn.unisg.ch/eurmacro/tutor/cobb-douglas.html](http://www.fgn.unisg.ch/eurmacro/tutor/cobb-douglas.html).
- Make sure you click the forward arrow on top to start the self guided exercise.

### After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?

- What is a production function?
- What are the primary factors of production?
- What are the secondary factors of production?
- Can I demonstrate that the Cobb-Douglas production function has constant returns to scale?
- Do I know the economic meaning of constant returns to scale?
- Can I show that the Cobb-Douglas production function features diminishing marginal productivity of the primary factors?
- Can I illustrate (i) average productivity and (ii) marginal productivity?
- Can I derive and interpret the growth accounting formula?
- Can I interpret the results from growth accounting exercises on a diagram?
### Week 9, Lecture 18: The Solow-Swan Model of Economic Growth

#### What are the main issues to be explored in this lecture?
Under what circumstances can countries maintain high rates of economic growth? It turns out that it is not at all obvious that high growth rates can be maintained in the long run. This is because diminishing marginal returns ultimately limit the extent to which continued acquisition of the factors of production will promote more growth. Does this mean an end to growth? The model we will develop in today’s lecture, the Solow-Swan model, provides an answer to these questions.

#### Textbook Reading
<table>
<thead>
<tr>
<th>Edition</th>
<th>Pages</th>
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<tbody>
<tr>
<td>Fourth Edition</td>
<td>pp. 366 - 374</td>
</tr>
<tr>
<td>Third Edition</td>
<td>pp. 334 - 340</td>
</tr>
<tr>
<td>Second Edition</td>
<td>pp. 402 - 410</td>
</tr>
<tr>
<td>First Edition</td>
<td>pp. 392 - 399</td>
</tr>
</tbody>
</table>

#### Relevant textbook exercises
- Page 385, Questions 1 – 5 (Fourth Edition)
- Page 352, Questions 1 – 5 (Third Edition)

#### Further reading or resources to deepen your understanding

#### After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?
- Do I understand the concept of the steady-state?
- Can I explain the (i) the savings function and (ii) the \((d + n)\) function?
- Can I find the (i) steady-state capital stock and (ii) the steady state level of GDP?
Week 10, Lecture 19: Convergence and New Developments

What are the main issues to be explored in this lecture?

In this lecture, we focus on an important implication of the Solow-Swan model; the “convergence hypothesis”. This hypothesis predicts the existence of a negative relationship between a country's initial level of per capita income and its subsequent rate of growth. This is somewhat counter-intuitive – it implies that relatively poorer countries grow rapidly and that relatively richer countries grow slowly. However, it makes perfect sense in the context of the Solow-Swan model and is supported by some empirical evidence (under certain conditions). We will also consider, briefly, some of the recent developments in economists’ thinking about economic growth.

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<tbody>
<tr>
<td>Relevant textbook exercises</td>
<td>Page 385 Questions 6 - 10 (Fourth Edition)</td>
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<tr>
<td></td>
<td>Page 353, Questions 6 - 10 (Third Edition)</td>
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<tr>
<td>Further reading or resources to deepen your understanding</td>
<td>Wikipedia has a nice overview of the Solow-Swan model, including the convergence hypothesis, at <a href="http://en.wikipedia.org/wiki/Exogenous_growth_model">http://en.wikipedia.org/wiki/Exogenous_growth_model</a>.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?</td>
<td>• Do I understand the Solow-Swan diagram?</td>
<td>• Do I know in what sense the Solow-Swan model predicts a zero long-run rate of economic growth?</td>
<td>• Do I know what is meant by the convergence hypothesis?</td>
<td>• What is the empirical evidence on convergence?</td>
</tr>
</tbody>
</table>
Week 10, Lecture 20: The Balance of Payments

What are the main issues to be explored in this lecture?

We focus in this lecture on the Balance of Payments – a set of accounts that records all transactions between a country and the rest of the world. These transactions can be both in terms of goods, services and income flows (the current account) and borrowing and lending (the capital account). The current account balance, in particular, gets a lot of attention in Australia at the moment because of the size of the current account deficit. Why is it so large and is this a problem? We will explore these questions.

Textbook Reading

|----------------|---------------|----------------|---------------|

Relevant textbook exercises

Pages 468 – 469, Questions 1 - 5 (Fourth Edition)

Page 436, Questions 1 – 5 (Third Edition)

Further reading or resources to deepen your understanding

- Do I understand the distinction between the current account and the capital and financial account?
- Can I explain the relationship between capital flows and the interest rate?
- How does risk affect this relationship?
- How is the domestic interest rate for a small open economy influenced by the world interest rate?
- What is the relationship between national savings, investment and the trade deficit?
### Week 11, Lecture 21: The Foreign Exchange Rate

**What are the main issues to be explored in this lecture?**

A country’s exchange rate is an important economic variable, one that is discussed in every nightly news bulletin and every daily newspaper. In this lecture, we look at exchange rates, noting that the exchange rate usually discussed in the media, the nominal exchange rate, is not actually as important in macroeconomics as a different concept of the exchange rate, the real exchange rate. We also look at two important theories of exchange rate determination; the first relating to long run exchange rate behaviour – purchasing power parity – the second dealing with short run movements in the exchange rate – the demand and supply of domestic currency.

|------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|

**Relevant textbook exercises**

Pages 450 – 451, Questions 1 - 6 (Fourth Edition)

Pages 415 - 416, Questions 1 – 6 (Third Edition)

**Further reading or resources to deepen your understanding**

- One way to tell if a currency is undervalued or overvalued is to consider the nominal exchange rate in terms of a uniform commodity. *The Economist* has been conducting such a study for a number of years now, looking at the price of McDonald’s Big Macs hamburgers in different countries.
- What does this tell us about the value of the Australian dollar? Is it overvalued or undervalued?

**After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?**

- Do I know the difference between a nominal exchange rate and a real exchange rate?
- Do I understand the link between the real exchange rate and international competitiveness?
- Can I explain the Purchasing Power Parity (PPP) hypothesis?
- Can I use demand and supply analysis to explain the determination of the nominal exchange rate?
- Can I explain how monetary policy impacts on the nominal exchange rate?
Countries face choices about how to manage their exchange rates. Some, like Australia, largely leave it up to market forces. Others, like China, closely manage their exchange rates. In this lecture, we look at some of the issues that surround the choice of exchange rate system. One important consequence of the choice of exchange rate system is the extent to which this creates stability or instability. To illustrate these issues, we will look at some instances of currency crisis.

|------------------|-------------------------------|-----------------------------|-----------------------------|-----------------------------|

**After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?**

- Do I understand how an exchange rate can be fixed?
- Can I distinguish between an overvalued and an undervalued exchange rate?
- Can I explain how expectations of an exchange rate change can be self-fulfilling?
- Do I understand how currency attacks occur?
Week 12, Lecture 23: Exchange Rate Change: Consequences

<table>
<thead>
<tr>
<th>What are the main issues to be explored in this lecture?</th>
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<tr>
<td>In this lecture we explore two related themes. Firstly, what are the consequences for a country of exchange rate movement; both appreciation and depreciation? Second, why do some countries fix their exchange rates or at least closely manage their exchange rate, while other countries allow market forces to determine their exchange rate?</td>
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<tr>
<th>Relevant textbook exercises</th>
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<tr>
<th>Further reading or resources to deepen your understanding</th>
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<table>
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<tr>
<th>After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Can I explain the consequences for a country of exchange rate appreciation and depreciation?</td>
</tr>
<tr>
<td>• Can I explain the arguments used to support a fixed exchange rate?</td>
</tr>
<tr>
<td>• Can I explain the arguments used to support a floating/flexible exchange rate?</td>
</tr>
</tbody>
</table>
## Week 12, Lecture 24: Schools of Thought in Macroeconomics

### What are the main issues to be explored in this lecture?

![Cartoon](image)

"Never mind the food. Just bring us the bill so we can argue about it."

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<td>Relevant textbook exercises</td>
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<td>Further reading or resources to deepen your understanding</td>
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<tr>
<td><strong>After reviewing the lecture, textbook and tutorials, what questions should students be able to answer?</strong></td>
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</table>

- What are the main characteristics of the various schools of thought in macroeconomics?
Tutorials

- All tutorials in this subject will be conducted under a **collaborative learning format**. This means that the tutor will not stand in front of the tutorial giving a mini-lecture each week. The emphasis will be on student participation through discussing macroeconomic problems and issues in small groups.

*Each week, you will receive two handouts*: a pre-tutorial guide (blue in colour) and a tutorial tasks list (pink in colour). The pre-tutorial guide will tell you what to read and do, to prepare for the next week's tutorial. It is essential that you prepare for each week's tutorial by working through the pre-tutorial guide for that tutorial. It is not long or difficult and it directly reinforces what you have learned in lectures. The second handout is the tutorial tasks list that will be distributed to you at the beginning of the class. It contains the exercises you will have to address in that tutorial. Note that you will not be told beforehand what questions you will have to answer in tutorials. It is therefore important that you prepare using the pre-tutorial guide.

The format of the tutorials will be as follows:

- each tutorial class will be split into groups of 4-5 students. The groups need not be the same every week but should not be larger than 5.
- some weeks all groups will do the same questions, while in other weeks, each group will attempt a different question.
- after the questions have been answered, there will be a short presentation time where a spokesperson for each group will report back to the tutorial class.
- students are expected to comment on other groups' presentations.

You will be assessed on the extent of your participation (remember, 10% of your final grade for this course is based on your tutorial work). **You cannot participate if you do not attend!** Your tutor will subtract ONE mark for each tutorial missed during the semester without a valid reason. In cases of illness, this will require a medical certificate. Other reasons must also be documented.

The criteria that will be used by your tutor in awarding your mark are:

- **Evidence of preparation for the tutorial**
- **Frequency of participation in discussion**
- **Relevance and logic in discussion**
- **Evidence of active listening to the contributions of others**
All of this means that you are expected to work actively in tutorials. Your tutor, as always, will be more than willing to help you with individual questions, but remember the basis of tutorials will be your group-based discussions.

**Past experience in ECON10003 Introductory Macroeconomics has shown that students who actively participate in tutorials have a better understanding of the material and perform at a higher level.**

The marks for tutorial participation (including attendance) will only be allotted by the student's regular (official) tutor. It is important that you:

- check with your tutor that your name is on the tutor’s official tutorial roll,
- ensure that any note issued to you for attendance at another tutorial is given to your regular tutor
- check that if you transfer from one tutorial to another during the semester that your 'old' tutor has made arrangements for your tutorial mark (to the time of transfer) to be transferred to your new tutor.
- go to any other tutorial during the week if you miss your regular tutorial for illness and collect an irregular attendance form from that tutor. **However, you can only do this twice in the whole semester.**

**Enrolling in Tutorials**

There will be weekly tutorials starting in the week beginning Monday August 4. The Student Timetable is accessible via the Student Portal. For Semester 2 2014, the Timetable will open on 30 June 2014. If you encounter timetable problems you must contact the Commerce Student Centre, Upper Ground Level, FBE Building, **NOT the lecturer.** Note that tutors are not permitted to authorise a transfer from one tutorial to another, not even from one of their own tutorials to another of their own tutorials.

Timetable changes in this subject will not be possible after Friday 8 August 2014.

Tutors are NOT permitted (with one exception) to allow a student, without an official authorisation, to 'sit in' on one of their tutorials. The exceptional case is where a student, because of illness, has missed his/her allocated tutorials in a particular week. In that case, a tutor may permit that student to 'sit in' for that week only and on no subsequent occasion during the semester. Any student who 'sits in' in this way must ask the tutor for a note confirming the student's attendance. The student must give this note to his/her regular tutor.
Assessment

Assessment Overview

Your assessment for this subject comprises the following:

<table>
<thead>
<tr>
<th>Assessment Task</th>
<th>Due</th>
<th>Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macroeconomics Feedback and Assessment Task 1 (FAT online test based on the first 8 lectures).</td>
<td>August 25, 9.00am to August 27, 2.00pm</td>
<td>5%</td>
</tr>
<tr>
<td>Macroeconomics Feedback and Assessment Task 2 (FAT online test based on all lectures from 1, up to and including 20).</td>
<td>October 13, 9.00am to October 15 2.00pm</td>
<td>5%</td>
</tr>
<tr>
<td>Assignment 1 (1000 words)</td>
<td>August 20 (4.00pm)</td>
<td>10%</td>
</tr>
<tr>
<td>Assignment 2 (1000 words)</td>
<td>October 8 (4.00pm)</td>
<td>10%</td>
</tr>
<tr>
<td>Attendance and Participation in tutorials</td>
<td>Weekly</td>
<td>10%</td>
</tr>
<tr>
<td>End-of-semester exam</td>
<td>Assessment period</td>
<td>60%</td>
</tr>
</tbody>
</table>

Macroeconomics Feedback and Assessment Tasks

There are two multiple choice tests administered online through the LMS.

A practice test with feedback will be available for students prior to taking Assessment Task 1. The purpose of the practice test is so that students can familiarise themselves with the process of an online test and with the style of questions (rather than the content) that will be used for both tasks 1 and 2.

To access the tests you need to log on to the FAT (Feedback and Assessment Tests) site via the LMS sometime during the period August 25 (9.00am) to August 27 (2.00pm) for Test 1 and October 13 (9.00am) to October 15 (2.00pm) for Test 2 and complete the task. There is a thirty minute time period. You will be asked to complete fifteen questions for each test.

Assignments 1 and 2

These will be individual essay or short answer style tasks which may require that you use and demonstrate an understanding of economic statistics and statistical sources as well as economic analysis. More detailed criteria regarding our expectations will be released along with the assignments themselves.
Using the Assignment Tool

During the course of the semester, you’ll be asked to submit your assignments in electronic format to the Commerce Students Centre via the Assignment Submission Tool. You can access the Assignment Submission Tool by clicking on Assignment Tool in the navigation menu from the LMS page for this subject.

Please note that you will be required to submit these in electronic form via the assignment submission system by 4pm on the due date. The following details are very important:

- It is important that you keep a copy of your assignment
- Plagiarism or other forms of academic dishonesty will result in discipline proceedings being brought against you.

Plagiarism and Collusion

Presenting material from other sources without full acknowledgement (referred to as plagiarism) is heavily penalised. Penalties for plagiarism can include a mark of zero for the piece of assessment or a fail grade for the subject.

Plagiarism is the presentation by a student of an assignment identified as his or her own work even though it has been copied in whole or in part from another student’s work, or from any other source (eg. published books, web-based materials or periodicals), without due acknowledgement in the text.

Collusion is the presentation by a student of an assignment as his or her own work when it is, in fact, the result (in whole or in part) of unauthorised collaboration with another person or persons. Both the student presenting the assignment and the student(s) willingly supplying unauthorised material are considered participants in the act of academic misconduct.


The CELT has developed a web-based ‘Academic Honesty Module’ that allows you to learn more about and test your knowledge of plagiarism and collusion. You are strongly encouraged to complete this module, which can be accessed at:

Late Submission

Late submissions must be requested from the Commerce Student Centre, NOT the lecturer or tutor. Late assignments, where approval for late submission has not been given, will be penalised at the rate of 10% of the total mark per day, for up to 5 days, at which time a mark of zero will be given. For details see:


Special Consideration

Students who have been affected significantly by illness or other serious circumstances during the semester may be eligible to apply for Special Consideration.

The following website contains detailed information relating to who can apply for Special Consideration and the process for making an application:

http://fbe.unimelb.edu.au/csc/assistance/special_consideration

Referencing

All sources used for a written piece of assessment must be referenced. This is to acknowledge that your material is not based entirely on your own ideas, but is based, in part, on the ideas, information, and evidence of others. This is desirable as you are attending University in order to learn from others.

You will be required to use the APA system or Harvard System of referencing. The CELT has prepared a booklet for each system specifically to assist students to reference correctly. Each booklet contains many examples that will help you when preparing your assignments. The booklets can be found here:


It is important that all material you present for assessment is referenced correctly. Material that has not been referenced correctly may be considered to be plagiarised, and as such may be penalised. We will also look for evidence that material included in the bibliography has been used in the assignment. Including references that have not been used may also result in your assignment being penalised.
Further Assistance

If you need assistance during the semester, you have several options:

Online Tutor

The Online Tutor allows you to direct questions to a tutor via the LMS. The Online Tutor can be accessed 24 hours a day, 7 days a week. The Online Tutor will attempt to answer your question within 24 hours (weekdays only).

Your questions and the tutor’s answers can be accessed by all students in the subject, allowing everyone to benefit from the question and answer. Importantly, your identity will not be revealed to other students. Even if you don’t want to ask a question, you can still view existing questions and answers.

Note that the Online Tutor is not designed to replace attendance at tutorials, but rather to complement the tutorial process. Also, simple questions that can be answered by referring to the prescribed readings will not usually be answered. You can access the Online Tutor via the Online Tutor link, located in the navigation menu of this subject’s LMS page.

The Online Tutor will operate from the second week of the semester; that is, from Monday August 4.

Your Tutor’s Consultation Time

Once tutorials commence each tutor will have a time available each week when they can answer your brief questions. Your tutor will notify you of these times and they will also appear on the Announcements Page of the LMS.

Lecturer’s Consultation Time

This time will vary from week to week to allow all students the opportunity to talk with the lecturer. Look at the Announcements Page of the LMS.

The Centre for Excellence in Learning and Teaching (CELT)

The FBE Centre for Excellence in Learning and Teaching (CELT) provides services and resources to enhance your learning in Business and Economics.

Maximise your academic success by taking part in CELT programs that are intended to develop:

- Skills in research, referencing and academic writing
- Mastery of different assignment types
• Effective study techniques
• Abilities to learn effectively with your peers
• Transition to the faculty and understanding of academic expectations

The Centre also provides an extensive range of Help Sheets that can enhance your academic performance in Business and Economics. These are available online at the CELT website.

Visit the CELT site fbe.unimelb.edu.au/celt to learn more and get involved.
Keynes offers us the best way to think about the financial crisis

By Martin Wolf

We are all Keynesians now. When Barack Obama takes office he will propose a gigantic fiscal stimulus package. Such packages are being offered by many other governments. Even Germany is being dragged, kicking and screaming, into this race.

The ghost of John Maynard Keynes, the father of macroeconomics, has returned to haunt us. With it has come that of his most interesting disciple, Hyman Minsky. We
all now know of the “Minsky moment” – the point at which a financial mania turns into panic.

Like all prophets, Keynes offered ambiguous lessons to his followers. Few still believe in the fiscal fine-tuning that his disciples propounded in the decades after the second world war. But nobody believes in the monetary targeting proposed by his celebrated intellectual adversary, Milton Friedman, either. Now, 62 years after Keynes’ death, in another era of financial crisis and threatened economic slump, it is easier for us to understand what remains relevant in his teaching.

I see three broad lessons.

The first, which was taken forward by Minsky, is that we should not take the pretensions of financiers seriously. “A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows, so that no one can really blame him.” Not for him, then, was the notion of “efficient markets”.

The second lesson is that the economy cannot be analysed in the same way as an individual business. For an individual company, it makes sense to cut costs. If the world tries to do so, it will merely shrink demand. An individual may not spend all his income. But the world must do so.

The third and most important lesson is that one should not treat the economy as a morality tale. In the 1930s, two opposing ideological visions were on offer: the Austrian; and the socialist. The Austrians – Ludwig von Mises and Friedrich von Hayek – argued that a purging of the excesses of the 1920s was required. Socialists argued that socialism needed to replace failed capitalism, outright. These views were grounded in alternative secular religions: the former in the view that individual self-seeking behaviour guaranteed a stable economic order; the latter in the idea that the identical motivation could lead only to exploitation, instability and crisis.

Keynes’s genius – a very English one – was to insist we should approach an economic system not as a morality play but as a technical challenge. He wished to preserve as much liberty as possible, while recognising that the minimum state was unacceptable to a democratic society with an urbanised economy. He wished to preserve a market economy, without believing that laisser faire makes everything for the best in the best of all possible worlds.

This same moralistic debate is with us, once again. Contemporary “liquidationists” insist that a collapse would lead to rebirth of a purified economy. Their leftwing opponents argue that the era of markets is over. And even I wish to see the punishment of financial alchemists who claimed that ever more debt turns economic lead into gold.

Yet Keynes would have insisted that such approaches are foolish. Markets are neither infallible nor dispensable. They are indeed the underpinnings of a productive economy and individual freedom. But they can also go seriously awry and so must be managed with care. The election of Mr Obama surely reflects a desire for just such pragmatism. Neither Ron Paul, the libertarian, nor Ralph Nader, on the left, got
anywhere. So the task for this new administration is to lead the US and the world towards a pragmatic resolution of the global economic crisis we all now confront.

The urgent task is to return the world economy to health.

The shorter-term challenge is to sustain aggregate demand, as Keynes would have recommended. Also important will be direct central-bank finance of borrowers. It is evident that much of the load will fall on the US, largely because the Europeans, Japanese and even the Chinese are too inert, too complacent, or too weak. Given the correction of household spending under way in the deficit countries, this period of high government spending is, alas, likely to last for years. At the same time, a big effort must be made to purge the balance sheets of households and the financial system. A debt-for-equity swap is surely going to be necessary.

The longer-term challenge is to force a rebalancing of global demand. Deficit countries cannot be expected to spend their way into bankruptcy, while surplus countries condemn as profligacy the spending from which their exporters benefit so much. In the necessary attempt to reconstruct the global economic order, on which the new administration must focus, this will be a central issue. It is one Keynes himself had in mind when he put forward his ideas for the postwar monetary system at the Bretton Woods conference in 1944.

No less pragmatic must be the attempt to construct a new system of global financial regulation and an approach to monetary policy that curbs credit booms and asset bubbles. As Minsky made clear, no permanent answer exists. But recognition of the systemic frailty of a complex financial system would be a good start.

As was the case in the 1930s, we also have a choice: it is to deal with these challenges co-operatively and pragmatically or let ideological blinkers and selfishness obstruct us. The objective is also clear: to preserve an open and at least reasonably stable world economy that offers opportunity to as much of humanity as possible. We have done a disturbingly poor job of this in recent years. We must do better. We can do so, provided we approach the task in a spirit of humility and pragmatism, shorn of ideological blinkers.

As Oscar Wilde might have said, in economics, the truth is rarely pure and never simple. That is, for me, the biggest lesson of this crisis. It is also the one Keynes himself still teaches.

The undeniable shift to Keynes

By Chris Giles in London, Ralph Atkins in Frankfurt and Krishna Guha in Washington

More than three decades have passed since Richard Nixon, the Republican US president, declared: “We are all Keynesians now.”

The phrase rings truer today than at any time since, as governments seize on John Maynard Keynes’s idea that fiscal stimulus – public spending and tax cuts – can help dig their economies out of recession.
The sudden resurgence of Keynesian policy is a stunning reversal of the orthodoxy of the past several decades, which held that efforts to use fiscal policy to manage the economy and mitigate downturns were doomed to failure. Now only Germany remains publicly sceptical that fiscal stimulus will work.

The new Keynesian consensus was set out in the communiqué issued by the Group of 20 leading industrialised and emerging economies in November, in which they vowed to "use fiscal measures to stimulate domestic demand to rapid effect" within a policy framework "conducive to fiscal sustainability".

The incoming administration of Barack Obama is preparing a two-year fiscal stimulus package with a reported price tag of $675bn-$775bn, which many Washington-based analysts believe could swell to $850bn (£580bn, €600bn) or even $1,000bn – between 5 per cent and 7 per cent of national income.

Gordon Brown, UK prime minister, told reporters in late December that if monetary policy was impaired – in large part because of problems within the financial system – "then governments have to use fiscal policy, and that has been seen in every country of the world".

Launching France's fiscal stimulus, President Nicolas Sarkozy said: "Our answer to this crisis is investment because it is the best way to support growth and save the jobs of today – and the only way to prepare for the jobs of tomorrow."

But not all policymakers have been so keen to jump on board what they see as a dangerous journey, not back to the theory Keynes laid out to combat a deep and protracted economic slump but to the failed fiscal fine-tuning of the 1970s, in which governments tried to maintain full employment at all times.

Germany has voiced the strongest principled objections to large-scale fiscal stimulus packages. Peer Steinbrück, the finance minister, has complained about the "crass Keynesianism" pursued by Mr Brown, accusing him of "tossing around billions" and saddling a generation with having to pay off British debt.

Jürgen Stark, an executive board member of the European Central Bank, who was previously vice-president of the Bundesbank, warned of a "substantial risk" of a repeat of the 1970s. "I really cannot see why discretionary fiscal policies, which have proven to be ineffective in the past, should work this time," he said.

Jean Claude Trichet, ECB president, has taken a cautious stance, arguing in a Financial Times interview for countries to allow their deficits to rise in line with the so-called automatic stabilisers – such as higher unemployment benefits and reduced tax revenues during a recession – but warning that the prospect of future tax rises could reduce consumer confidence. "One might lose more by loss of confidence than one might gain by additional spending," he said.

In the US, Lawrence Summers, the former Treasury Secretary now lined up to head Mr Obama’s National Economic Council, said the fiscal stimulus will address the need to increase investment in energy, education, health and infrastructure as well as the need to stimulate the economy.
Laurence Boone, a Paris-based economist at Barclays Capital, argued that large European countries fall into two camps. In one are countries with highly indebted consumers where housing markets have made a big contribution to economic growth in recent years – namely the UK and Spain. Here, fiscal stimulus packages were larger and focused on supporting consumers and housing.

Elsewhere, especially Germany and France, stimulus plans were less ambitious and “are set to rely more heavily on public sector investment, especially in infrastructure, with little support to consumption”, Ms Boone notes.

The contrasting rhetoric is more exaggerated than the reality of the differing positions. In gung-ho Britain and France, for example, the planned fiscal stimulus is no bigger than in reluctant Germany. And in all three countries, reduced tax revenues and higher welfare state payments will contribute the vast majority of prospective higher budget deficits, not the discretionary measures introduced in recent months.

The US stimulus package appears to dwarf the European efforts. But any fiscal stimulus has to be larger in the US to have a similar effect because more generous European social safety nets guarantee higher payments to the unemployed.

Mr Trichet argues that these “automatic stabilisers . . . have perhaps twice as much influence . . . as a percentage of GDP in the euro area as compared with the US”.

But it is clear a worldwide shift towards Keynesian deficit financing has occurred this year. Partly this is the result of the credit crisis impeding the effectiveness of monetary policy, partly the fact that interest rates cannot be cut further in the US and Japan, and also partly because banks will not lend to many households and companies even if they want to borrow.

But the move towards using fiscal policy as a means of boosting advanced economies still has limits, recognised by all those who experienced the 1970s.

Unsustainable fiscal positions can destroy confidence. The US, which issues the dollar, the world’s reserve currency, has more latitude than most. But even Mr Obama has been keen to stress his ambition to “get our mid-term and long-term budgets under control”.

Smaller countries with fragile currencies, such as the UK, are even more vulnerable to the effects of the confidence of foreign investors. The UK government announced a five-year government austerity package to reduce deficits from 2011 at the same time as its stimulus in an attempt to provide evidence of its longer-term good intentions. Continental European economies are bound by the stability and growth pact, limiting both budgets and debt. But the deterioration of the outlook for the global economy has been so rapid that addressing the immediate problems has overtaken consideration of longer-term consequences.

This trend was first evident almost a year ago in January, when Dominique Strauss-Kahn, the managing director of the International Monetary Fund, stunned delegates
at the World Economic Forum in Davos when he called for “a new fiscal policy [as] . . . an accurate way to answer the crisis”.

On the podium with him was Mr Summers. He remarked: “This is the first time in 25 years that the IMF managing director has called for an increase in fiscal deficits and I regard this as a recognition of the gravity of the situation that we face.”

Mr Summers now argues that the outlook has deteriorated further. With the prospect of the economy remaining weak and unemployment high for a protracted period, he believes spending on projects that continue beyond 2009 is justified.

Critics said this was a convenient cover for spending programmes that the Democrats wanted anyway. However, many economists agreed with the argument. “The US economy needs not only a large package of fiscal stimulus in 2009 but one that provides substantial support beyond next year,” said Ed McKelvey, an economist at Goldman Sachs.


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