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Development macroeconomics workshop

July 31 – August 6, 2007

Objectives, sources, prerequisites and other general information

This is a five day macroeconomics workshop aimed to provide junior-level economists in government, academia and NGOs/think-tanks with the fundamentals of the neoclassical macroeconomic framework. The workshop will emphasize issues and applications tailored to specificities of developing small open economies.

Structure and sources: The curriculum is broadly separated into two main parts. Part one covers days 1 and 2, which focus on Keynesian open economy macroeconomics. Part two (days 3 through 5) covers basic neoclassical general-equilibrium models. The curriculum is structured in line with the first-year macroeconomic sequence taught in the MPA/ID program at Harvard University¹. Specifically, part one draws on “Advanced Macroeconomics for the Open Economy I” course taught by Prof. Jeffrey Frankel, and part two draws on Prof. Federico Sturzenegger’s “Advanced Macroeconomics for the Open Economy II”². I am the teaching fellow in both of these classes, and will rely primarily on review session notes I use in both classes. For deeper analysis turn to:

- Romer, David (2005) *Advanced Macroeconomics, 3rd Edition*. McGraw-Hill/Irwin.
- Caves, Richard E., Frankel, Jeffrey A. and Jones Ronald W. (2006) *World Trade and Payments: An Introduction (10th Edition)*. Addison Wesley.

Economic prerequisites: This is *not* an introductory economics workshop. It provides a light version of what is normally taught in a MA in Economics programs (or even Ph.D.). It would be helpful if you have heard of: utility and production functions, elasticity, isoquants, marginal utility, marginal cost and marginal productivity, constant/increasing/decreasing returns to scale. Do not worry if you haven’t—they will be briefly explained when first introduced.

Math prerequisites: The workshop will use basic calculus at the level of the derivative (no integrals though). I will go slowly enough to accommodate even those who have not encountered a single derivative since the first year of university — I assume that’s the majority.

Working language: Romanian, but all supporting materials will be in English.

Workshop location: ARIA Study Center. 6 Calea Ieșilor St. 7th floor (“Artima” Building)

Daily schedule: 14:00-18:00 with two coffee breaks.

¹ See <http://www.ksg.harvard.edu/programs/mpaid/>

² Course descriptions: <http://ksgaccman.harvard.edu/courses/course.aspx?number=API-120> (Prof. Frankel’s course) and <http://ksgaccman.harvard.edu/courses/course.aspx?number=API-119> (Prof. Sturzenegger’s course).

Topics

For each topic, I have listed a couple of economic questions that can be analyzed in the framework of the corresponding model.

Tuesday, July 31. Basic macroeconomic identities. Keynesian open economy

- Fundamental economic identities in the open economy: GDP, the balance of payments and their components. (30 min)
 - > Every developing country wants to run a trade surplus *and* to attract FDIs. Is such an arrangement sustainable in the long run?
- The foreign exchange market, monetary aggregates and the central bank. (45 min)
 - > How do Central Bank's foreign exchange operations affect monetary policy? Can the CB decouple the two?
- Devaluation and the trade balance (45 min)
 - > Does currency devaluation necessarily improve the trade balance?
- The Mundell-Fleming model of the balance of payments and the basics of macroeconomic management. (2 hours)
 - > How do the main macroeconomic stabilization policies (monetary, fiscal and exchange rate) affect the balance of payments and its components?
 - > What are the options faced by a country experiencing a large inflow of foreign currency?

Wednesday, August 1. Models with PPP and non-tradable goods

- Purchasing Power Parity: theory and empirical evidence. (1 hour)
 - > Should the exchange rate affect prices at all?
- Devaluation in developing countries with non-traded goods. The Salter-Swan model and the Dutch disease. (2 hours)
 - > Why should the governments track the real exchange rate?
 - > Which sector should the government support: the tradable or the non-tradable sectors?
- Exchange rate regimes in the real world and optimal currency area (OCA) criteria. (1 hour)
 - > What are the strengths and weaknesses of various exchange rate regimes?
 - > Should a small open economy the size of Moldova have its own currency?
 - > What questions will Moldova face if it is ever to consider adopting the Euro?

Thursday, August 2. Fundamentals of the neoclassical model

- The production function, equilibrium wage and interest rate, returns to scale. (30 min)
 - > What is the interest rate from an economic point of view?
 - > Can the state lower interest rates?

- The Solow model. Dynamic inefficiency and the golden rule (*1.5 hours*)
 - > What are the supply-side instruments a country can use to increase per-capita income?
 - > Why are Moldova's roads so bad?
- Endogenizing savings. A graphical introduction to intertemporal utility maximization and the Euler equation (it's less scary than it sounds). A sketch of the Ramsey model (*1 hour*)
 - > Can the government affect the savings rate? Should it?
- Opening up the economy to capital flows: the open economy Ramsey model (*30 min*).
 - > Is a large current account deficit necessarily an evil?
 - > Should countries affected by a negative terms-of-trade shock run a CA deficit?

Friday, August 3. Social security

- The overlapping generations (OLG) model. (*2 hours*)
- Pay as you go (PAYG) and fully-funded social security systems and transitions. (*2 hours*)
 - > Why are capitalized social security systems better?
 - > What are the problems associated with the transition from PAYG to a capitalized system, and can a country in transition reap all the benefits of the second?

Monday, August 6. Applications³

- Poverty traps: Solow-model poverty traps and coordination failures (*45 min*)
 - > What is the rationale behind foreign aid and the "big push"?
- Fiscal policy in a Ramsey model: the Ricardian equivalence and its failures. (*45 min*)
 - > Does increased fiscal spending affect total demand?
 - > Do temporary tax cuts affect spending in an economy?
- Technological progress and endogenous growth. (*45 min*)
 - > Is technological progress happening in SMEs or large monopolies? What does the answer depend on?
- Putting the neoclassical framework to work: the constraints analysis framework and selected results for Moldova. (*1.5 hours*)
 - > How can the theory covered over the last few days inform real-life development policy?

³ There is a non-zero probability that the last day will be moved to Tuesday, August 7.