

Lecture 1: Seminar on Monetary Theory and Policy

I. INTRODUCTION

- Economics 331 is a seminar course that will cover some of the latest developments in two areas: the theory of monetary economics and the conduct of monetary policy.
- The main goal of this course is to expose you to several areas of research in monetary policy that currently are of interest to academics and policy makers. The secondary goal is to stimulate your interest in an in-depth exploration of a specific area of research. In other words, by taking this course, I hope that you will develop a broad understanding of the key issues in monetary economics and become interested in doing some research in a particular area.
- On the theoretical front, economists have made significant breakthroughs in developing macroeconomic models that help establish some important principles of good monetary policy making. In this class, we will tackle some tough papers in academic economic journals that describe some of these advances.
- On the practical front, most of you have been exposed to sustained media interest about the role played by the Federal Reserve over the last decade: first in sustaining the longest peace-time economic expansion, then its valiant attempts to help keep the economy afloat during the 2001 recession and finally, the most recent attempts to move back to a neutral policy stance by raising interest rates from historically low levels. We will look at some of the challenges that the Fed has overcome in the past and also look ahead to the challenges it faces in the future.
- In addition, we will also focus some of our attention on other countries by reading economic research that deals with the way in which monetary policy makers, in Japan, Europe, China, and a host of other smaller countries conduct monetary policy.

II. CLONING ALAN GREENSPAN

- Next to the stock market, monetary policy is the area of economics that has most captured the public interest. Monetary policy changes initiated by the Federal Reserve are covered in great detail in newspapers, and the Chairman of the Fed, Alan Greenspan is acknowledged as being the most powerful figure as far as the U.S. economy is concerned.
- A humorous anecdote supporting this claim comes from the Republican presidential primary debates in 2000:

MR. HUME: Senator McCain, where do you come out on this question of this stock market, as high as it is, and on the issues that have just been asked of Mr. Forbes relating to Mr. Greenspan, who seems, at times, alarmed by the level of the stock market? Do you think it's a bubble? Do you think we should be afraid of this? What?

Senator MCCAIN: I share Mr. Greenspan's concern. And, by the way, I would not only reappoint Mr. Greenspan; if Mr. Greenspan should happen to die, God forbid, I would do like they did in the movie "Weekend at Bernie's." I'd prop him up and put a pair of dark glasses on him and keep him as long as we could.

- The humor in this little exchange masks the pivotal role that Alan Greenspan plays in today's economy. He is clearly the most powerful man in the American economy, every word he speaks is closely scrutinized by the press, financial markets await his actions with bated breath and no politician in power could ever dream of trying to impose his/her will on Mr. Greenspan.
- In the late 1990s when the economy was booming, it would not be an exaggeration to say that Alan Greenspan was idolized as the man responsible for the nation's unprecedented economic prosperity. However once the economy started slumping in late 2000 and entered into recession in early 2001, Greenspan's aura took a little bit of a beating. Some people criticized Greenspan for keeping interest rates too low for too long, encouraging the formation of an asset bubble in 1998 and 1999. Others criticized Greenspan for being too hasty to raise interest rates and thus perpetuating the recession.
- During the subsequent downturn, and especially after the attacks of Sep 11th, criticism of Greenspan has become muted again (although the praise is not as lavish as it was in the late 1990s). Greenspan acted aggressively to lower interest rates to historically unprecedented levels, and after the economy showed signs of rebounding has now embarked on a gradual policy of increasing interest rates.
- Along with this success and high profile for the Fed has come greater academic and public scrutiny. Academics have tried to identify what policies and institutions make for a successful monetary policy maker. For example, since the high respect accorded to Greenspan today was uncommon among past governors of the Federal Reserve, academics have used historical analysis to study why the Fed may not have been as successful an institution in the past:
- Academics have also looked to the future, trying to understand changes that are taking place in the economy today and trying to identify how these events should influence the Fed's behavior, if at all, in order to ensure its continued success.
- Other countries have also tried to reform their central banks to incorporate some of the outstanding features of the Federal Reserve and other respected Central Banks like the German Bundesbank. There is an increased emphasis place on reforming central banks and financial systems spearheaded by the Bank for International Settlements, which is located in Basel, Switzerland.
- This course will introduce you to the features of good monetary policy making drawing on academic research and on practical policy making experience. We will cover many important topics that are relevant to current economic conditions in the U.S., Japan, Europe as well as other developed and developing countries. The primary tool of learning will be academic research papers, which are often technically quite challenging as well as being very densely written. Therefore, this class is only recommended for majors who were very comfortable with their intermediate level theory courses: 200, 201 and 202.

III. OVERVIEW OF TOPICS

- What are some of the issues that we will cover in this class? First, we want to establish some basic principles of good monetary policymaking.
- This will basically involve reviewing some of the topics covered in Economics 202, albeit with a different macroeconomic model than what you are used to from your intermediate classes. In the first two weeks of class we will use a model called the Aggregate Demand/Inflation Adjustment model that is basically a spin off of the IS-LM and AD/AS framework that you studied in Economics 202.
- This model will highlight some of the basic features of monetary policy such as the impact of expansionary and contractionary monetary policy on output and inflation in the short and long run, the interplay between monetary and fiscal policy, the role that potential output plays in influencing monetary policy decisions etc. In short, it will give you a good intuitive base for understanding what good monetary policy should be, in theory.
- We will then use a second economic model: the Phillips Curve, to review some key concepts about the potential trade-off between inflation and unemployment and also examine the role of expectations in influencing the effectiveness of monetary policy decisions.
- These two basic models will give us a foundation for thinking about monetary policy. We will build on this foundation by analyzing subtle extensions to these basic models in much greater depth, using research papers as our guide.
- The first set of topics we will discuss are the impact of monetary policy on the ‘real’ economy and the channels through which monetary policy impacts the real economy. We will read a paper that provides a historical analysis of how pivotal a role monetary policy has played in driving economic fluctuations in the United States. We will also read a paper identifying the different channels through which policy changes of the Federal Reserve are transmitted to the economy. Finally, we will explore one of these channels in great depth by covering the very important topic of the term structure of interest rates, which shows how monetary policy decisions of the Fed (that move short-term interest rates in the economy) affect longer term interest rates (like mortgages and business loans) that govern most economic activity.
- Once we establish the degree to which, and the means by which, the Fed’s decisions have a significant impact on the economy, we will study the institutional structure of central banks. In particular, we will focus on why credibility, reputation and independence are vitally important for central banks. In other words, we will study why it is important for central banks to be credible (i.e. for people to believe that they will do what they promise) when they announce policy plans, why it is important for central banks to have a reputation for fighting inflation and why it is important for central banks to be independent from political influence.
- The third set of topics looks at an area of research known as monetary policy rules. Monetary policy rules are an area of research that has attracted a lot of recent attention and are widely used in economic models to capture the systematic behavior of monetary policy making. We will use this exciting research tool for analyzing monetary policy decisions, both for gaining historical perspective but also for developing a framework for understanding how to conduct monetary policy in a more integrated global economy.
- The last set of topics focuses on current ‘hot’ topics in monetary policy. I have outlined a set of potential areas that you could explore. You should pick the topic that interests you the

most and do some reading about it. You will be responsible for writing a literature summary and coming up with a research question on the topics as well as giving a short presentation of a representative paper dealing with that topic to the rest of the class.

- I have chosen 6 topics, but you are welcome to go outside these areas if you'd like, with my approval. The first topic I chose is on how monetary policy makers should react (or whether they should react at all) to asset bubbles, whether it be in the stock market or in the real estate market.
- The second topic focuses on the vexing economic situation facing Japan, where the economy has now been in almost a decade long slump, albeit with some encouraging recent signs of recovery. For much of the past decade, monetary policy in Japan has been rendered impotent by the fact that nominal interest rates have been driven to zero, making expansionary monetary policy limited in its efficacy. We will analyze some of the problems faced by monetary policy makers in this type of "liquidity trap" or zero interest rate scenario.
- The third topic area is built around the topic of uncertainty: how to conduct monetary policy in an environment of major structural change in the economy, whereby the past may not have much guidance to offer about the future. One example is the recent boom in productivity in the United States driven by increased use of information technology. The Federal Reserve Bank of Kansas City held a symposium last year on this question, and I would like you to delve deeper into this question about whether (or how) monetary policy makers should change their behavior in a more uncertain environment.
- The fourth area focuses on a particular quirk of monetary policy that has gone unexplored until very recently: namely that monetary policymakers have to work with whatever data is available to them at the time they make their decisions, but those of us who judge their actions often do so with hindsight and with the benefit of revised data. By looking at monetary policy decisions with the appropriate data, we can determine whether the actions of the policymakers were in fact misguided or whether its just hindsight being 20/20.
- The fifth topic focuses on the use of exchange rates as anchors in monetary policy making - whether by using a currency board, a fixed exchange rate or by dollarization. Using the exchange rate as an anchor has been a common approach to monetary policy making in low-income countries but there are signs that some of these countries are breaking the shackles.
- Finally, I selected the topic of "open mouth operations", which refers to attempts by monetary policy makers to influence economic developments simply by making statements about what their policy actions are going to be. In other words, central banks influence the economy not just by changing interest rates but also by saying that they are going to change interest rates. Understanding how this works, to what extent it works, and the role played by credibility and reputation is also very important.

IV. LIABILITY WAIVER

- These, then, are the central issues covered in this course. You should only take the class if you are interested in learning more about these issues. If the basic questions don't interest you, or only mildly interest you then you should not take the course or else you are guaranteed to have an unhappy semester.

- In essence, if you find the goals uninteresting, then you are definitely likely to find the means to achieve those goals terribly uninteresting. I urge you to be 100% sure before committing to taking the class and being 100% committed once you do commit.
- There are 5 important questions that this class seeks to help answer. Throughout the quarter, everything we study is designed to directly or indirectly lead you along the path to answering these questions. At the end of the semester, we will reassess what we learned about these issues.
 1. Is monetary policy an important influence on the U.S. economy?
 2. How do monetary policy decisions get transmitted to the economy?
 3. Why is it important for a central bank to be independent and for a central banker to have good credibility?
 4. Should a central bank follow a strict rule for making monetary policy decisions or is it okay to allow the policy maker some discretion in determining the best course of action?
 5. What are the pressing challenges facing monetary policy makers in the leading economies of the world, and how should they meet those challenges?