



**College of Commerce  
Division of Economic and Financial Studies  
Economics Department**

## **UNIT OUTLINE**

# **ECON842: PRINCIPLES OF MONETARY ECONOMICS**

**Second Semester, 2007**

**Lecturer: Dr Stephen Kirchner**

**Students in this unit should read this unit outline carefully at the start of semester. It contains important information about this unit. If anything in it is unclear, please consult one of the teaching staff in the unit.**

**TEACHING STAFF:** Dr Stephen Kirchner ([s.kirchner@optusnet.com.au](mailto:s.kirchner@optusnet.com.au)). I would like to thank the previous lecturer, Joshua Kirkwood, for permission to adapt his lecture notes.

## **CLASSES**

There will be one three hour lecture on Tuesday evenings commencing at 6.00pm in E5A 118.

## **UNIT WEB PAGE**

- The web page for this unit can be found at:  
<http://www.econ.mq.edu.au/courses/econ842/index.htm>
- Lecture notes will be available on this page weekly:  
[http://www.econ.mq.edu.au/courses/econ842/lecture\\_notes.htm](http://www.econ.mq.edu.au/courses/econ842/lecture_notes.htm)

## **TEXTBOOKS**

### **Readings will be assigned from:**

Lewis, M. K. and P. D. Mizen (2000) *Monetary Economics*, OUP: Oxford.

Handa, J. (2000) *Monetary Economics*, Routledge: London.

## **ASSESSMENT**

In-class presentation	10%
Essay (due 9 October)	30%
Final Examination	60%

## **In-Class Presentation**

Each student is required to give an in-class presentation of 10-15 minutes duration on a journal article of their choice selected from the course readings. Any of the articles with an (\*) is eligible. A schedule for presentations will be worked out with students at the beginning of the course.

The presentation should include a handout of no more than two pages summarising the presentation. Students are encouraged to use overhead slides/Powerpoint as part of their presentation.

The presentation should give a brief summary of the chosen article, highlighting its main points and findings. Students should then evaluate the paper as though they were preparing a referee's report for the editor of economics journal, highlighting the strengths and weaknesses of the paper and its contribution to the literature. (Hint: the author(s) may say something about the strengths and weakness of their paper and its contribution, so you may build on what the author has to say). Feel free to draw on your knowledge from other courses in discussing the article.

## Essay

**Due date:** The essay must be submitted with the attached coversheet *in class* on Tuesday 9 October 2007. Late submissions will be penalised five marks per day late, unless the University grants special consideration.

**Word limit:** 3000 words, not including references. Marks will be deducted for essays exceeding the word limit.

**Presentation:** The essay must be printed on one side of the paper only in 12 point and at least 1.5 spaced. You should attach the coversheet supplied and sign the plagiarism declaration. Keep a spare copy of the essay.

**Research strategy:** Key references are given below. You are encouraged to go beyond these and find relevant *published* literature using the EconLit or other databases. Do not reference the lecture notes - reference the original sources contained in the notes. **References to Wikipedia are not acceptable. Marks will be deducted for essays referencing Wikipedia.**

**Essay writing technique:** the essay should be properly structured, with an introduction, conclusion and section headings. References can be either footnotes, endnotes, or you may use the Harvard citation system. You should include a bibliography at the end of your paper listing all sources cited in the essay. **URLs are NOT acceptable as references or in the bibliography: cite the actual article, not the web address! Marks will be deducted for references containing only URLs.** You should use equations, diagrams and charts where appropriate: this can help you economise on the word limit. Use equation editor in MS Word to handle Greek letters, sub-/superscripts etc. Equations, charts and diagrams should be numbered for ease of reference.

### Essay topic and references:

#### **Interest Rate Rules and the Zero Bound on Nominal Interest Rates in a New Keynesian Model**

What role do interest rate rules play in the New Keynesian macroeconomic models favoured by monetary policymakers? Under what circumstances do these models become unstable, resulting in a deflationary spiral? What strategies might policymakers adopt to address the zero bound problem for nominal interest rates?

Benhabib, J., S. Schmitt-Grohe *et al* (2002) 'Avoiding Liquidity Traps,' *Journal of Political Economy*, 110(3): 535-563.

Bernanke, B., V. Reinhart and B. Sack (2004) 'Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment,' *Brookings Papers on Economic Activity*, 2: 1-100.

Brunner, K. and A. Meltzer (1988) 'Money and Credit in the Monetary Transmission Process,' *AEA Papers and Proceedings*, May: 214-219.

- Clarida, R., J. Gali and M. Gertler (1998) 'Monetary Policy in Practice: Some International Evidence,' *European Economic Review*, 42: 1033-1067.
- Clarida, R., J. Gali and M. Gertler (1999) 'The Science of Monetary Policy: A New Keynesian Perspective,' *Journal of Economic Literature*, 37, December: 1661-1707.
- Clouse, J., D. Henderson *et al* (2000) 'Monetary Policy When the Nominal Short-Term Interest Rate is Zero,' Discussion Paper, Board of Governors, Federal Reserve System: Washington, DC.
- Eggertsson, G. and M. Woodford (2003) 'The Zero Bound on Interest Rates and Optimal Monetary Policy,' *Brookings Papers on Economic Activity*, 1: 139-233.
- Fuhrer, J., and B. Madigan (1997) 'Monetary Policy When Interest Rates are Bounded at Zero,' *The Review of Economics and Statistics*, 79(4): 573-585.
- Goodfriend, M (2000) 'Overcoming the Zero Bound on Interest Rate Policy,' *Journal of Money, Credit and Banking*, 32(4): 1008-1035.
- Laidler, D. (1999) 'The Quantity of Money and Monetary Policy,' Bank of Canada Working Paper 99-5.
- Meltzer, A., (1995) 'Monetary, Credit and (Other) Transmission Processes: A Monetarist Perspective,' *Journal of Economic Perspectives*, 9(4): 49-72.
- \*Orphanides, A. (2003) 'Monetary Policy in Deflation: The Liquidity Trap in History and Practice.' Discussion Paper, Board of Governors, Federal Reserve System: Washington, DC.
- Reifschneider, D. and J. Williams (2000) 'Three Lessons for Monetary Policy in a Low Inflation Era,' *Journal of Money, Credit and Banking*, 32(4): 445-457.
- Summers, L. (1991) 'How Should Long-Term Monetary Policy be Conducted in an Era of Price Stability,' *Journal of Money, Credit and Banking*, 23(3): 625-631.
- Taylor, J. (1993) 'Discretion versus Policy Rules in Practice,' *Carnegie-Rochester Conference Series on Public Policy*, 39: 195-214.

## **Essay Cover Sheet (two pages)**

### **School of Economic and Financial Studies**

UNIT: ECON 842 Principles of Monetary Economics

ASSIGNMENT: Essay

DUE DATE: Tuesday 17 October 2006

LENGTH: 3,000 words

CONTRIBUTION TO FINAL  
ASSESSMENT: 30%

INSTRUCTION: Bring to class

STUDENT NAME: \_\_\_\_\_  
(Surname) (Other Names)

STUDENT NUMBER: \_\_\_\_\_

ESSAY TOPIC: \_\_\_\_\_

ESSAY GRADE: \_\_\_\_\_

MARKER'S COMMENTS:

**(Remember to attach and sign the plagiarism declaration)**

## **PLAGARISM**

The University defines plagiarism in its rules: ‘Plagiarism involves using the work of another person and presenting it as one’s own.’ Plagiarism is a serious breach of the University’s rules and carries significant penalties. You must read the University’s practices and procedures on plagiarism. These can be found in the *Handbook of Undergraduate Studies* or on the web at: <http://www.student.mq.edu.au/plagiarism/>

The policies and procedures explain what plagiarism is, how to avoid it, the procedures that will be taken in cases of suspected plagiarism, and the penalties if you are found guilty. Penalties may include a deduction of marks, failure in the unit, and/or referral to the University Discipline Committee.

## **UNIVERSITY POLICY ON GRADING**

The Academic Senate has a set of guidelines on the distribution of grades across the range from fail to high distinction. Your final result will include one of these grades plus a standardised numerical grade (SNG).

On occasion your raw mark for a unit (i.e. the total of your marks for each assessment item) may not be the same as the SNG which you receive. Under the senate guidelines, results may be scaled to ensure that there is a degree of comparability across the university, so that units with the same past performances of their students should receive similar results.

It is important that you realize that the policy does not require that a minimum of students be failed in any unit. In fact it does something like the opposite, in requiring examiners to explain their actions if more than 20% of students fail in a unit.

The process of scaling does not change the order of marks among students. A student who receives a higher raw mark than another will also receive a higher final scaled mark.

For an explanation of the policy see

<http://www.mq.edu.au/senate/MQUonly/Issues/Guidelines2003.doc> or

<http://www.mq.edu.au/senate/MQUonly/Issues/detailguidelines.doc>.

### **STATEMENT TO BE SIGNED BY STUDENT:**

1. I have read the definition of plagiarism that appears above.
2. In my essay I have carefully acknowledged the source of any material which is not my own work.
3. I am aware that the penalties for plagiarism can be very severe.

Name and student number: \_\_\_\_\_

Signature: \_\_\_\_\_

## **WEEK 1 AND WEEK 2: ROLE OF MONEY IN THE ECONOMY; CLASSICAL AND KEYNESIAN MONETARY THEORY.**

- Role of money in an economy
- Monetary standards
- The classical theory of money
- Patinkin's critique of the classical theory and the real balance effect
- The Arrow-Debreu model
- OLG model
- Money in the utility function
- Keynes' monetary economics

Lewis, M. K. and P. D. Mizen (2000), Chs. 1, 2, 3, 4, 5.

Handa, J. (2000), Chs. 1, 3, 14, 17.

Brunner, K. and A. Meltzer (1993) *Money and the Economy: Issues in Monetary Analysis*, Cambridge University Press: Cambridge. 'Second Lecture: The Monetary Mechanism: Markets for Assets.'

Humphrey, T. (1991) 'Nonneutrality of Money in Classical Monetary Thought,' Federal Reserve Bank of Richmond *Economic Review*, March: 3-15.

Hynes, J. (1974) 'On the Theory of the Real Balance Effect,' *Journal of Money, Credit and Banking*, 6(1): 65-83.

Thornton, D. (2000) 'Money in a Theory of Exchange,' Federal Reserve Bank of St Louis *Review*, 82(1): 35-60.



### **WEEK 3: RATIONAL EXPECTATIONS; RULES VERSUS DISCRETION IN MONETARY POLICY; POLICY DESIGN**

- The rational expectations hypothesis
- The policy ineffectiveness proposition
- Rules versus discretion

Lewis, M. K. and P. D. Mizen (2000), Ch. 9 and 10.

Handa, J. (2000), Chs. 12, 15, 16.

Barro, R. (1986) 'Recent Developments in the Theory of Rules versus Discretion,' *The Economic Journal*, 96, Supplement: 23-37.

Barro, R. and R. Gordon (1983) 'Rules, Discretion and Reputation in a Model of Monetary Policy,' *Journal of Monetary Economics*, 12 (July): 101-121.

Goodhart, C. (1994) 'Game Theory for Central Bankers: A Report to the Governor of the Bank of England,' *Journal of Economic Literature*, 32: 101-114.

Kydland and Prescott (1977), 'Rules Rather than Discretion: The Inconsistency of Optimal Plans,' *Journal of Political Economy*, 85 (June): 473-492.

Maddock, R. and M. Carter (1982) 'A Child's Guide to Rational Expectations,' *Journal of Economic Literature*, 20, March: 39-51.

\*Mishkin, Frederic S. (2007) 'Inflation Dynamics,' National Bureau of Economic Research Working Paper no. 13147, June.

Sargent, T. (1993) *Rational Expectations and Inflation*, Second Edition, Harper Collins: New York.

## WEEK 4: THE MONEY SUPPLY AND INTEREST RATE DETERMINATION IN AUSTRALIA

- Money supply in Australia
- Interest rate determination and central bank operating procedures
- Framework for Australian monetary policy
- Inflation targeting

Lewis, M. K. and P. D. Mizen (2000), Ch. 13, 14 and 16.

Handa, J. (2000), chs. 10, 11.

About Monetary Policy ([http://www.rba.gov.au/MonetaryPolicy/about\\_monetary\\_policy.html](http://www.rba.gov.au/MonetaryPolicy/about_monetary_policy.html))

Battellino, R., J. Broadbent and P. Lowe (1997) 'The Implementation of Monetary Policy in Australia,' RDP 9703, RBA: Sydney.

Bell, S. (2004) *Australia's Money Mandarins: The Reserve Bank and the Politics of Money*, CUP: Sydney.

\*de Brouwer, G. and J. Gilbert (2005) 'Monetary Policy Reaction Functions in Australia,' *Economic Record*, 81, June: 124-134.

Edey, M (1997) 'The Debate on Alternatives for Monetary Policy in Australia,' in P. Lowe (ed) *Monetary Policy and Inflation Targeting*, RBA: Sydney.

Grenville, S., (1997) 'The Evolution of Monetary Policy: From Money Targets to Inflation Targets,' in P. Lowe (ed) *Monetary Policy and Inflation Targeting*, RBA: Sydney.

Gruen, D., and G Stevens (2000) 'Australian Macroeconomic Performance and Policies in the 1990s,' in D. Gruen and S. Shestha (eds) *The Australian Economy in the 1990s*, RBA: Sydney.

Kirchner, S. (2004) 'The Mandarins of Martin Place,' *Policy*, 20(3): 53-56.  
(<http://www.cis.org.au/policy/spring04/spring04-9.pdf>)

\*Levin, Andrew, Fabio Natalucci, and Jeremy Piger (2004) 'The Macroeconomic Effects of Inflation Targeting,' *Federal Reserve Bank of St. Louis Review*, 86, July: 51-80.

Macfarlane, I. (2006) *The Search for Stability*, ABC Books: Sydney.

Poso, M. and L. Stracca (2004) 'What is the Role of the Monetary Base in Monetary Policy Today?' *Kredit und Kapital*, 37(2): 169-201.

## WEEK 5: INTEREST RATE RULES IN NEW KEYNESIAN MODELS AND THE ZERO BOUND PROBLEM

- Taylor-type interest rate rules
- New Keynesian macroeconomic models
- Model stability and the zero bound problem
- Solutions to the zero bound problem

Benhabib, J., S. Schmitt-Grohe *et al* (2002) 'Avoiding Liquidity Traps,' *Journal of Political Economy*, 110(3): 535-563.

\*Bernanke, B., V. Reinhart and B. Sack (2004) 'Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment,' *Brookings Papers on Economic Activity*, 2: 1-100.

Brunner, K. and A. Meltzer (1988) 'Money and Credit in the Monetary Transmission Process,' *AEA Papers and Proceedings*, May: 214-219.

\*Clarida, R., J. Gali and M. Gertler (1998) 'Monetary Policy in Practice: Some International Evidence,' *European Economic Review*, 42: 1033-1067.

Clarida, R., J. Gali and M. Gertler (1999) 'The Science of Monetary Policy: A New Keynesian Perspective,' *Journal of Economic Literature*, 37, December: 1661-1707.

\*Clarida, R., J. Gali and M. Gertler (2000) 'Monetary Policy Rules and Macroeconomic Stability: Evidence and Some Theory,' *Journal of Economic Literature*, 37, December: 1661-1707.

Clouse, J., D. Henderson *et al* (2000) 'Monetary Policy When the Nominal Short-Term Interest Rate is Zero,' Discussion Paper, Board of Governors, Federal Reserve System: Washington, DC.

Eggertsson, G. and M. Woodford (2003) 'The Zero Bound Interest Rates and Optimal Monetary Policy,' *Brookings Papers on Economic Activity*, 1: 139-233.

Fuhrer, J., and B. Madigan (1997) 'Monetary Policy When Interest Rates are Bounded at Zero,' *The Review of Economics and Statistics*, 79(4): 573-585.

Laidler, D. (1999) 'The Quantity of Money and Monetary Policy,' Bank of Canada Working Paper 99-5.

Meltzer, A., (1995) 'Monetary, Credit and (Other) Transmission Processes: A Monetarist Perspective,' *Journal of Economic Perspectives*, 9(4): 49-72.

Orphanides, A. (2003) 'Monetary Policy in Deflation: The Liquidity Trap in History and Practice.' Discussion Paper, Board of Governors, Federal Reserve System: Washington, DC.

Reifschneider, D. and J. Williams (2000) 'Three Lessons for Monetary Policy in a Low Inflation Era,' *Journal of Money, Credit and Banking*, 32(4): 445-457.

Summers, L. (1991) 'How Should Long-Term Monetary Policy be Conducted in an Era of Price Stability,' *Journal of Money, Credit and Banking*, 23(3): 625-631.

Taylor, J. (1993) 'Discretion versus Policy Rules in Practice,' *Carnegie-Rochester Conference Series on Public Policy*, 39: 195-214.

## WEEK 6 AND WEEK 7: THE DEMAND FOR MONEY

- The Classical quantity theory
- The Cambridge equation
- Baumol's inventory-theoretic approach
- Keynes' liquidity preference theory
- Tobin's risk aversion theory of liquidity preference
- Friedman's modern quantity theory of money
- Buffer stock money
- Identification problems
- Stock adjustment and distributed lag models

Lewis, M. K. and P. D. Mizen (2000), Ch. 5, 6, 7, 11.

Handa, J. (2000), Chs, 2, 4, 5, 6, 7, 9.

Baumol, W.J. (1982) 'The Transactions Demand for Cash: An Inventory- Theoretical Approach,' *Western Journal of Economics*, 66, November: 545-556.

Belongia, M.T. and J.A. Chalfant (1989) 'The Changing Empirical Definition of Money: Some Estimates from a Model of the Demand for Money Substitutes,' *Journal of Political Economy*, 97, April: 387-97.

\*Bernanke, B.S. and A.S. Blinder (1988) 'Credit, Money and Aggregate Demand,' *American Economic Review*, 78, May: 435-439.

\*de Brouwer, G., I. Ng and R. Subbaraman (1993) 'The Demand for Money in Australia: New Tests on an Old Topic,' RDP 9314, RBA: Sydney.

Dickey, D.A., D.W. Jansen and D.L. Thornton, 'A Primer On Cointegration with an Application to Money and Income,' *FRB of St Louis Review*, 73 (Mar/Apr 1991), 58- 78.

Friedman, M. (1958) 'The Quantity Theory of Money: a Restatement' in *Studies in the Quantity Theory of Money*, Chicago University Press: Chicago.

McCallum, B. T. and M. Goodfriend (1987) 'Demand for Money: Theoretical Studies,' in *The New Palgrave* (1987).

Miller, M.H. and D. Orr (1966) 'A Model of the Demand for Money by Firms,' *Quarterly Journal of Economics*, 80: 413-35.

Tobin, J. (1958) 'Liquidity Preference as Behaviour Towards Risk,' *Review of Economic Studies*, 25: 65-86.

## WEEK 8: THEORY OF INTEREST RATES

- The Classical theory
- The loanable funds (LF) theory
- Keynes' liquidity preference (LP) theory
- The Fisher effect
- Empirical tests of the Fisher effect

Handa, J. (2000), Ch. 20.

Lewis, M.K. and P.D. Mizen (2000), Ch. 5.

\*Breedon, F., B. Henry and G. Williams (1999), 'Long-Term Real Interest Rates: Evidence on the Global Capital Market,' *Oxford Review of Economic Policy*, 15(2), Summer: 128-42

\*Mehra, Y. (1996) 'Monetary Policy and Long-Term Interest Rates,' FRB Richmond *Economic Quarterly*, Summer.

\*Mehra, Y. (1998) 'The Bond Rate and Actual Future Inflation,' FRB Richmond *Economic Quarterly*, Spring: 27-47.

\*Mishkin, F. and J. Simon (1994) 'An Empirical Examination of the Fisher Effect in Australia,' RDP 9410, RBA: Sydney.

## WEEK 9: THE TERM STRUCTURE OF INTEREST RATES

- The expectations theory
- The liquidity preference theory
- The market-segmentation theory
- Rational expectations and the term structure
- US and Australian studies

Lewis, M.K. and P. D. Mizen (2000), Ch. 5.

Handa, J. (2000), ch. 21.

\*Arturo, E. and M. Trubin (2006) 'The Yield Curve as a Leading Indicator: Some Practical Issues, 12(5), July/August: 1-7.

\*Alles, L. (1995) 'The Australian Term Structure as a Predictor of Real Economic Activity,' *The Australian Economic Review*, 4th Quarter: 71-85.

Bolder, D. and D. Streliski (1999) 'Yield Curve Modelling at the Bank of Canada,' Technical Report No. 84, Bank of Canada.

\*Ellingsen, T. and U. Soderstrom (2001) 'Monetary Policy and Market Interest Rates,' *The American Economic Review*, 91(5): 1594-1607

\*Lowe, P. (1992) 'The Term Structure of Interest Rates, Real Activity and Inflation,' RDP9204, RBA: Sydney.

\*Tease, W.J. (1988) 'The Expectations Theory of the Term Structure of Interest Rates in Australia,' *Economic Record*, 64: 120-127.

## WEEK 10: RICARDIAN EQUIVALENCE

- Government budget constraint
- Ricardian Equivalence Theorem
- Australian and international evidence

Handa, J. (2000), p. 363.

Barro, R.J (1974) 'Are Government Bonds Net Wealth?' *Journal of Political Economy*, 82 (Nov/Dec 1974), 1095-1117.

Barro, R.J. (1989) 'The Ricardian Approach to Budget Deficits,' *Journal of Economic Perspectives*, 3, Spring: 37-54.

Barro, R. J. (1989) 'The Neoclassical Approach to Fiscal Policy,' in R. Barro (ed) *Modern Business Cycle Theory*, Harvard University Press: Cambridge.

\*Comley, B. et al (2002) 'The Effectiveness of Fiscal Policy in Australia,' *Economic Roundup*, Australian Treasury, Winter: 45-72.

Elmendorf, D. and G. Mankiw (1999) 'Government Debt,' in John Taylor and Michael Woodford (eds) *Handbook of Macroeconomics*, Elsevier Science: Amsterdam.

\*Engen, E. and R Glenn Hubbard (2004) *Federal Government Debt and Interest Rates*, AEI Working Paper #105, AEI: Washington, DC.

\*Laubach, T. (2003) *New Evidence on the Interest Rate Effects of Budget Deficits and Debt*, Finance and Economics Discussion Series, Federal Reserve Board: Washington, DC.



## WEEK 11: MARKET-DETERMINED MONETARY SYSTEMS

- Critique of central banking
- Historical episodes of free banking
- Commodity and non-commodity private money
- Competitive payments systems without base money
- Black-Fama-Hall system, new monetary economics, legal restrictions theories

Cowen, T. and R. Kroszner (1987) 'The Development of the New Monetary Economics,' *Journal of Political Economy*, 95(3): 567-90.

Dowd, K. (1993) *Laissez-Faire Banking*, Routledge: New York. Ch. 7 'Free Baking in Australia.'

\*Greenfield, R. and L. Yeager (1983) 'A Laissez-Faire Approach to Monetary Stability,' *Journal of Money, Credit and Banking*, 15: 302-315.

Hayek, F. A. (1976) *Choice in Currency: A Way to Stop Inflation*, IEA: London.  
(<http://www.iea.org.uk/files/upld-book409pdf?.pdf>)

McCallum, B. (2004) 'Monetary Policy in Economies with Little or No Money,' *Pacific Economic Review*, 9(2): 81-92.

Selgin, G. (1988) *The Theory of Free Banking: Money Supply under Competitive Note Issue*, Rowman & Littlefield: Totowa, NJ.

Selgin, G. and L. White (1994) 'How Would the Invisible Hand Handle Money?' *Journal of Economic Literature*, XXXII, December: 1718-1749.

White, L. (1989) *Competition and Currency: Essays on Free Banking and Money*, New York University Press: New York. Ch. 13 'Accounting for Non-Interest Bearing Currency: A Critique of the Legal Restrictions Theory of Money.'