

Semester 2013/2014

Monetary Policy under Uncertainty

Alfred V Guender

*Master Economics: "Geldtheorie (Monary Econmics)"*

*Master Public Economics: "Ausgewählte Themen der Makroökonomie (Selected Topics of Macroeconomics)"*

**Lectures:** On Blackboard!

**Office Hours:** By appointment!

**Course Content:**

The focus of this course is on the conduct of optimal monetary policy in open and closed economies. Various issues in monetary policy under uncertainty are explored. A great deal of attention is devoted to analyzing the differences in policy-making under rules as versus discretion. We address topics as diverse as nominal income targeting vs. price level / inflation targeting, instrument versus target rules, the delegation issue, policy implications of transmission lags, etc. Policymaking during the Global Financial Crisis is considered as well.

**This course aims at**

- showing how thought on monetary policy has evolved over the past 40 years
- demonstrating the advantages and disadvantage of various monetary policy strategies
- highlighting the difference between the conduct of monetary policy in open as opposed to closed economies
- helping the student appreciate the difficulties central banks face in framing monetary policy under uncertainty.

The student's understanding of the course material will be examined in a compulsory final exam.

**Assessment:** Final Examination: 100%

**Text:** Froyen and Guender (F&G), *Optimal Monetary Policy under Uncertainty*, Edwin Elgar, Cheltenham, UK, 2008 (paperback). Available from online booksellers (Amazon.com, etc. \$59).

This book analyzes current issues in monetary policy. There should be copies of the book on reserve in the library.

**Other Texts:**

Gali, J., *Monetary Policy, Inflation, and the Business Cycle*, Princeton, 2008.

Walsh, C., *Monetary Theory and Policy*, MIT, 2<sup>nd</sup> edition 2003, 3<sup>rd</sup> edition 2010.

Woodford, M., *Interest and Prices*, Princeton, 2003.

**Abbreviations:**

*	required reading
AER	American Economic Review
EJ	Economic Journal
IF	International Finance
JEL	Journal of Economic Literature
JIE	Journal of International Economics
JMCB	Journal of Money, Credit, and Banking
JME	Journal of Monetary Economics
JIMF	Journal of International Money and Finance
JPE	Journal of Political Economy
JMACRO	Journal of Macroeconomics
QJE	Quarterly Journal of Economics

I. The Recent Financial Crisis:

A. OVERVIEW (own notes).

B. The Mandate of Central Banks.

\*Alan Blinder, "How Central Should Central Banks Be?" *JEL* (March 2010).

Martin Feldstein, "What Powers for the Federal Reserve?" *JEL* (March 2010).

Olivier Blanchard O, G. Dell'Ariccia and P. Mauro, "Rethinking Macroeconomic Policy," *JMCB* (September 2010).

II. The Strategy of Monetary Policy

OVERVIEW:

\*Benjamin M. Friedman, "Targets and Instruments of Monetary Policy," in Friedman & Hahn, *Handbook on Monetary Economics*, Vol. II.

A. Monetary Policy in a Stochastic Closed Economy Setting: Additive Uncertainty.

William Poole, "Optimal Choice of Monetary Policy Instruments in a Simple Macro Model," *QJE* (1970).

\*F&G, Chapter 2.

B. Monetary Policy under Multiplicative Uncertainty.

William Brainard, "Uncertainty and the Effectiveness of Policy," *AER* (1967).

John C. Williams, "A Defense of Moderation in Monetary Policy," Working Paper 2013-15: <http://www.frbsf.org/publications/economics/papers/2013/wp2013-15.pdf>

\*F&G Chapter 2.

III. Recent Monetary Policy Issues: The Debate on Rules vs. Discretion

A. The Time Inconsistency Problem and Strategic Consideration in Monetary Policy: a Simple Model.

\*Robert Barro & David Gordon, Rules, "Discretion and Reputation in a Model of Monetary Policy," *JME* (July 1983).

B. Revisiting the Time Inconsistency Problem in a Modified Model: A Discussion of Possible Solutions.

\*F&G, Chapter 6.

C. Consideration of Monetary Policy Rules in Closed and Open Economies: the Standard AS-AD Framework.

Jeffrey Frankel & Menzie Chinn, "The Stabilizing Properties of a Nominal GDP Rule," *JMCB* (May 1995).

\*Richard Froyen & Alfred Guender, "Alternative Monetary Policy Rules for Small Open Economies," *Review of International Economics* (November 2000).

IV. Optimal Monetary Policy in Closed and Open Economies: the New Literature

A. Choosing a New Framework for Monetary Analysis: The Forward-Looking Model.

McCallum, B., and Edward Nelson, "An Optimizing IS-LM Specification for Monetary Policy and Business Cycle Analysis," *JMCB* (August 1999).

R. Clarida, J. Gali, and M. Gertler, "The Science of Monetary Policy: A New Keynesian Perspective," *JEL* (December 1999).

\*F&G, Chapter 7.

B. The Phillips Curve: Recent Incarnations (Light Coverage).

- a. Calvo Framework
- b. Quadratic Price Adjustment Cost Model

- c. Staggered Nominal Wage Contracts
- d. Sticky Information Model
- e. The Natural Rate Hypothesis.

F&G, Chapter 8

- C. Optimal Monetary Policy in the Forward-Looking Model: the Closed Economy.
  - a. Optimal Monetary Policy under Commitment
  - b. Optimal Monetary Policy under Discretion
  - c. Efficient Monetary Policy Strategies
  - d. The Debate on Target vs. Instrument Rules.

\*F&G, Chapter 9.

- D. Optimal Monetary Policy in the Forward-Looking Model: the Open Economy.
  - a. Optimal Monetary Policy under Commitment
  - b. Optimal Monetary Policy under Discretion
  - c. Appending an Instrument Rule to the Open Economy Model.

\*F&G, Chapter 11.

- E. Monetary Policy during the Financial Crisis

\*Benjamin Friedman, "The Simple Analytics of Monetary Policy: A Post-Crisis Approach," NBER Working Paper 18960, 2013.

<http://www.nber.org/papers/w18960>

- F. Advanced Topics in the Closed Economy (Light Coverage)
  - a. Optimal Monetary Policy from the Timeless Perspective
  - b. Price Level vs Inflation Targeting
  - c. "The Delegation Issue" in the Context of Price-Level Targeting
  - d. Policy-Making in Practice: Speed Limit Policy?
  - e. Average Inflation Targeting.

\*F&G, Chapter 10

- G. Advanced Topics in the Open Economy: Which Rate of Inflation to Target?

Alfred Guender, "Stabilizing Properties of Discretionary Monetary Policies in a Small Open Economy: Domestic vs CPI Inflation Targets," *EJ* (January 2006).

Richard Froyen and Alfred Guender, "The Choice of an Inflation Objective when Openness Matters." (mimeo).

H. Optimal Monetary Policy in the Backward-Looking Model.

- a. Optimal Policy in the Closed-Economy Model
- b. Efficient and Inefficient Strategies of Monetary Policy
- c. Is the Taylor Rule an Efficient Strategy?
- d. Targeting the Inflation Forecast: the Svensson Framework.
- e. Optimal Policy in the Open-Economy Model
- f. Potential Problems with Monetary Conditions Indices (MCI).

\*F&G, Chapter 12.

Alfred V. Guender & David Gillmore, "Practical Monetary Policies", *IF* (Spring 2010).

V. Interaction of Monetary Policy with Fiscal Policy: Seigniorage vs Tax Rates

OVERVIEW:

\*Stanley Fischer, "Modern Approaches to Central Banking," NBER Working Paper #5046, 1995.

Gregory Mankiw, "The Optimal Collection of Seigniorage: Theory and Evidence," *JME* (September 1987).

\*Alfred V. Guender & Kirdan Lees, "The Revenue Smoothing Hypothesis: Evidence from New Zealand," *JMACRO* (June 1999).

\*Walsh, Ch. 4.4.