

Syllabus
ECON 312 Monetary Theory
Prof. Miles Cahill
Fall 2009

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Course meeting time: Tuesdays and Thursdays, 01: 9:30-10:45, 02: 11:00-12:15, Stein 304

Office Hours: Tues.: 3:30-4:30, Wed.:10-12, 1-2, Thurs.: 3:30-4:30 and by appointment and drop-in

Important web resources

Moodle: <http://www.holycross.edu/login/>; *login:* your Novell logon ID

Reserve articles (ERes): <http://eres.holycross.edu/coursepage.asp?cid=213>; *password:* greenspan

Textbook web site: http://websites.swlearning.com/cgi-swlearning/course_products_sw.pl?fid=M20b&product_isbn_issn=9780324176735

Overview of course: Monetary policy has probably never been as central to a nation as has been recently in the U.S. Recent years has also seen radical changes in the way monetary policy is implemented. This course will explore how money, the financial sector and policy can impact the economy by building models and working with data. Considerable time will be spent understanding the policy reaction to what is being referred to as “the great panic” as well as conventional policy.

Prerequisites: This is an advanced economics course, suitable for 3rd and 4th year students. The prerequisites include ECON 255 and 256, as well as the prerequisites for ECON 255 and 256 (including the Calculus requirement). Knowledge of basic microeconomic and macroeconomics models is assumed, including the IS-LM/aggregate demand model.

Important dates:

Midterm 1: Thursday, October 1, in class, 100 points (20%)

Midterm 2: Thursday, November 12, in class, 100 points (20%)

Final Exam: Saturday, Dec. 12, 2:30 p.m., Wednesday, Dec. 16 8:30 a.m., 150 points (30%)

Quizzes (6): Announced one class ahead of time, 15 points (3%) each

Project overview: Thursday, October 22 in class, 10 points (2%)

Presentation: Tuesday December 1 or Thursday December 3, 25 points (5%)

Written report: Tuesday, December 8 at 2:00, 25 points (5%)

Attendance: Every day, 5 bonus points total (1%)

COURSE MATERIALS

Required Text: Thomas, Lloyd, Money, Banking and Financial Markets, South-Western/Cengage Learning, 2006.

Suggested Supplements:

The Wall Street Journal: You are strongly encouraged to subscribe to the *WSJ*. If you are planning on any type of financial career, it is required daily reading.

The New York Times: The *NYT* has an excellent business and financial section, and is free around campus and on the web (<http://www.nytimes.com>).

Textbook on-line supplement web site: Contains on-line quizzes and other useful tools.

Additional Readings – ERes: There are several reserve readings listed on the course outline below. All reserve readings are available through ERes (<http://eres.holycross.edu/coursepage.asp?cid=213>), linked in Moodle. During the semester other short readings will be distributed in class.

Office hours: You are very strongly encouraged to meet with me during my office hours if you need any assistance understanding material covered in class or the readings; if you would like to go over exams, quizzes or other questions; have any questions about the economics major or economics courses; or if you would like to ask about and/or discuss any economic issue. The biggest mistake many students make at college is not using office hours, especially early in the semester. So, stop by early and often!

e-mail: You are responsible for checking your Holy Cross e-mail and responding to course-related e-mails as appropriate.

GRADING

Exams: There will be two in-class midterms and one cumulative final exam during finals week. The exams will be a combination of problems, short answer and essay questions. Even if you study hard, you can expect to need the entire 75 minute period to complete the midterms, while you will not need the entire 3 hour period to complete the final. Be warned: many questions will require you to apply your knowledge in a way that you previously have not considered. Dates for exams are given above.

Quizzes: There will be six short (10-15 min.) quizzes during the semester, announced one class ahead of time.

Homework assignments: Throughout the semester, you will be assigned individual problems and problem sets in homework assignments. Although homework will not be collected or graded, you are strongly encouraged to complete them on time. They will be of great assistance in mastering the material, and preparing for exams and quizzes. Answers will be posed on Moodle.

Computer laboratory: We will have some computer laboratory sessions where we will estimate key economic relationships and explore economic data.

Presentation and report: The class will be divided into 6 groups of 3 or 4 students. Each group will be assigned a financial crisis upon which to present a twenty minute report. The report must consist of the following elements: a concise description of the causes of the crisis, an overview of the effects of the including relevant data, and a review of the Federal Reserve response to the crisis, including relevant data. The written report should be approximately 10 pages with sources fully cited. All members of the group will receive the same base grade based on the presentation and the report, adjusted by an assessment report by the other members of the group.

Attendance: Attendance at each class is mandatory. If you have a serious problem that forces you to miss class, make sure you let me know, ahead of time if possible. Furthermore, I reserve the right to demand a note from the class dean or other authority. If you miss a quiz or test due to an excused absence, your final score will be reweighted, except in extreme circumstances. If you do not miss classes (without an excuse) you will be awarded 5 bonus points on to your final grade.

Distribution of grades: The grade distribution for each assignment will be provided when assignments are turned back to you. Your cumulative point and grade total will be provided when exams are turned back to you. As an insurance policy, you are guaranteed at least the “straight scale,” but it is likely that the distribution will be looser than the straight scale. In the past, my courses have tended to have the department average of about 2.8/4.0.

Academic dishonesty: The College policy on academic dishonesty is clear and spelled out in the *College Catalogue*. Academic dishonesty includes cheating on exams and assignments (by using or providing prohibited materials) and plagiarism, which includes the deliberate *or unintentional* use of another's ideas or language without proper attribution. See the presentation assignment handout for specific guidelines on avoiding plagiarism. I am required to report any act of plagiarism (intentional or not) that results in any grade reduction to your Class Dean for academic dishonesty disciplinary proceedings as described in the *Catalogue*.

COURSE OUTLINE AND READINGS

On the following pages, a list of topics organized by “units,” and associated readings are provided. Make sure you keep careful track of where you are in the class at all times. The approximate number of classes spent on each topic are given in parentheses after each unit title. The appropriate chapter(s) in the text is given next to each topic, and specific page numbers for chapters are given when only part of a chapter needs to be read. When a significant amount of material is not found in the text, an asterisk (*) is given. Reserve readings are coded by brackets { } where appropriate. This list of reserve readings is as follows:

List of Reserve readings

The following readings are available on ERes, which is accessible through Moodle. The number codes refer to the topics on the course outline. On ERes, the articles are named exactly as they appear below (though with no number designation). The documents are Adobe Acrobat (*.pdf) files of articles. For your convenience, the URL of each article is provided in the citation when available.

- {1} Yellen, Janet L. (2008), “The Mortgage Meltdown, Financial Markets, and the Economy,” *FRBSF Economic Letter*, 2008-35-36; November 7.
<http://www.frbsf.org/publications/economics/letter/2008/el2008-35-36.html>
- {2} McCandless, George T. and Weber, Warren, (1995) “Some Monetary Facts,” *Quarterly Review* (Fed-Minneapolis), Summer: pp. 2-11. <http://www.minneapolisfed.org/research/qr/qr1931.pdf>
- {3} Valderrama, Diego, (2003), “Financial Development, Productivity, and Economic Growth,” *FRBSF Economic Letter* (Fed-SF), No. 2003-18, June 27.
<http://www.frbsf.org/publications/economics/letter/2003/el2003-18.html>
- {4} Gomme, Paul, (2003), “Iowa Electronic Markets,” *Economic Commentary*, April 15.
<http://www.clevelandfed.org/Research/Commentary/2003/0415.pdf>
- {5} Moreno, Ramon, (1998), “What Caused East Asia’s Financial Crisis?” *FRBSF Economic Letter*, August 7. <http://www.frbsf.org/econsrch/wklyltr/wklyltr98/el98-24.html>
- {6} Blinder, Alan S., (1996), “Central Banking in a Democracy,” *Economic Quarterly* (Fed-Richmond), Fall: pp. 1-14.
http://www.richmondfed.org/publications/research/economic_quarterly/1996/fall/pdf/blinder.pdf
- {7} Altig, David E. and Nosal, Ed, (2002), “Why Haven’t Long-term Interest Rates Fallen?” *Economic Commentary* (Fed-Cleveland), January 1.
<http://www.clevelandfed.org/research/Commentary/2002/0102.pdf>
- {8} Lambert, Michael J., and Stanton, Kristen D., (2001), “Opportunities and Challenges of the U.S. Dollar as an Increasingly Global Currency: A Federal Reserve Perspective,” *Federal Reserve Bulletin* (Board of Governors), September: pp. 567-75.
<http://www.federalreserve.gov/pubs/bulletin/2001/0901lead.pdf>
- {9} Ragan, Kelly, and Trehan, Bharat, (1998), “Is It Time to Look at M2 Again?” *FRBSF Economic Letter*, March 6. <http://www.frbsf.org/econsrch/wklyltr/wklyltr98/el98-07.html>
- {10} Garfinkle, Michelle R., (1989), “What Is an ‘Acceptable’ Rate of Inflation? A Review of the Issues,” *Review* (Fed-St. Louis), July/August.
http://research.stlouisfed.org/publications/review/89/07/Inflation_Jul_Aug1989.pdf

- {11} Wu, Tao, (2004), "Understanding Deflation," *FRBSF Weekly Letter*, 2004-8, April 2.
<http://www.frbsf.org/publications/economics/letter/2004/el2004-08.html>
- {12} Sill, Keith, (1999), "Forecasts, Indicators, and Monetary Policy," *Business Review* (Fed-Philadelphia), May/June: pp. 3-14. <http://www.phil.frb.org/files/br/brmj99ks.pdf>
- {13} Pianalto, Sandra, (2004), "A Perspective on Monetary Policy" *Economic Commentary* (Fed-Cleveland), May 1. <http://www.clevelandfed.org/Research/commentary/2004/05-01.pdf>
- {14} Rudebusch, Glenn D. (2008a), "Publishing FOMC Economic Forecasts," *FRBSF Economic Letter* 2008-01 (January 18). <http://www.frbsf.org/publications/economics/letter/2008/el2008-01.html>
- {15} Rudebusch, Glenn D. (2008b), "Publishing Central Bank Interest Rate Forecasts," *FRBSF Economic Letter* 2008-02 (January 25).
<http://www.frbsf.org/publications/economics/letter/2008/el2008-02.html>
- {16} Tootell, Geoffrey M. B., (1997), "How Farsighted Is the FOMC?" *New England Economic Review* (Fed-Boston), January/February: pp. 49-65.
- {17} Taylor, John B. (1993), "Discretion vs. Policy Rules in Practice," *Carnegie-Rochester Series on Public Policy* 39 (December), pp. 195-214.
- {18} Judd, John P. and Glenn D. Rudebusch (1998), "Taylor's Rule and the Fed: 1970-1997," *FRBSF Economic Review* 1998:3. pp. 3-16. <http://www.frbsf.org/econsrch/econrev/98-3/3-16.pdf>
- {19} Fernandez, Adriana Z. and Alex Nikolsko-Rzhevskyy (2007), "Measuring the Taylor Rule's Performance," *Economic Letter* (Fed-Dallas), Vol. 2, No. 6 (June).
<http://www.dallasfed.org/research/eclett/2007/el0706.html>
- {20} Neely, Christopher J., (2004), "The Federal Reserve Responds to Crises: September 11th Was Not the First", *Review* (Fed-St. Louis), Vol. 86, No. 2 (March/April): pp. 27-42.
<http://research.stlouisfed.org/publications/review/04/03/Neely.pdf>
- {21} Yellen, Janet L. (2009), "U.S. Monetary Policy Objectives in the Short and Long Run," *FRBSF Economic Letter*, 2009-01-02 January 9.
<http://www.frbsf.org/publications/economics/letter/2009/el2009-01-02.html>
- {22} Duca, John V., Danielle DiMartino and Jessica J. Renier (2009), "Fed Confronts Financial Crisis by Expanding Its Role as Lender of Last Resort," *Economic Letter* (Fed- Dallas), Vol. 4, No. 2 (February/March). <http://www.dallasfed.org/research/eclett/2009/el0902.html>

Unit	Text	Reserve
UNIT 1: INTRODUCTION TO MONEY AND MONETARY POLICY (2½ classes)		
Overview of the financial crisis	*	{1}
Review of standard monetary policy		
Review of money: role, definitions, types, effects	1,2(18-32)	
Review of money creation	14	
Review of long run effects of money on economy	1	{2}
Review of short run effects of money on economy	"	
Measuring money: M1, M2, M3, alternatives	2(32-8)	
Introduction to money demand	*	
Velocity of money and instability of money demand	"	
UNIT 2: STRUCTURE OF THE FINANCIAL SYSTEM (2½ classes)		
Purpose of financial system		{3}
Types of securities and markets	3	
Example of a market: Iowa electronic markets		{4}
Roles of financial institutions	4	
Asymmetric information: Moral hazard/adverse selection	"	{5}
Government vs. self regulation		
Banking	10	
Bank regulation	11	
UNIT 3: THE FEDERAL RESERVE SYSTEM (2 classes)		
Overview of Fed		
Purposes, functions	12	
Financial structure	"	
Organizational structure	"	
Independence, proposals for reform	"	{6}
UNIT 4: INTEREST RATES IN FINANCIAL MARKETS (3 classes)		
Real vs. nominal interest rates	5(95-7)	
Interest rates and securities prices: present value	5(97-99)	
The equilibrium level of interest rates		
Loanable funds market model	5(99-103)	
Factors affecting interest rates	5(103-120)	
Interest rate structures		{7}
Term structure theory and forward rates	6(123-39)	
Risk structure	6(139-43)	

Unit	Text	Reserve
UNIT 5: MONETARY THEORY (7 classes)		
Money demand theory	22	
Early theories: Quantity and Keynesian theory	"	
Modern (cash-inventory) theory with fixed deposit rate	*	
Modern precautionary, portfolio choice demand	*	
Currency demand	*	{8}
Money demand with market-determined deposit rates	*	
Market for bank deposits & dep. rate determination	*	
Equilibrium deposit demand	*	
Regulated vs. deregulated money market demand	*	
Empirical investigations of money demand	*	{9}
Money supply in detail	15, 16	
Monetary Base	15	
Monetary base multiplier	16	
Money supply curve	*	
Equilibrium in the money market	*	
Review of short run macroeconomic model: IS-LM	*	
Review of aggregate demand and supply model	20	
Aggregate demand	"	
Aggregate supply	"	
Long run (potential) aggregate supply and growth	*	
Effect of changes in output on price level	*	
Price adjustment from short run to long run	*	
UNIT 6: CONVENTIONAL MONETARY POLICY (3 classes)		
Tools	18	
Goals	19(423-9)	{10},{11}
Operating and intermediate targets	19(429-39)	{12}
Monetary transmission mechanism	23	
Optimal monetary policy	24	{13}
Transparency	*	{14},{15}
Active vs. passive	24(552-563)	
Lags and uncertainty	"	{16}
Rules vs. discretion	24(563-73)	
Taylor Rule	"	{17},{18},{19}
Inflation targeting	25	
History of standard monetary policy actions	19(439-46), 21	
UNIT 7: MONETARY POLICY DURING CRISES (4 classes)		
The Great Depression	17	
Crises in the last 40 years (student presentations)	*	{20}
Penn Central Railroad Crisis (1970)	*	
Franklin National Bank Crisis (1974-5)	*	
Hunt Brothers Silver crisis (1980)	*	
Stock Market Crash of 1987	*	
Preparations for the Y2K bug (years leading to 2000)	*	
September 11, 2001	*	
The "Great Panic" (2007-present)	*	{21},{22}