

Macroeconomic Policy and Financial Markets

Module Introduction and Overview

Contents

1	Introduction to the Module	2
2	The Module Author	2
3	Study Resources	2
4	Module Overview	4
5	Learning Outcomes	5

1 Introduction to the Module

This module, Macroeconomic Policy and Financial Markets, is specially constructed for postgraduates studying finance and related subjects. The module is designed to increase the depth of your understanding whether or not you have studied economics or macroeconomics previously. Although it does not require previous study of macroeconomics, if you have studied macroeconomics at undergraduate level, this module adds to your knowledge because, unlike other modules, we focus on the relation financial markets have to macroeconomics.

Our intention is that after successfully completing the module, students from varied backgrounds will understand the key elements of macroeconomics and their connection with financial markets. We place the subject in a real-world context, aiming to show how theoretical and empirical knowledge of macroeconomics and financial markets provides ways to analyse the salient problems faced by modern macroeconomic policymakers.

2 The Module Author

Laurence Harris is Professor of Economics in the University of London and contributes to CeFiMS as a member of the Department of Financial and Management Studies, SOAS University of London. He has previously taught at several universities including London School of Economics; University of California Berkeley; Harvard University; Birkbeck, University of London; the Open University; University of Zimbabwe. He has published nine books and eighty articles. Books include *Monetary Theory*; *New Perspectives on the Financial System*; *City of Capital*; and *Peculiarities of the British Economy*.

3 Study Resources

This study guide is your central learning resource as it structures your learning unit by unit. Each unit should be studied within a week. It is designed in the expectation that studying the unit and the associated readings in the key text and module readings will require 15 to 20 hours during the week.



Key text

In addition to this study guide you must read, as core readings, assigned chapters in the key text:

David Miles, Andrew Scott and Francis Breedon (2012) *Macroeconomics: Understanding the Global Economy*. 3rd Edition. New York: JohnWiley & Sons.

We have chosen Miles, Scott and Breedon's book, instead of one of the many other macroeconomics texts available, because it is written for the same type of postgraduate students as this module. Designed for MBA students and others, it deals with advanced subjects and relates them to modern problems without requiring previous study of macroeconomics. This text gives more attention than others to the role of financial markets, and is written for students who do not have advanced mathematical or statistical knowledge.

Module readings

We also provide you with access to academic articles and other reports, which are assigned as core readings in the study guide. You are expected to read them as an essential part of the module although you will find that some academic articles range more widely than the study guide or use more advanced techniques and have a greater level of conceptual difficulty than the key text. That is the nature of academic articles, but we have selected articles and reports whose main arguments can be understood and appreciated at the level appropriate to this module.

Optional reading

The study guide refers to academic articles, books, and other items that you can choose to read if you wish to investigate a particular topic further. We have not provided access to such materials but, where possible, provide an internet address (URL) where you can read the item. These items are not required reading and you will not be assessed on them in the examination or assignments. But we believe you can enrich your studies during the module or after it by looking at the optional reading. Indeed, we would encourage you to choose your own optional readings on macroeconomics and financial markets by searching the internet and accessing academic journals through the Library resources on the CeFiMS Virtual Learning Environment (VLE).

Video: Macroeconomics – The Decision Makers

An additional element provided for this module is a video, available via the VLE, in which leading policymakers talk to CeFiMS about their experiences. All the decision makers and advisers in the video have dealt with difficult macroeconomic problems in a range of countries and they explain how they approached the problem and considered alternative policies.

They include:

- Paul Volcker, looking back on his experience as Chairman of the Federal Reserve
- Sir Alan Budd, as Economic Adviser in the British Treasury (Ministry of Finance),
- Guillermo Ortiz, as the Governor of Mexico's central bank
- Professor Lord Richard Layard, as advisor to the Russian government
- Benno Ndulu, of the World Bank
- Professor Rudiger Dornbusch, on experience of Latin American macroeconomic policy

- Professor Sakakibura, on Japan's recent policy problems.

The interviews were recorded by CeFiMS for the International Monetary Fund and designed for officials studying macroeconomics with the IMF Institute. They are reproduced here with kind permission of the IMF. They show case studies intended to enable students to link their study of principles to actual macroeconomic policymaking in the complex real world.

The interviews in the video are divided into four sections, each lasting approximately 30 minutes and each focusing on a different element of macroeconomic policy:

1. Monetary Policy in Theory and Practice
2. Fiscal Policy in Theory and Practice
3. Foreign Trade and Exchange Rate Policy
4. Capital Flows and Exchange Rates

How should you relate these sections to your study of this module?

Each section of the video has a direct relevance to the topic of a particular unit in the module. Section 1 relates to Unit 4; section 2 to Unit 5; section 3 to Unit 7; and section 4 to Unit 8. However, your use of the video is optional and is not a required element of your study for the module. You will not be assessed on the video's contents in the examination or the assignments.

Nonetheless, we believe that watching the video will enrich your studies and deepen your understanding. Since it is not a compulsory element, you can watch it at any time during your study of the module (or after) without trying to watch a particular section in the same week as you are studying a particular unit.

4 Module Overview

Unit 1 Macroeconomics and the World of Finance

- 1.1 Introduction
- 1.2 Getting Macroeconomics in Perspective
- 1.3 Long-Run and Short-Run Macroeconomics
- 1.4 Aggregate Demand and National Income Accounts
- 1.5 Alternative Windows on Macroeconomics
- 1.6 Macroeconomics and Financial Markets
- 1.7 Macroeconomics and Finance in Subsequent Units

Unit 2 Saving and Finance

- 2.1 Introduction: Real and Financial Saving
- 2.2 Life Cycle Theory of Saving
- 2.3 Flow of Savings to Financial Markets – Demographic Fundamentals
- 2.4 Impact of Financial Markets on Saving – Interest Rate Effect
- 2.5 Impact of Financial Markets on Saving – Wealth Effect

Unit 3 Investment and Financial Markets

- 3.1 Capital Accumulation
- 3.2 Interest Rates and Investment – the Basic Model
- 3.3 Beyond the Basic Model
- 3.4 Investment and the Stock Market
- 3.5 Financing Hierarchy and the Role of Internal Funds
- 3.6 Conclusion – Investment and Monetary Policy

Unit 4 Monetary Policy and the Central Bank

- 4.1 Central Banks and Macroeconomic Policy – Inflation Targeting
- 4.2 Policy's Intermediate Targets – Money Supply and Interest Rate
- 4.3 Taylor Rules
- 4.4 Transmission Mechanisms of Monetary Policy
- 4.5 Monetary Policy in Context

Unit 5 Fiscal Policy and Government Finances

- 5.1 Effects of Fiscal Policy – Aggregate Demand and Financial Markets
- 5.2 Fiscal Policy and Monetary Policy
- 5.3 Fiscal Policy and the Sustainability of Debt Financing
- 5.4 Fiscal Policy in Perspective

Unit 6 Expectations, Inflation, and Interest Rates

- 6.1 Markets Reflect the Expected Future Today
- 6.2 Macroeconomic Expectations and Financial Markets
- 6.3 Inflation Expectations and the Inflation Output Trade Off

Unit 7 Foreign Exchange Markets and Foreign Trade

- 7.1 Foreign Exchange Markets and the Economy
- 7.2 Case Study – China's Macroeconomic Policy Choices
- 7.3 Exchange Rates, Inflation and Aggregate Demand
- 7.4 Exchange Rates and Monetary Policy

Unit 8 International Capital Flows and Financial Markets

- 8.1 International Capital Flows – Balance and Shocks
- 8.2 Interest Rates, Expectations and Currency Crises
- 8.3 Currency Crises and Exchange Rate Systems
- 8.4 Is There a Case for Controls on International Capital Flows?

5 Learning Outcomes

When you have completed your study of this module, you will be able to:

- outline and discuss the connection between financial markets, real saving by households, and real investment by firms
- analyse how monetary policy can affect real macroeconomic activity through its interaction with financial markets
- explain the relation between financial markets and governments' fiscal policies

- discuss the effect that expectations of future inflation and interest rates can have on macroeconomic policy and financial markets
- analyse the connection between foreign exchange markets, imports and exports
- examine the possibility of instability arising from interaction between international capital flows and financial markets
- evaluate theories in the light of empirical evidence
- use theory and evidence to analyse actual problems facing macroeconomic policymakers.