MACQUARIE UNIVERSITY
School of Economic and Financial Studies

UNIT OUTLINE

ECON844: MONETARY AND FINANCIAL POLICIES

SEMESTER 2, 2003

I Course requirements
II Assessment
III Lecture topics
IV Lecture guide and references
V Essay topics and references

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

Students should attend all lectures and are required to submit an essay of approximately 3,000 words on one of the topics listed at the end of this Study Guide or on a topic approved by the Lecturer-in-Charge. There is a three-hour final examination. The essay is due on 15 October, 2003.

In writing the essay, students are judged on the understanding of the theory and empirical works, clarity of exposition, originality in approach and effort put into the research. The essay should be properly structured and divided into sections with appropriate headings. It should include a synopsis, footnotes and references. Students are warned to guard against PLAGIARISM. All quotations and ideas must be properly acknowledged. Students should keep photocopies of their essays.

II. ASSESSMENT

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<tr>
<th>Component</th>
<th>Percentage</th>
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<tr>
<td>Essay</td>
<td>30%</td>
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<td>Assignment</td>
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<td>Final Examination</td>
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III. LECTURE TOPICS

1. Definition of Money
2. Monetary Targets and Instruments
3. Monetary Policy Indicator Problem
4. Monetary Policy Under Uncertainty
5. Monetary Policy Reaction Functions
6. Rational Expectations and Monetary Policy
7. Control of Monetary Aggregates
8. Monetary Rules Versus Discretion
9. Interest Rate targeting
10. Exchange Rate Targeting
11. Nominal Income Targeting
12. Inflation Targeting
IV. LECTURE GUIDE AND REFERENCES

Textbook:


Useful Reference Books


Useful websites:

www.rba.gov.au
www.abs.gov.au
www.bankofcanada.ca
www.bankofengland.co.uk
www.boj.or.jp
www.stls.frb.org
www.ny.frb.org
www.kc.frb.org
1. **The Definition of Money**

Functions of money  
Money and near-moneys  
Problems of defining money  
Empirical approaches  
Divisia monetary aggregates


2. Monetary Targets and Instruments

IS-LM-BP, AD-AS
Instruments and targets
Pros and cons of monetary targeting
Choice of intermediate targets
Controllability of money supply
Control of base money
Credit aggregates


Friedman, B.M. "Targets and Instruments of Monetary Policy", in B.M. Friedman and F.H. Hahn (1990), 1185-1230.


Wells, G. (1995), Ch. 3.
3. The Monetary Policy Indicator Problem

The transmission mechanism
Lags in monetary policy
Indicators and intermediate targets
Term structure as an indicator


4. Monetary Policy Under Uncertainty

Tinbergen's approach
Theil's approach
Theil's certainty equivalence theorem
Quadratic preference functions
One target, one instrument case
Poole’s analysis


*Handa, J. (2000), Ch. 15.


Wells, G. (1995), Ch. 3.
5. Monetary Policy Reaction Functions

Theil's reaction function
a. No uncertainty
b. With uncertainty
Simultaneous equations bias
Structural model vs reduced form model
Problems using econometric models


6. **Rational Expectations and Monetary Policy**

Rational expectations
Lucas aggregate supply function
Policy ineffectiveness debate
Econometric policy evaluation
New Classical Economics


Kantor, B. "Rational Expectations and Economic Thought", *Journal of Economic Literature*, (December 1979), 1422-1441.


7. **Control of Monetary Aggregates**

- Open market operations
- Discount windows
- Techniques of monetary control
- Reserve requirements
- Monetary base control
- Instrument instability


*Handa, J. (2000), Ch. 10.


8. Monetary Rules Versus Discretion

Proponents of monetary rule
Opponents of monetary rule
Statistical tests of various monetary rules
Optimal feedback rules
Rational expectations and monetary policy
Time inconsistency


*Handa, J. (2000), Ch. 16.


Sayers, R.S. Central Banking After Bagehot, 1957.


9. **Interest Rate Targeting**

- Interest rate targets
- Implementation
- Interest rate smoothing


10. **Exchange Rate Targeting**

Target zones for exchange rates  
Speculation  
Monetary Conditions Index  
Critique


11. **Nominal Income Targeting**

Pros and cons  
Implementation  
Evaluation  


12. **Inflation Targeting**

Rationale and general issues  
Design issues  
Operational issues  
Central bank independence  
Country experiences


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

V. 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.

Topic 1 Transparency and Monetary Policy

One of the propositions demonstrated by New Classical Economics (NCE) is that systematic policy has no impact on the real economy. Only unanticipated policy will influence economic activity. Proponents of inflation targeting (IT), however, claim that IT makes monetary policy more transparent and accountable and produce superior economic performance. Can the two points of view be reconciled? Critically evaluate the merits of central bank transparency, accountability, independence and credibility. Should monetary policy in Australia be more or less transparent?

Starter reference:


Topic 2 Neutrality of Money

"… in the long run, the central bank has influence over only nominal magnitudes. As a result, the Federal Reserve can be quite explicit about its ultimate objectives - price stability and the maximum sustainable growth in output that is fostered when prices are stable." (Greenspan, 2002, p.6)

Critically evaluate the above comment by the Chairman of the Federal Reserve, Alan Greenspan. Is money neutral in the long run? Distinguish between "neutrality" and "super-neutrality". If monetary policy can affect output and employment, commodity prices, interest rates and exchange rates in the short run (say, one to two years), why can’t it affect economic activity in the long run (say, 10 to 15 years) when the long run is nothing but an aggregation of the short run?

Starter references:


**Topic 3. Pre-emptive Strikes**

The Coalition of the Willing invaded Iraq in March 2003. The avowed aim was to take pre-emptive strikes against the Saddam regime which was reported to possess weapons of mass destruction (WMD).

Should the Reserve Bank of Australia tackle perceived inflationary threats in the future by taking pre-emptive strikes? Is the military analogy appropriate when a central bank formulates its monetary policy? Analyse the case for and against taking pre-emptive strikes to achieve the goals of price stability and sustainable economic growth.

Examine the record of "pre-emptive strikes" adopted by the Reserve Bank of Australia.

**Starter references:**


Brash, D. T. "Reserve Bank Forecasting: Should We Feel Guilty?" in www.rbnz.govt.nz/speeches/sp981021.htm


Sephton, P. "Forecasting recessions: Can We do Better on MARS?" FRB of st Louis Review, 83 (2) (Mar/Apr 2001), 39-49.


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.
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