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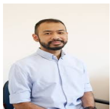

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Macroeconomics II
Lecture notes (4) on:
Dynamic macroeconomic models of real-financial interactions

(F. Bagliano, 2012)

The rational expectations hypothesis has been introduced in many macroeconomic models, even outside the framework of the new classical macroeconomics, to investigate the interactions between asset prices and real activity. These notes outline two dynamic models that focus on the determinants of stock prices and exchange rate fluctuations, and their effects on the real economy.

1. The stock market in a dynamic IS-LM model (Blanchard 1981)

This section describes a simplified version of the dynamic $IS-LM$ model in Blanchard (1981), that extends this elementary macroeconomic scheme along two dimensions: (i) by considering dynamics, and (ii) by enlarging the set of financial markets beyond the traditional "money" and "bonds". In the model below, the latter extension is limited to the *stock market*. Stock prices have a *forward-looking* nature, since they incorporate agents' expectations on the future course of the economy (particularly on the determinants of stock market returns: dividends, future stock prices, and interest rates).[1] The changes in stock prices (and, in extended versions of the model, in the prices of other financial assets such as long-term bonds) highlight the role of expectations as driving forces of real variables

[1] In the model, absent any stochastic element, the rational expectations hypothesis coincides with perfect foresight.

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