

Freie Universität, Berlin

Macroeconomic Policy in an Interdependent World

Fall Semester 2008-2009

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Course Objectives

After reviewing the basic elements of fiscal and monetary policy and their effects on inflation and unemployment, the course explores the operation of such policies in an increasingly interdependent world. Exchange rate arrangements are the most common historical examples of the interdependence of monetary policies between countries but the primacy of central banking and monetary policy also suggest that inflation targeting has perhaps become the new international monetary order.

Term Grades

Item	Title	% of Total
Assignment # 1: Due: November 25 th , 2008	Replication Exercise Presentation: November 25 th , 2008 (1)	20% + 5% presentation
Assignment # 2: Due: December 16 th , 2008	Measuring Central Bank Independence Presentation: December 16 th , 2008 (1)	20% + 5% presentation
Assignment # 3: Due: January 15 th , 2008	Monetary Policy 'Game' Presentation: January 13 th , 2009 (2)	20% (½ for individual press release, ½ for group press release) + 5% presentation (Group only)
Final Exam	TIME & LOCATION TO BE ANNOUNCED	25

Details about the assignments, and the Final exam, are provided after the details of the course outline.

- (1) A STRICT MAXIMUM OF **5 MINUTES**. IDEALLY YOU WILL USE A VERY FEW SLIDES TO MAKE YOUR CASE.
- (2) THIS IS A MIX OF GROUPWORK AND INDIVIDUAL EFFORT. DETAILS ARE FOUND BELOW.

Topics

Note: I have tried to keep readings to a minimum. Note taking in class will be a very useful complement to these readings, and to the slides that will be distributed, unless you wish to read several more papers! The readings are NOT listed in order of importance. Number of lectures under each section is approximate. Adjustments will be made as required.

Required Readings

1. *Introduction: The World of Central Banking and Macroeconomic Policy*
[1 lecture]
 - a. Meyer (1998)
 - b. Mankiw (2006)
 - c. Mahadeva and Sterne (2000), chapters 1 and 2
 - d. Siklos (2002), chapter 1

2. *The Conduct of Monetary and Fiscal Policy: General Principles. Can The Two Be Run the Same Way?*
[2 lectures]
 - a. Meyer (2004), pp.36-40, chapters 3,4,6
 - b. Gali and Gertler (2007)
 - c. Hetzel (2008), Chapters 18,19,20
 - d. Orphanides (2007)
 - e. Crow (2002), chapter 9

3. *Why Should Central Banks Be Independent?*
[2 lectures]
 - a. Blinder (2004), chapter 3
 - b. Walsh (1993), section 4
 - c. Siklos (2002), chapter 3
 - d. Padoa-Schioppa (2004), pp. 27-36, 91-96 only
 - e. Faust (1996), for the ideas only and not the technical details

4. *Accountability, Disclosure, Governance*
[1 lecture]
 - a. Bernanke (2004)
 - b. Goodfriend (1986)
 - c. Sibert (2006)
 - d. Bernanke (2007)
 - e. Siklos (2002), chapter 6
 - f. Crowe and Meade (2007)

5. *Globalization and Monetary Policy and the Role of Exchange Rate Regimes*
[1 lecture]

- a. Carney (2004)
 - b. Trichet (2007)
 - c. Borio and Filardo (2007), part I, pp. 8-10, 13-21
 - d. Rogoff (2006)
 - e. Reinhart and Rogoff (2004)
6. *A New International Monetary Order? Inflation Targeting Around the World*
 [1 lecture]
- a. Paulin (2006)
 - b. Faust and Henderson (2004)
 - c. Bernanke et. al (1999), chapters 1,2,3
 - d. Rose (2007) read for the ideas not the detailed statistical analysis
 - e. Siklos (2002), chapter 7

Class Schedule (all classes Tuesdays 12-2 pm)

Date	Class Location	Topic #
October 21, 2008	TBA	1
October 28, 2008	TBA	2
November 4, 2008	X	Preparation: replication exercise
November 11, 2008	TBA	2
November 18, 2008	TBA	3
November 25, 2008		Presentations: assignment 1
December 2, 2008	TBA	3
December 9, 2008	TBA	4
December 16, 2008	TBA	Presentations: assignment 2
January 6, 2009	X	Preparation: Monetary policy game
January 13, 2009	TBA	Monetary Policy Game
January 20, 2009	TBA	5
January 27, 2009	TBA	6

All non-book items can be downloaded from the Internet.

There is no textbook for the course. However, throughout the course I will refer to the following references. Library call numbers are provided in brackets. Since it is much easier, and convenient, if the books are not placed on reserve please make sure that everyone has access to these books.

Books

Ben Bernanke, Thomas Laubach, Frederic Mishkin, and Adam Posen (1999), *Inflation Targeting* (Princeton, N.J.: Princeton University Press).

Alan Blinder (2004), *The Quiet Revolution: Central Banking Goes Modern* (New Haven, CN: Yale University Press).

John Crow (2002), *Making Money: An Insider's Perspective on Finance, Politics, and Canada's Central Bank* (Etobicoke, ON: John Wiley & Sons).

L. Mahadeva, and G. Sterne , Editors (2000), *Monetary Policy Frameworks in a Global Context* (London: Routledge).

Robert L. Hetzel (2008), *The Monetary Policy of the Federal Reserve: A History* (Cambridge: Cambridge University Press).

Laurence H. Meyer (2004), *A Term at the Fed* (New York: Harper Business).
Tomasso Padoa-Schiopa (2004), *The Euro and Its Central Bank* (Cambridge: Cambridge University Press).

Pierre L. Siklos (2002), *The Changing Face of Central Banking* (Cambridge: Cambridge University Press)

Speeches and Articles

Speeches

All speeches from the **Fed** are available from <http://www.federalreserve.gov/newsevents/speech/2008speech.htm>. You can change the year to find the speech. For the **European Central Bank**, speeches are available by speaker at <http://www.ecb.int/press/key/speaker/pres/html/index.en.html>. [it is also possible to choose by date <http://www.ecb.int/press/key/date/2008/html/index.en.html>]

Ben Bernanke (2007), "Federal Reserve Communication", 14 November.

Ben Bernanke (2004), "Fedspeak", 3 January.

Mark Carney (2004), "The New International Monetary Order", in Bank of Canada *Review* (Winter): 49-57.

Laurence Meyer (1998), "Come With Me to the FOMC", April.

Jean-Claude Trichet (2007), "The Role of Central Banks in a Globalized World", 18 June.

Articles

Graydon Paulin (2006), "Credibility with Flexibility: The Evolution of Inflation Targeting Regimes, 1990-2006", Bank of Canada *Review* (Summer): 5-18.

Working Papers and Journal Articles

Lawrence Ball and Niamh Sheridan (2003), "Does Inflation Targeting Matter?", IMF working paper 03/129, June.

Claudio Borio and Andrew Filardo (2007), "Globalization and Inflation: New Cross-Country Evidence on the Global Determinants of Domestic Inflation", BIS working paper 227, May.

Stephen Cecchetti, Peter Hooper, Bruce Kasman, Kermti Schoenholtz, and Mark Watson (2007), "Understanding the Evolving Inflation Process", working paper, Brandeis University, July.

Christopher Crowe and Ellen Meade (2007), "The Evolution of Central Bank Governance Around the World", *Journal of Economic Perspectives* 21 (Fal): 69-90.

Alex Cukierman, Bilin Neyapti, and Steven Webb (1992), "Measuring the Independence of Central Banks and Its Effects on Policy Outcomes", *World Bank Economic Review* 6(3): 353-398.

Jon Faust (1996), "Whom Can We Trust to Run the Fed? Theoretical Support for the Founders' Views", *Journal of Monetary Economics* 27 (April): 267-83.

Jon Faust and Dale Henderson (2004), "Is Inflation Targeting Best-Practice Monetary Policy?" *Review of the Federal Reserve Bank of St. Louis* 86 (July/August): 117-144.

Stanley Fischer (1994), "Modern Central Banking", in Forrest Capie et.al. *The Future of Central Banking: The Tercentenary of the Bank of England* (Cambridge: Cambridge University Press).

James Forder (1999), "Central Bank Independence: Reassessing the Measurements", *Journal of Economic Issues* 33: 23-40.

- Jordi Gali and Mark Gertler (2007), “Macromodelling for Monetary Policy Evaluation”, *Journal of Economic Perspectives* 21(Fall): 25-45.
- Marvin Goodfriend (1991), “Interest Rates and the Conduct of Monetary Policy”, *Carengie-Rochester Conference Series on Public Policy* 34, 7-30.
- Marvin Goodfriend (1986), “Monetary Mystique: Secrecy in Central Banking”, *Journal of Monetary Economics* 17 (January): 63-92.
- N. Gregory Mankiw (2006), “The Macroeconomist as Scientist and Engineer”, *Journal of Economic Perspectives* (Fall): 29-46.
- Athanassios Orphanides (2007), “Taylor Rules”, in the *New Palgrave: A Dictionary of Economics* 2nd Edition. The article can also be downloaded from the Board of Governors working papers series website.
<http://www.federalreserve.gov/pubs/feds/2007/200718/200718pap.pdf>.
- William Poole (2006), “The Fed’s Monetary Policy Rule”, *Review of the Federal Reserve Bank of St. Louis* 88 (January/February): 1-12.
- William Poole (2003), “Institutions for Stable Prices: How to Design an Optimal Central Bank Law”, *Review of the Federal Reserve Bank of St. Louis* 85 (September/October): 1-6.
- Carmen Reinhart and Kenneth Rogoff (2004), “The Modern History of Exchange Arrangements: A Reinterpretation”, *Quarterly Journal of Economics* 119 (February): 1-48.
- Kenneth Rogoff (2006), “Impact of Globalization on Monetary Policy”, in *The New Economic Geography: Effects and Policy Implications*, Symposium Proceedings, 2006 Jackson Hole Conference, Federal Reserve Bank of Kansas City.
- Andrew K. Rose (2007), “A Stable International Monetary System Emerges: Inflation Targeting is Bretton Woods, Reversed”, *Journal of International Money and Finance* 26: 663-681.
- Anne Sibert (2006), “Central Banking By Committee”, *International Finance* (August): 145-68.
- Pierre Siklos (2008), “Inflation Targeting Around the World”, working paper, Wilfrid Laurier University, available at
[http://www.wlu.ca/documents/27768/Inflation Targeting Around the World.pdf](http://www.wlu.ca/documents/27768/Inflation%20Targeting%20Around%20the%20World.pdf).

Pierre Siklos (1999), "Inflation-Target Design: Changing Inflation Performance and Persistence in Industrial Countries", *Review of the Federal Reserve Bank of St. Louis* 81 (March/April): 47-58.

Pierre Siklos and Martin Bohl (2007), "Asset Prices as Indicators of Euro Area Monetary Policy: An Empirical Assessment of Their Role in a Taylor Rule", Wilfrid Laurier University,
http://www.wlu.ca/documents/1075/Siklos_Bohl_BBkII_31082007.pdf.

Carl Walsh (1993), "Central Bank Strategies, Credibility and Independence: A Review Essay", *Journal of Monetary Economics* 32(2): 287-302.

NOTE: All assignments must be electronically submitted to psiklos@wlu.ca (no exceptions) no later than 18:00 on the due date (see Term Grades section).

Assignment # 1: Replication Exercise

Choose ONE of the TWO OPTIONS listed below;

OPTION # 1:

1. Read Poole (2006). The data are available from <http://research.stlouisfed.org/publications/review/past/2006/#top>.
2. Replicate the results in Poole Figures 1 and 2.
3. Given the data sources (these are easily found; the basic economic data can be found from <http://research.stlouisfed.org/fred2/>; the CBO data is available from <http://www.cbo.gov/Spreadsheets.shtml> [scroll down the page to find the relevant series]) update the estimates to 2008. Can you do better by changing the weights? If so, do the events and policy decisions of the Fed possibly help explain the differences? If not, what do the results say about the usefulness of such policy rules to help understand how the Fed acts? Go to <http://www.federalreserve.gov/monetarypolicy/fomc.htm> for the Fed's announcements.

OPTION # 2: Repeat the same analysis as in OPTION # 1, using data for the **euro area** (data are available from <http://sdw.ecb.europa.eu/home.do>). The Only difference in this case is that you will have to construct your own measure of the output gap. Its easy. Simply estimate the following regression:

$$\log \text{real GDP}_t = c + \beta_0 \text{TIME}_t + \beta_1 \text{TIME}_t^2 + \varepsilon_t$$

where TIME is a time trend (i.e., a series that starts at 0, 1, 2, ..., until N, where N is the number of observations). The output gap is then the residuals series (ε_t). In either case contrast your results with those of the US. Also, if you choose the euro area example don't use data before 1999Q1 (Q means quarterly data). ECB announcements are at <http://www.ecb.int/press/tvservices/webcast/html/index.en.html>.

Your report should be submitted in a word file with any Tables and Figures included. The entire report should not exceed 10 pages.

Assignment # 2: Measuring Central Bank Independence

1. Read Cukierman-Webb-Neyapti (1992).
2. Go to <http://www.bis.org/cbanks.htm>. This page provides links to central banks around the world with websites.
3. Select 2 countries where the legislation has been changed since Cukierman-Webb-Neyapti (1992). You should be able to find out based on the date the legislation passed. Try to select countries on different continents, if possible. Obviously, the legislation should be available online and in English (most but not all websites have an English page even though the home page may not be in English). Send me a list of the

countries selected. Choices are on a first come, first served basis to avoid an overlap of countries chosen.

4. Update, as best you can, the index of CBI following the coding used by Cukierman-Webb-Neyapti (1992). Did the central bank become more independent?
5. Estimate the inflation rates (or get it from the relevant central bank website if you can) since the previous legislation was in force for each of the two countries in your sample. Did inflation fall (rise) relative to what C-W-N (1992) report? Did your index value of independence rise (fall)? Are your results consistent with their hypothesis?
6. Are there aspects of the legislation, or the governance of the central bank, that are not properly reflected in the Cukierman-Webb-Neyapti index? Explain. Related your answers to the arguments in Poole (2003), and Forder (1999).

NOTE: Please provide your index in a spreadsheet format. Explanations are to be provided in a separate Word file of no more than 3 double-spaced pages.

Assignment # 3: Monetary Policy Decision-Making

NOTE: THE ECB WILL ANNOUNCE ITS INTEREST RATE DECISION ON January 15th, 2009.

1. Read Sibert (2006). NOTE: A working paper version is also available on the Netherlands (Dutch) central bank's web site. Find out the pros and cons of decision-making by committee.
2. Groups of 5 students will be randomly assigned to a committee during the week of JANUARY 6th, 2009.
3. Each individual student will have to come to the January 13th, 2009 class with a ONE PAGE press release indicating their decision regarding their preferred setting of the minimum bid rate on the main refinancing operations of the Eurosystem. This decision is NOT to be shared with any other member of the committee before hand (The Final draft of the press release is due no later than January 15th).
4. On January 15th, each committee will come to a collective decision regarding their preferred setting of the minimum bid rate on the main refinancing operations of the Eurosystem. Each committee must decide on a voting rule and a Chair must also be selected. Choices include: 'consensus', rolling of the dice, the Chair votes FIRST, the Chair votes LAST.
5. The group must also prepare a press release explaining their decision. The Chair of the group presents the decision (although all members of the committee are graded equally).

Final Exam: the final exam will consist of short answer and essay type questions based on the material listed under the topic headings. There will be at least 6 questions and you can choose ANY 4 to answer.