



School of Business
Te Kura Pakihi

ECON 426 (18 points)

Monetary Economics

Semester 2, 2011

PAPER DESCRIPTION

This paper examines theoretical and empirical aspects of the role of money and other financial assets in the macroeconomy and the implications for monetary policy. The emphasis is on applied monetary modelling, involving an understanding of relevant theoretical models and empirical results from such models.

Prerequisites: ECON 375

Pre-or Co-Requisite: ECON 376

Lecture Times: Thursdays, 10 am- noon.

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Learning Aims and Objectives

This paper examines theoretical and empirical aspects of the role of money in the macro-economy and the implications for monetary policy. The emphasis is on applied monetary modelling, involving an understanding of relevant theoretical models and empirical results from such models. Recent empirical techniques will be covered. The paper is geared towards students who are interested in empirical applications and who plan to work in the government or finance sectors or plan to continue to write an Master's or Ph.D. thesis with an empirical focus.

Assessment

There will be a **test**, worth 25% of the assessment, during the regular lecture time. The exact date will be announced in class. There will also be one **assignment** with a weight of 15% towards the overall grade. The assignment must be handed in by the due date. The **final examination** will be worth 60%. ***Plussage will not be applied in the usual way.*** If the midterm test score is lower by one full letter grade (10%), or more, than the mark on the final examination, the midterm test will only count 10% (instead of 25%) towards the assessment and the final examination in this case will count 75%. If a student misses the midterm test for a valid and approved reason, the 25% weight will be transferred to the final examination. The test and final examination will **not** be “open book” examinations.

Workload

Note that this is an 18-point semester paper. Under the University’s points conventions, an 18-point paper corresponds approximately to an average workload of 12 hours per week (including contact hours), or roughly 180 hours in total over a 15-week period (including the end-of-semester exam period).

DISHONEST PRACTICE AND PLAGIARISM

STUDENTS SHOULD MAKE SURE THAT ALL SUBMITTED WORK IS THEIR OWN.

Plagiarism is a form of dishonest practice. Plagiarism is defined as copying or paraphrasing another’s work and presenting it as one’s own (University of Otago Calendar 2011 page 224). In practice this means plagiarism includes any attempt in any piece of submitted work (e.g. an assignment or test) to present as one’s own work the work of another (whether of another student or a published authority). Any student found responsible for plagiarism in any piece of work submitted for assessment shall be subject to the University’s dishonest practice regulations which may result in various penalties, including forfeiture of marks for the piece of work submitted, a zero grade for the paper, or in extreme cases exclusion from the University. The University of Otago reserves the right to use plagiarism detection tools.

Materials and Resources

The lectures will not follow specific textbooks. The material covered will be based on various journal articles and chapters in books as indicated below in the outline. More details on important readings or important sections of readings will be provided during the lectures. A class handout with an overview of each lecture will be provided at the beginning of the lecture.

Readings marked with “” indicate important papers that the lectures will focus on. Please note that we will not cover all theoretical models in the important readings.*

Readings marked with “+” provide an overview of the issues involved for a specific topic.

Unmarked readings are intended for further study.

Recommended Textbooks:

Romer, D., 2006, *Advanced Macroeconomics*, 3rd edition, McGraw-Hill.

Blanchard, O.J. and S. Fischer, 1989, *Lectures on Macroeconomics*, MIT Press.

Woodford, M, 2003, *Interest and Prices*, Princeton University Press.

Ljungqvist, L. and T.J. Sargent., 2004, *Recursive Macroeconomic Theory*, 2nd ed., MIT Press.

Enders, W., 2010, *Applied Econometric Time Series*, 3rd edition, John Wiley & Sons.

Hamilton, J.D., 1994, *Time Series Analysis*, Princeton University Press.

Paper Outline/Lecture Programme

I. Introduction

Mainstream schools of thought in macroeconomics and the major differences among them.

II. Monetary Policy, Rational Expectations, and the Lucas Critique: the 1970s Debate

- Money and the policy ineffectiveness proposition
- Money in models with rational expectations and sticky prices
- Consequences of the debate in the 1970s for modelling money

Suggested readings:

Lucas, R.E., 1976, "Econometric Policy Evaluation: A Critique," reprinted in K.D. Hoover, *New Classical Macroeconomics*, Elgar, 1992.

*Sargent, T.J. and Wallace, N., 1976, "Rational Expectations and the Theory of Economic Policy," *Journal of Monetary Economics* 2, 169-183.

*Fischer, S., 1977, "Long-Term Contracts, Rational Expectations, and the Optimal Money Supply Rule," *Journal of Political Economy* 85, 191-205.

+Romer (2006), Ch. 6

III. Microfoundations: Models of Money

- Problems with Baumol's model of transactions demand for money and related models
- Models with money as a store of value
- Models with cash-in-advance constraints
- Models with money in the utility function
- Recent search-theoretic models

Suggested readings:

+McCallum, B. T. and M. Goodfriend, 1987, “Demand for Money: Theoretical Studies”, in J. Eatwell, M. Milgate and P. Newman, eds., *The New Palgrave: A Dictionary of Economics*, Macmillan, 775-781. (only up to 1987!)

+Ljungqvist and Sargent (2004), Chs. 24, 25 and 26 (at an advanced level only!)

*Blanchard and Fischer (1989), Ch. 4

*Rupert, P., M. Schindler, S. Shevchenko and R. Wright, 2000, “The Search-Theoretic Approach to Monetary Economics: A Primer,” available at:

http://www.clevelandfed.org/Research/Review/2000/pcf36_4.pdf

*Berentsen, A., G. Menzies and R. Wright (2011), “Inflation and Unemployment in the Long Run,” *American Economic Review*, 101, 371-398.

IV. Some Recent Monetary Policy Issues

- Great Recession of 2007/08
- Controlling Monetary Aggregates
- Interest rate rules
- Commitment and Reputation

Suggested readings:

Ljungqvist and Sargent (2004), Ch. 24

+Woodford (2003), Ch. 1

*Keister, T and J. J. McAndrews, 2009, “Why Are Banks Holding So Many Excess Reserves?”, Federal Reserve Bank of New York *Current Issues* 15, 1-10, available at:

http://www.newyorkfed.org/research/current_issues/ci15-8.pdf

+ *Berg, C., P. Jansson and A. Vredin, 2006, “How Useful are Simple Rules for Monetary Policy? The Swedish Experience,” Sveriges Riksbank, Research Paper 12, available at:

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=922669

Woodford, M., 1998, “Doing Without Money: Controlling Inflation in a Post-Monetary World,” *Review of Economic Dynamics* 1, 172-219.

*McCallum, B.T., 2001, “Monetary Policy Analysis in Models Without Money,” available at:

<http://research.stlouisfed.org/publications/review/01/05/145-160McCallum.qxd.pdf>

*Nelson, E., 2003. “The Future of Monetary Aggregates in Monetary Analysis,” *Journal of Monetary Economics* 50, 1029-1059.

McCallum, B.T. and E. Nelson, 2004, “Targeting Versus Instrument Rules for Monetary Policy,” available at:

<http://research.stlouisfed.org/wp/2004/2004-011.pdf>

V. Empirical Studies: I(1), Cointegration, VECMs and Money Demand

- Econometric issues: I(1). Cointegration, VECMs and modelling issues
- Cointegration and stability of money demand functions

Suggested readings:

*Enders (2010), Ch. 6 (for the econometrics involved).

+*Colander, D., P. Howitt, A. Kirman, A. Leijonhufvud and P. Mehrling, 2008, “Beyond DSGE Models: Toward an Empirically Based Macroeconomics,” *American Economic Review: Papers & Proceedings* 98, 236–240.

*Hoover, K.D., S. Johansen and K. Juselius, 2008, “Allowing the Data to Speak Freely: The Macroeconometrics of the Cointegrated Vector Autoregression,” *American Economic Review: Papers & Proceedings* 98, 251–255.

*Ireland, P. N., 2004, “A Method for Taking Models to the Data,” *Journal of Economic Dynamics & Control* 28, 1205 – 1226.

Stock, J. H. and M.W. Watson, 1993, “A Simple Estimator of Cointegrating Vectors in Higher Order Integrated Systems,” *Econometrica* 61, 783-820.

Bordo, M.D., L. Jonung and P.L. Siklos, 1997, “Institutional Change and the Velocity of Money: A Century of Evidence,” *Economic Inquiry* 35, 710-724.

Ball, L., 2001, “Another Look at Long-Run Money Demand,” *Journal of Monetary Economics* 47, 31-44.

VI. Empirical Studies: Long-Run Neutrality of Money

- Econometric issues
- Testing long-run neutrality in reduced-form models

Suggested readings:

*Enders (2010), Ch. 4, parts of Ch. 5 (for the econometrics involved).

Fisher, M.E., and J.J. Seater, 1993, “Long-Run Neutrality and Superneutrality in an ARIMA Framework,” *American Economic Review* 83, 402-415.

*King, R.G., and M.W. Watson, 1997, “Testing Long-Run Neutrality,” available at: http://www.richmondfed.org/publications/economic_research/economic_quarterly/years.cfm/1997

+Bullard, J., 1999, “Testing Long-Run Monetary Neutrality Propositions: Lessons from the Recent Research,” available at: <http://research.stlouisfed.org/publications/review/99/11/9911jb.pdf>

VII. Empirical Studies: Structural VARs and Impulse Response Functions

- Econometric issues
- VARs, the structure, and impulse response functions

Suggested readings:

*Enders (2010), Ch. 5 (for the econometrics involved).

Hamilton (1995), Ch. 11 (for an advanced treatment of the econometrics involved).

*Christiano L. J., M. Eichenbaum and C. Evans, 1998, "The Effects of Monetary Policy Shocks: Evidence from the Flow of Funds," *Review of Economics and Statistics* 78, 16-34.

Peersman, G. and F. Smets, 2001, "The Monetary Transmission Mechanism in the Euro Area: More Evidence from VAR analysis," available at:
<http://www.ecb.int/pub/pdf/scpwps/ecbwp091.pdf>

*Haug, A. A., O. Karagedikli, and S. Ranchhod, 2005, "Monetary Policy Transmission Mechanisms and Currency Unions: A Vector Error-Correction Approach to a Trans-Tasman Currency Union." *Journal of Policy Modeling* 27, 55-74. Available at:
http://www.rbnz.govt.nz/research/discusspapers/dp03_04.pdf

Davig, T., and E.M. Leeper, 2009, "Monetary-Fiscal Policy Interactions and Fiscal Stimulus." Working Paper No. 15133, National Bureau of Economic Research. In press, *European Economic Review*.

*Perotti, R., 2007, "In Search of the Transmission Mechanism of Fiscal Policy." Working Paper No. 13143, National Bureau of Economic Research.

CLASS REPRESENTATIVES

The class representative system is an avenue for encouraging communication and consultation between staff and students involved in a particular paper or course of study at the University of Otago. It provides students with a vehicle for communicating their views on matters associated with the teaching and delivery of their paper or course of study. It provides staff with the opportunity to communicate information to and gain constructive feedback from students. It contributes to the development of a sense of community within a Department/School/Faculty and it adds a further dimension to the range of support services that the University of Otago offers its students. The School of Business fully supports the class representative system.

Volunteers to act as class representatives for this paper will be called early in the semester. The OUSA then invites all class representatives to a training session, conducted by OUSA, about what it means to be a class representative and some of the possible procedures for dealing with issues that arise. They also provide information on the services that OUSA offers and the role OUSA can play in solving problems that may occur. The OUSA also provides ongoing support to class representatives during the semester. School of Business staff will also meet during the semester with the class representatives for this paper to discuss general issues or matters they wish to have considered

DISCLAIMER

While every effort has been made to ensure that the information contained in this document is accurate, the information is subject to change. Changes will be notified in class and/or tutorials. Students are encouraged to check notice boards, etc for any changes. It is your responsibility to be informed.