This course shall build on the macroeconomic theory courses (Economics 309, 419, and 429) and the survey course in monetary theory and policy (Economics 346). Nevertheless, some students may not have taken Economics 346. Thus, Economics 346 is not a prerequisite for this course. The coverage focuses on a number of important topics in monetary theory and policy.

Course Grading Procedure:

We shall have a mid-term and final exam. In addition, you will be asked to write a paper and to do several homework assignments. Your grade will be an average of the exams, paper, and homework assignments.

Text:

The text for the course is *Monetary Theory and Policy* by Carl E. Walsh, MIT Press, 1998. The Co-op has ordered copies for your convenience.

Reference Books: (On reserve in the library)

2. Dornbusch, R., *Open Economy Macroeconomics*.

Course Outline and Bibliography:

I. Introduction and Basics

   A. Basic IS-LM-AS Model

   B. Basic Empirical Regularities

      1. Inflation, Money Growth, and Output Growth

   C. Government Budget Constraint Basics

      1. Linkage between Monetary and Fiscal Policy
         a. Closed Economy
         b. Open Economy
      2. Government Deficit and Inflation
         a. Seigniorage Revenue
         b. Monetary Policy Reaction Functions
D. Is Government Debt Wealth?

1. Government Bonds
2. Government Money

E. Relative Importance of Monetary and Fiscal Policy

1. Ando/Modigliani and Friedman/Meiselman Debate
2. St. Louis Equation
3. VAR Models

Readings:

1. Walsh, C., Chapter 1
II. Monetary Conundrum: Why Does the Private Sector Simultaneously Hold (Use) Government Bonds and Government Money?

A. What Is Money and Why Is It Held (Used)?

1. Functions of Money
   a. Medium of Exchange
   b. Store of Value
2. Legal Restrictions

A. Introduction of Money into a General Equilibrium Model

1. Tobin Model/Tobin Effect
2. Criticisms of Tobin Model
   a. Positive Correlation between Inflation and Output
   b. No Role for Money in Model
   c. No Micro Foundations for Money

A. Solutions to Criticisms of Tobin Model

1. Money in the Utility Function: Ad Hoc Solution
2. Transactions Approaches: Medium of Exchange Function
   a. Shopping Time
   b. Cash In Advance
   c. Search
1. Public Finance Approaches: Store of Value Function

E. Short-Run IS-LM-AS Model Again

1. Price and/or Inflation Stickiness

Readings:

1. Walsh, C., Chapters 2, 3, 4, and 5.
2. Simpson, T., Chapter 2.
III. Monetary Policy Implementation

A. Monetary Policy Implementation Basics

1. Instruments
2. Immediate and Intermediate Targets
3. Ultimate Objectives

B. Timing Problems

1. Inside and Outside Lag
   a. Policy Instability

C. Uncertainty Problems

1. Optimal Choice of Monetary Policy Instruments
   a. Closed Economy
   b. Open Economy

A. Rules Versus Discretion

1. Money Base Rules
2. Interest Rate Rules
3. Monetary Policy Reaction Functions Again

Readings:

1. Walsh, C., Chapters 9 and 10.
2. Simpson, T., Chapters 10, 11, 12, and 13.
12. McCallum, B., "Could a Monetary Base Rule Have Prevented the Great Depression?" JME, August 1990.

I. Credit Channel for Monetary Policy

A. Imperfect Information and Credit Markets

1. Adverse Selection
2. Moral Hazard
3. Monitoring Costs
4. Agency Costs

B. Credit Rationing and Macroeconomic Policy

Readings:

1. Walsh, C., Chapter 7.

I. Central Banking and Institutional Design

A. Discretionary Policy and Time Inconsistency

1. Inflationary Bias

A. Solutions to Inflationary Bias

1. Conservative Central Banker
2. Inflation (Money Growth) Targets
3. Performance Contracts

Readings:

1. Walsh, C., Chapter 8.

VI. Empirical Evidence on Money Demand

A. Long-Run and Short-Run Money Demand

B. Money Demand Instability

C. Money Demand as a Buffer Stock

Readings:

1. Laidler, D., Chapters 1-12.

VII. Special Topics in Monetary Theory

A. Financially Repressed Developing Countries

B. Inflation Uncertainty

C. Banks as Firms

Readings:

4. Fry, M., Money, Interest and Banking in Economic Development.

**List of Abbreviations:**

- **AER** -- American Economic Review
- **BPEA** -- Brookings Papers on Economic Activity
- **CRCS** -- Carnegie-Rochester Conference Series on Public Policy
- **Econ** -- Econometrica
- **EEJ** -- Eastern Economics Journal
- **EER** -- European Economic Review
- **EI** -- Economic Inquiry
- **EJ** -- Economic Journal
- **EL** -- Economics Letters
- **FRBB** -- Federal Reserve Bank of Boston
- **FRBC** -- Federal Reserve Bank of Cleveland
- **FRBK** -- Federal Reserve Bank of Kansas City
- **FRBM** -- Federal Reserve Bank of Minneapolis
- **FRBNY** -- Federal Reserve Bank of New York
- **FRBR** -- Federal Reserve Bank of Richmond
- **FRBSL** -- Federal Reserve Bank of St. Louis
- **FRBSF** -- Federal Reserve Bank of San Francisco
- **IBF** -- Journal of Banking and Finance
- **IEL** -- Journal of Economic Literature
- **IEP** -- Journal of Economic Perspectives
- **IET** -- Journal of Economic Theory
- **IFSR** -- Journal of Financial Services Research
- **IMACRO** -- Journal of Macroeconomics
- **JMCB** -- Journal of Money, Credit and Banking
- **IME** -- Journal of Monetary Economics
- **IPM** -- Journal of Policy Modeling
- **JPE** -- Journal of Political Economy
- **QJE** -- Quarterly Journal of Economics
- **QREF** -- Quarterly Review of Economics and Finance
- **SJE** -- Swedish Journal of Economics
- **SSQ** -- Social Science Quarterly
- **WEJ** -- Western Economic Journal