College of Commerce
Division of Economic and Financial Studies
Economics Department

UNIT OUTLINE

ECON842: PRINCIPLES OF MONETARY ECONOMICS

Second Semester, 2006

Lecturer: Joshua Kirkwood
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:** Joshua Kirkwood (kirkwoodj@rba.gov.au)

**CLASSES:**

There will be one 3 hour lecture on Tuesday evenings commencing at 6.15pm 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](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)

**ASSESSMENT**

<table>
<thead>
<tr>
<th>Essay (due 17 October)</th>
<th>30%</th>
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<td>Final Examination</td>
<td>70%</td>
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**TOPICS OUTLINE**

1. Role of Money in the Economy
2. Rational Expectations and Monetary Theory
3. Money Supply Process
4. Optimum Money Supply
5. Demand for Money
6. Financial Model Building
7. Theory of Interest Rates
8. Term Structure of Interest Rates
9. Ricardian Equivalence
10. Credit Rationing
TEXTBOOKS AND GENERAL REFERENCES

Textbook:


Reference Books:


* = recommended reading
1. 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.


2. RATIONAL EXPECTATIONS AND MONETARY THEORY

- The rational expectations hypothesis
- Learning
- Critique


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


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

3. 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.


4. 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),
5. **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.


6. 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.


7. 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.


8. 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.


9. RICARDIAN EQUIVALENCE

- Government budget constraint
- Ricardian Equivalence Theorem
- Liquidity constraints
- Critique


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

10. 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.


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.
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/plagarism/

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


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 sever.

Name and student number: ____________________________________________

Signature: ____________________________________________