ABBREVIATED PROLOGUE

FOUNDATIONS OF FINANCIAL MACROECONOMICS: A POLICY RATE APPROACH (PRA)

There is an apocryphal rule about new textbooks: they can only have 15% new material. A successful new textbook must be similar enough to the old standards to keep the process of switching from requiring professors to throw away all their old lecture notes and completely redesign their courses….It makes intellectual progress---nearly impossible…

Smart students notice this incongruity. They wonder what is going on. Other students don't wonder, but then they have a very hard time understanding the newspaper: "why," they ask, "does the newspaper talk about ***interest rate*** *changes instead of shifts in the* ***LM curve****?" from "A Macroeconomics Textbook Manifesto", by Brad de Long, Berkeley economics Professor 2000.*

This prologue has been written mainly for those teaching macroeconomics and wishing to replace the irrelevant and erroneous IS/LM framework with a Policy Rate approach. To understand this Prologue, it is best to refer back to the Schematic and go over it carefully. The Policy Rate Approach book that follows after this book EGI, is Module III of my comprehensive text.

As early as 1998, three years after I started teaching at IIM Bangalore, I signed a contract with a major publisher to write a macro text. I was acutely aware, based on my experience at the Federal Reserve Bank of New York, that the central bank's policy instrument is the interest rate, *not* some measure of money supply corresponding to the LM curve. Hence I felt the dire need for a Policy Rate approach text to replace IS/LM. However, with too many things going on then, I was not able to make much headway in working out the Policy Rate approach, and so dropped writing the text.

While doing a co-authored study on India's debt in 1999 and 2000 for the RBI, I worked out such a Policy Rate model of public debt, embedded in a classical macroeconomics framework. A macro text required a simplified version, which I slowly developed and finally started teaching in 2005. Unfortunately the response from students was increasingly unfavourable. As the number of sections in core macroeconomics grew, they were complaints that, when all other section are teaching IS/LM, why am I doing things differently? In response to that I wrote a note "Why IS/LM is Irrelevant and Wrong: An Explanation, if it is needed", critiquing the defence of IS/LM for his text by Gregory Mankiw in his blog, and that of Paul Krugman too (February 2015 on my website).

Overall, I realized there is huge resistance to changing the core course. Even though the Policy rate approach is conceptually and algebraically *much simpler* than IS/LM, it cannot be easily introduced. Hence I decided to write these mini-books. In the meantime, I expanded the Module II content pertaining to the 1970s OPEC stagflation to cover India's stagflation in 2012 and 2103. This detailed foray into India's policies, for better or for worse, took up several years of time and effort, and has greatly delayed my original pre 2000 aim of bringing out a Policy Rate text.

Those continuing to use IS/LM can <u>still use this book EGI</u> to teach an elective course, or to cover labour and product markets in a core course. Those who **wish to replace** IS/LM can use EGI as the foundation for the Policy Rate approach. As Brad de Long insightfully stated (cited at start), given the reluctance of instructors to switch, new textbooks can have *only about* 15% new material. So although these books are part of a connected menu, they have to be introduced *a la carte*.

What I call the Policy Rate Approach (PRA) is usually called the three equation model, and it is slowly replacing IS/LM globally. By some remarkable coincidence, in the year 2000 when my study based on the Policy Rate framework came out, along with Brad de Long's splendid comments, John Taylor and David Romer published articles outlining macroeconomics without the LM curve. This abbreviated Prologue to PRA is not the place to discuss them, or various other critiques of IS/LM over decades. This abbreviated prologue is merely meant to prepare those professors seeking a replacement to IS/LM to teach macroeconomics to look out for the PRA mini book to be out, hopefully, before December 2017. How to apply the Policy Rate approach for the open economy to replace the invalid DD AA framework of Krugman and Obstfeld's international economics text, is discussed in the full Prologue to the forthcoming PRA book.

Postscript: I came across these splendid comments on IS/LM by Brad de Long, around 2009. My short response to them: I fervently wish a few students where I teach, would ask the question that Brad de Long's students raised, and more so those who teach macroeconomics, here and elsewhere!