API-120: Advanced Macroeconomics for the Open Economy, Fall 2019

Harvard Kennedy School

Course Syllabus: prospectus, outline/schedule and readings

Staff:
Professor: Jeffrey Frankel Littauer 217; jeffrey_frankel@harvard.edu.
Office hours: Mon. & Wed. 4:15-5:15, L217.
Faculty Assistant: Minoo Ghoreishi Belfer 510A. (617) 384-7329.
Teaching Fellow: Can Soylu
Course Assistants: Jason Keene, Juan Paez & Stella Tam.

Times:
Lectures: Littauer 140, Mondays and Wednesdays, 2:45-4:00 pm.¹
Review Sessions: Tuesdays: 4:15-5:30 pm (in R-304);
Fridays: 8:45 -10 am or 10:15 -11:30 am (in L-230).
Final exam: Friday, Dec. 13, 2:00-5:00 pm.

Course Description: This course is the first in the two-course sequence on Macroeconomic Policy in the MPA/ID program. It particularly emphasizes the international dimension. The general perspective is that of developing countries and other small open economies, defined as those for whom world income, world inflation and world interest rates can be taken as given, and possibly the terms of trade as well. The focus is on monetary, fiscal, and exchange rate policy, and on the determination of the current account balance, national income, and inflation. Models of devaluation include those where the price of internationally traded goods in terms of non-traded goods is central. A theme is the implications of increased integration of global financial markets. Another is countries’ choice of monetary regime, especially the degree of exchange rate flexibility. There will be applications to the problems of commodity-exporting countries, among other topics. (Such topics as exchange rate overshooting, speculative attacks, portfolio diversification and debt crises will be covered in the first half of API 119.)

Nature of the approach: The course is largely built around analytical models. Although real-world examples will appear throughout, we will rely heavily on theoretical and econometric analysis, as is customary in economics classes. Having said that, the course largely leaves to the successor course, API 119, the mathematical derivation of behavioral equations from first principles of individuals’ optimization of intertemporal utility.

Who is expected to take the course: This course, like Advanced Macroeconomics for the Open Economy II (API 119), is a required component of the MPA / International Development sequence. It is envisioned that some students might one day be making policy recommendations or decisions in a central bank or economics ministry or an international financial institution, but first needs training at a high level of intellectual rigor. Others may less macro-oriented, and just want to be able better to read the Economist or FT. In addition to MPA/ID students, a very few other students are sometimes admitted by permission of instructor – for example, someone who has taken BGP-620 and done well in it, and who in addition is comfortable with calculus and the other mathematical tools that distinguish the MPA/ID curriculum.

Required tools: Besides macroeconomics, some knowledge of basic microeconomics and international economics is presumed. Analytical tools to be used include especially calculus.

Grading: Problem sets 25%, mid-term exam 25%; final exam 50%.

Problem Set Due date (10:10 a.m. in the MPA/ID drop box)

1. Thurs., Sept. 12
2. Thurs., Sept. 19
3. Thurs., Sept. 26
4. Thurs., Oct. 3
5. Thurs., Oct. 10
   [Midterm exam Wed., Oct. 16]
6. Thurs., Oct. 31
7. Thurs., Nov. 7
8. Thurs., Nov. 21

Please check the dates of the midterm and final exams. 
*If you cannot take the exams, do not take the course.*

Students are responsible for knowing what is in the Academic Code.

Readings:

For most lectures, there is a single triple-starred reading that students are required to read *in advance of the lecture*. You may be called on in class to answer a question based on the reading.

Readings are either scholarly articles, short news media stories, or textbook chapters. The main textbook is the second half of *World Trade and Payments, R. Caves, J. Frankel, & R. Jones (10th edition, Addison-Wesley Longman, 2007)*, which is abbreviated *WTP* on the reading list. Chapters are available online at the course page and also on my Publications page. For those who want to try to buy a hard copy, possible options include the Coop or online from Amazon (either new or used). Also there may be some copies on reserve in the HKS library, G floor of Littauer.

For lectures 7 and 10-13 [Money & Inflation], the text is “Monetary Policy,” Chapter 12, of David Romer’s *Advanced Macroeconomics*, 5th ed., McGraw Hill, 2019, or Chapter 10 in the 4th ed., 2012. (Romer is also the text for the 2nd half of API119, Macro II.)

**Textbooks for further background:** Most students will have already studied basic or intermediate macroeconomics. The necessary pre-requisite background in macroeconomics at a basic level is represented by Greg Mankiw, *Macroeconomics*, e.g., 9th ed. (Worth: NY), 2015.

API-120: Macroeconomic Policy Analysis I

Prof. Jeffrey A. Frankel, Harvard Kennedy School

Topics and schedule:

Tentative due dates for Problem Sets:

I. REVIEW OF BASIC MACRO CONCEPTS
1. (9/4) GDP accounting
2. (9/6) Balance of payments accounting & the National Saving identity
3. (9/9) The traditional Keynesian multiplier model

II. DEVALUATION AND THE TRADE BALANCE
5. (9/16) The trade balance in practice.

III. THE MUNDELL-FLEMING MODEL
6. (9/18) The Mundell-Fleming model with a fixed exchange rate _ PS 2 due 9/19
7. (9/23) Monetary policy at the Zero Lower Bound
9. (9/30) The model with a floating rate & perfect capital mobility; The Impossible Trinity.

IV. INFLATION
10. (10/2) Aggregate Demand and Aggregate Supply __ PS 4 due 10/3
11. (10/7) Inflation and the rational expectations hypothesis
12. (10/9) Dynamically inconsistent monetary policy vs. monetary rules __PS5 due 10/10
   [10/14 Columbus Day holiday]

MIDTERM EXAM
13. (10/16)
14. (10/21) Seigniorage and hyperinflation

V. INTEGRATION OF GOODS MARKETS
17. (10/30) Barriers to integration. __ PS 6 due10/31

VI. SMALL OPEN ECONOMIES
19. (11/6) Devaluation in small countries __ PS 7 due 11/7
   [11/11 Veterans Day holiday]
20. (11/13) The Salter-Swan model featuring nontraded goods
21. (11/18) EM crises: currency mismatches & contractionary devaluation __PS8 due 11/21
22. (11/20) Dutch Disease
22½ (11/22?) Possible optional lecture: The Natural Resource Curse

VII. EXCHANGE RATE REGIMES
23. (11/25) Classification; Pros and cons of fixed vs. floating Rates
24. (12/2) Optimum Currency Areas & currency unions.
25. (12/4) More on EM currencies
25½ (12/6?) Possible optional lecture: Macro policy in China #2

Friday, Dec. 13, 2:00-5:00 pm. FINAL EXAM
API-120: Macroeconomic Policy Analysis I
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READING ASSIGNMENTS

* = required reading, available online when possible
** = required strongly, available online when possible
*** = required strongly to read before lecture. You may be called upon.
[ ] = background readings

I REVIEW OF MACROECONOMIC CONCEPTS

1. (9/4) GDP accounting
   “The lives of the parties: China’s economy is more Soviet than you think,” Economist, Dec.15, 2018. *
   Reported in “The Indian growth fable: A former official casts doubt on India’s GDP figures,” Economist, June 15, 2019. **

2. (9/6) Balance of payments accounting and the National Saving identity
   Caves, Frankel & Jones, World Trade and Payments (WTP), 2007, Chapter 15 & 17.2 ***
   “China Concerns: Tourism deficit leaves current account vulnerable to trade shock,” Financial Times, June 14, 2018. **
   “Pakistan’s economy: In need of re-stitching,” The Economist, June 16, 2018. *

3. (9/10) The Keynesian multiplier model
   Caves, Frankel and Jones WTP, 2007, Chapters 17.1, 17.3 & 18.1-18.2. ***
II. DEVALUATION AND THE TRADE BALANCE

Caves, Frankel & Jones, WTP, 2007, Chapter16 & Supplement, pp. S43-S44. ***

5. (9/16) The trade balance in practice.

III. THE MUNDELL-FLEMING MODEL

6. (9/18) Mundell-Fleming model of monetary & fiscal policy with a fixed exchange rate
Caves, Frankel and Jones WTP, 2007, Chapters 18.3-18.4, 22.1-22.3 ***
[Also Romer, Chapter 6.1]
“Argentine businesses battle to survive 40% interest rates,” Fin. Times, June 11, 2018. **

7. (9/23) Monetary Policy at the Zero Lower Bound
Romer’s Advanced Macroeconomics, Chapter 12.2 & 12.6-12.7 in 5th ed. *

Caves, Frankel and Jones WTP, 2007, Chapters 19.1, 22.4-22.7. ***
“Hot money flows into Argentine peso spook President Macri,” Fin. Times, May 27, 2016. *
“Turkish lira up 2% after central bank raises interest rates to keep inflation in check,”
Financial Times, July 8, 2018. **
9. (9/30) The model with a floating rate & perfect capital mobility; Impossible Trinity.
    Caves, Frankel and Jones WTP, 2007, Chapter 23. ***
    Robert Mundell, 1963, "Capital Mobility and Stabilization Policy under Fixed and Flexible
    "Brazil's economy: Wild horses – A soaring currency..." The Economist, Apr.23, 2011. **

IV. MONEY AND INFLATION

10. (10/2) Aggregate Demand, Aggregate Supply, and money growth
    WTP, Chapter 26.1 ***
    Romer’s Advanced Macroeconomics (McGraw Hill, 2019), Chapter 12.1 in 5th ed. *
    Prachi Mishra & Peter Montiel, 2013,”How Effective is Monetary Transmission in Low-
    income Countries? A Survey of the Empirical Evidence,” Economic Systems. vol.37, issue 2, June,
    187–216. IMF WP12143. *
    “Some like it hot: Which emerging economies are at greatest risk of overheating?" Economist, July 2,
    2011, p.65. **
    “India lifts interest rate to curb price pressures," Financial Times, June 7, 2018. *

11. (10/7) Inflation and the rational expectations hypothesis
    David Romer, Advanced Macroeconomics, Chapter 12.3 in 5th ed. ***
    [Chapter 6.2-6.4 of David Romer’s Advanced Macroeconomics 4rd ed., 2011]
    “The winding road: Monetary policy in Africa has become more orthodox,” The Economist, Jan. 26,
    2019. **

12. (10/9) Dynamically inconsistent monetary policy vs. monetary rules
    WTP, Chapters 26.3-26.4 ***
    Romer, Advanced Macroeconomics, Chapters 12.8-12.9 in 5th ed. (11.7-11.8 in 4th ed.) **
    Kenneth Rogoff, 1985, "The Optimal Degree of Commitment to an Intermediate Monetary
    Bank of Kansas City, 88, no. 4, 4th quarter, pp. 45-78.
    J. Frankel, 2011, "Monetary Policy in Emerging Markets: A Survey,” in Handbook of
    Monetary Economics, Benjamin Friedman & Michael Woodford, eds. (North Holland). HKS RWP
    11-003; NBER WP 16125.
    Mario Blejer, 2013, “Political Central Banking: Get ready for the end of central bank
    independence,” The International Economy, 27, no.2, spring, pp. 32-33.
    “The desperation of independents: Stubbornly low interest rates may mean the end of central-
    “Erdogan deals a fresh blow to Turkey’s economy,” Financial Times, July 8, 2019.
    “Recep Tayyip Erdogan sacks the head of Turkey’s central bank,” The Economist, July 13, 2019. *

13. (10/16) MIDTERM EXAM
14. (10/21) Seigniorage and hyperinflation

WTP, Chapter 19.3 & page 582 ***
Romer’s Advanced Macroeconomics, Chapter 12.10 in 5th edition (11.9 in 4th ed.) *
“Venezuela – The half life of a currency: Hyperinflation is hard to grasp, harder still to tolerate,” The
“Hyperinflation can end quickly, given the right sort of regime change,” Economist, Jan. 31, 2019. ***


from Economics, Politics and Law, edited by S. Evenett (CEPR: London), 51-60. **
and possible explanations," in Capital Controls and Capital Flows in Emerging Economies:

V. INTEGRATION OF GOODS MARKETS

16. (10/28) PPP

Caves, Frankel and Jones, WTP, 2007, Chapter 19.2. ***
Economic Perspectives, 18, 4, 135-158, Fall. *
Camila Casas, Federico Diez, Gita Gopinath, and Pierre-Olivier Gourinchas, 2017,

17. (10/30) Barriers to trade integration

Currencies on Trade, “ Economic Policy vol.15, no.30, April. **
Charles Engel and John Rogers, 1996, "How Wide is the Border?" Am.Econ.Rev. 86, 5, Dec.,
1112-25. NBER WP 4829. *
Michael Mussa, 1986, "Nominal Exchange Rate Regimes and the Behavior of Real Exchange

18. (11/4) Nontraded goods and Balassa-Samuelson

“The Big Mac Index: Of Bucks and Burgers,” The Economist, July 15, 2017. **
Jose De Gregorio, Alberto Giovannini, and Holger Wolf, 1994, “International Evidence on
Tradables and Nontradables Inflation,” European Economic Review 38, no. 6, June, 1225-44.
VI. SMALL OPEN ECONOMIES

19. (11/6) Devaluation in small open countries
   Caves, Frankel and Jones, World Trade and Payments, Ch. 19.4 & Appendix 19.C. ***

20. (11/13) The Salter-Swan Model
   Caves, Frankel and Jones, World Trade and Payments, Chapter 20. ***

21. (11/18) EM crises: Sudden stops, currency mismatches & contractionary devaluation
   WTP, 2007, Ch. 24.1-24.2, 24.6-24.7 ***

22. (11/20) Dutch Disease
   “Nigeria’s economy: More misery ahead,” The Economist, June 1, 2019. **

22 ½ OPTIONAL LECTURE: The Natural Resource Curse & solutions

VII. EXCHANGE RATE REGIMES

23. (11/25 ) Classification; Pros and cons of fixed vs. floating Rates
Guillermo Calvo and Carmen Reinhart, "Fear of Floating," QJE, 117, 2, May, 379-408. *

24. (12/2) Optimum Currency Areas & Currency Unions

WTP, Chapter 26.5. ***

25. (12/4) Intermediate Exchange Rate Regimes


25 ½ POSSIBLE OPTIONAL LECTURE: Macro Policy in China #2 (RMB policy & 2012-19 slowdown)


To be covered in API-119 --

More on EM currency crises: early warning indicators and contagion

WTP, Chapter 24.3-24.5, 24.8-24.9
“Hot and Sour: What Asia learned from its financial crisis 20 years ago,” Economist, July 1, 2017.