School of Economic and Financial Studies

UNIT OUTLINE

MASTER OF ECONOMICS BY COURSEWORK

ECON842  PRINCIPLES OF MONETARY ECONOMICS

Semester 2, 2003

I. Course Requirements

II. Assessment

III. Topics Outline

IV. General References

V. References

VI. Essay topics and references

Dr P C Ip
Senior Lecturer in Economics
I. COURSE REQUIREMENTS

Students should attend all lectures and submit an essay on one of the topics listed at the end of this Study Guide or on a topic approved by the Lecturer-in-Charge. Besides a three-hour final examination, there is a written assignment which is to be submitted in the last lecture. The essay is due on **14 October, 2003**.

II. ASSESSMENT

<table>
<thead>
<tr>
<th>Component</th>
<th>Percentage</th>
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<tr>
<td>Essay</td>
<td>30%</td>
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<tr>
<td>Assignment</td>
<td>10%</td>
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<tr>
<td>Final Examination</td>
<td>60%</td>
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<td><strong>Total</strong></td>
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III. TOPICS OUTLINE

I. Role of Money in the Economy

II. Rational Expectations and Monetary Theory

III. Money Supply Process

IV. Optimum Money Supply

V. Demand for Money

VI. Financial Model Building

VII. Theory of Interest Rates

VIII. Term Structure of Interest Rates

IX. Ricardian Equivalence

X. Credit Rationing
IV. TEXTBOOKS AND GENERAL REFERENCES

Textbook:


Reference Books:


Useful websites:

www.rba.gov.au
www.abs.gov.au

www.bankofcanada.ca
www.bankofengland.co.uk

www.stls.frb.org
www.ny.frb.org

www.kc.frb.org
www.boj.or.jp
V. REFERENCES

I. FUNDAMENTALS OF MONETARY THEORY: ROLE OF MONEY IN THE ECONOMY

A barter exchange economy
A monetary economy à la Patinkin
Transaction costs and a monetary economy
The Walrasian general equilibrium system
Say’s Law
The Classical dichotomy
Patinkin’s arguments for the invalidity of the Classical dichotomy


Duffie, D. “Money in General Equilibrium Theory,” in Friedman and Hahn (1990), 82-100.

Hahn, F.H., "Liquidity", in Friedman and Hahn (1990), 64-80.


II. RATIONAL EXPECTATIONS AND MONETARY THEORY

The rational expectations hypothesis
Learning
Critique


McCallum (1989) Chaps. 8, 9, 10.


Scarff, W. M. (1996), Chapters 5, 6

III. THE MONEY SUPPLY PROCESS

The monetary base in Australia
Money multiplier analysis
Australia's institutional features
Money supply control
Stability of the money multiplier
Seasonal liquidity pattern in Australia

*Brunner, K. "Money Supply", in Friedman and Hahn (1990), 357-398.


IV. **THE OPTIMUM SUPPLY OF MONEY**

The optimum quantity of money
Theoretical problems
Empirical problems
Seigniorage


Freeman, S. "Resolving Differences over the Optimal Quantity of Money," *Journal of Money, Credit and Banking*, 25 (Nov 1993), 801-11.

*Friedman, M. "The Optimum Quantity of Money", in Friedman (1969).


Stein, J.L., "The Optimal Quantity of Money", *Journal of Money, Credit and Banking*, II, 4 (November 1970), 397-419.


Woodford, M. "The Optimum Quantity of Money," in Friedman and Hahn (1990),
V. 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
Stability analysis


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


VI. FINANCIAL MODEL BUILDING

Pitfalls in financial model building
Adding up constraints
Dynamics of adjustment
Tobin's "A General Equilibrium Approach to Monetary Theory"
Tobin's Nobel Lecture
Critique of Tobin


Matthews, K. "Modelling the Monetary Sector," in Green and Llewellyn (1991), Vol 1, Ch. 6, 324-78.


VII. THEORY OF INTEREST RATES

The Classical theory
The loanable funds (LF) theory
Keynes' liquidity preference (LP) theory
Conflict between LF and LP theories
Tsiang's resolution of the conflict
The Fisher effect
Invariance of interest rate to monetary policy
Inflation and real interest - Mundell
Empirical test of the Fisher effect
The Gibson Paradox
The Darby hypothesis
The inverted Fisher hypothesis


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


VIII. THE TERM STRUCTURE OF INTEREST RATES

The mathematics of bond prices
The expectations theory
The liquidity preference theory
The market-segmentation theory
Operation "Twist"
Meiselman's error-learning model
The term-premium hypothesis
The preferred market habitat hypothesis
Rational expectations and the term structure

Australian studies


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


Modigliani, F. and Sutch, R., "The Term Structure of Interest Rates: A Re-examination of the Evidence", *Journal of Money, Credit and Banking*, 1 (February 1969), 112-120.


IX. RICARDIAN EQUVALENCE

Government budget constraint
Ricardian Equivalence Theorem
Liquidity contraints
Critique


Scarth, W. M. (1996), Ch.7.

X. CREDIT RATIONING

Definitions of credit rationing
Adverse selection effects
Adverse incentive effects
Enforcement problems
Collateral, loan size and non-price rationing
Efficiency and welfare


*Handa, J. (2000), Ch. 2.


Jaffee, D. and J. Stiglitz, "Credit Rationing", in Friedman and Hahn (1990), 837-887.


VI. ESSAY TOPICS AND REFERENCES

Research strategy – some of the starter references are given below. You are expected to go beyond these and find more recent publications. An excellent source is recent issues of *Journal of Economic Literature*.

Essay writing technique – the essay should be properly structured. Presentation is important. The essay should contain a synopsis and be divided into sections with appropriate headings. It should start with an introduction and end with a conclusion. Footnotes or endnotes, where appropriate, should be added. References must be done consistently and listed alphabetically by author at the end of the essay.

The essay must be typed on one side of the paper and double spaced. You need to keep a spare copy of the essay just in case the one that you claim that you have submitted is misplaced. You should check with the lecturer after the due date to make sure that your essay has been received.

1. Dollarisation

Some Latin American countries have abandoned their own national currencies and adopted the U.S. dollar as legal tender. Analyse the theoretical issues and policy implications of such a move. Is the role of money served better when a small country adopts the currency of a large country like the United States or the currency of a large currency bloc like the European Monetary Union (EMU)? Should Australia and New Zealand form a common currency area, adopt the U.S. dollar or the euro, or maintain the status quo?

Starter References


2. Currency Substitution

Analyse the impact on the demand for money when currency substitution (CS) is practised. Is there any empirical evidence in support of CS? Australians have been able to hold foreign currency accounts after the financial system was deregulated in the 1980s. Is CS a problem for the Reserve Bank of Australia, the Reserve Bank of New Zealand and the Bank of England, when they conduct their monetary policy?

Starter references


Further references may be found by looking up recent issues of Journal of Economic Literature and by conducting a catalogue search using Macquarie University Library website.
Macquarie University
School of Economic and Financial Studies

UNIT: ECON 842 Principles of Monetary Economics

ASSIGNMENT: Essay

DUE DATE: Tuesday 14 October 2003

LENGTH: 3,000 - 3,500 words

CONTRIBUTION TO FINAL ASSESSMENT: 30%

INSTRUCTION: Submit to ERIC

STUDENT NAME: ____________________________
(Surname) (Other Names)

STUDENT NUMBER:

ESSAY TOPIC NUMBER:

TITLE OF ESSAY:

ESSAY GRADE:

MARKER’S COMMENTS:
DEFINITION OF PLAGIARISM

Plagiarism involves using the work of another person and presenting it as one’s own. Any of the following acts constitutes plagiarism unless the source of each quotation or piece of borrowed material is clearly acknowledged:

(a) copying out part(s) of any document of audio-visual material (including computer-based material);
(b) using or extracting another person’s concepts, experimental results, or conclusions;
(c) summarising another person’s work;
(d) in an assignment where there was collaborative preparatory work, submitting substantially the same final version of any material as another student.

Encouraging or assisting another person to commit plagiarism is a form of improper collusion and may attract the same penalties.

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: ___________________________________________

Signature: _________________________________________

Student Number: _______________________________________

THIS PAGE MUST BE COMPLETED AND ATTACHED TO THE ESSAY