



GRA 6631 Monetary Policy

Program

Master of Science in Business Administration (MScBA), Specialization Course

Responsible for the course

Kai Leitemo

Department

Economics

Term

Spring

ECTS Credits

6

Objective

: During the past decade monetary policy has received increasingly more attention. Monetary policy is now considered the main policy tool for providing macroeconomic stability. Many central banks have become “independent” and also switched from strategies of targeting the exchange rate or money supply to targeting inflation directly. Through inflation targeting, monetary policy has been demystified and become more scientific as more and more research has been directed towards the question: how to stabilize inflation at the smallest cost in the form of fluctuations in output and employment.

In this course, participants will learn about the instruments and goals of monetary policy. How does the central bank think when setting its policy interest rate under the different strategies? How does the central bank operate in the money market and what consequences do the operation have for long-term interest rates. How does monetary policy affect the macroeconomy? How is monetary policy coordinated with fiscal policy? How should monetary policy be designed if it wants to stabilize inflation at the smallest cost in the form of fluctuations in inflation and output?

The course will be somewhat more mathematically oriented than the course *Macroeconomic Theory and Policy*. The course will be taught by use of the whiteboard, and written lecture notes will be provided when the textbooks do not cover the topics adequately.

The following topics constitute the core of the course (with compulsory reading in parenthesis):

1. The money market: Interest rates and money.
(Bofinger Ch. 1-3. Mishkin Ch. 4-6,15,16)

What is money? Money demand and supply. How is the interest rate determined?
Term Structure of Interest rates.

2. The instruments and objectives of monetary policy.
(Bofinger Ch. 5,10. Mishkin Ch. 17,18)

What are the objectives of monetary policy and how does the central bank pursue

its target? The role of instruments, intermediate targets and objectives in monetary policymaking are discussed.

3. The monetary transmission mechanism.
(Bofinger Ch. 4. CGG 1999 (comp). Walsh Ch 1 (comp). Mishkin Ch. 25,26.)

This part of the course discusses the transmission mechanism of monetary policy, first within the empirical literature and then within the Neo-Keynesian and New-Keynesian macroeconomic frameworks. The trade-off between inflation and output stabilization is illustrated and discussed.

4. Central bank independence
(Bofinger Ch. 6-7.)

Should the central bank be made independent? This part of the course discusses the pros and cons of central bank independence. The discussion will be somewhat focused on the Barro-Gordon model.

5. Monetary-policy strategy
(Bofinger Ch. 8-9, 12-13. Mishkin Ch.18,20. Romer Ch. 10.)

We briefly discuss the historical evolution of monetary policymaking and then the new framework of inflation targeting pursued by many central banks. We discuss different strategies toward the implementation of inflation targeting: simple rules and inflation-forecast targeting.

6. Coordination of macroeconomic policies.
(Lecture notes)

Monetary policy decentralization has raised concern about potential coordination problems with fiscal policy and perhaps also with incomes policy. Such questions are addressed using elementary game theory.

7. The optimal rate of inflation and the seigniorage.
(Bofinger Ch. 11. Romer Ch. 10)

This part discusses issues in the choosing the optimal rate of inflation. We discuss the Friedman rule, the zero-bound on interest rates, the "liquidity trap" and downward stickiness of prices and wages.

Prerequisites

GRA 6634 Macroeconomic theory and policy

Compulsory literature

Bofinger, Peter. 2001. *Monetary Policy. Goals, institutions, Strategies, and Instruments* . Oxford University Press.

Mishkin Frederic S. 2003. *The Economics of Money, Banking and Financial Markets*. 6th ed. Addison Wesley. Part II and IV, and chapters 25 and 26.

Walsh, Carl E. 1998. *Monetary Theory and Policy*. MIT Press. Chapter 1. (in the compendium)

Romer, David. 2001. *Advanced macroeconomics* . 2nd ed. Boston, MA.: McGraw Hill. Chapter 10. (in the compendium)

A compendium of articles.

Recommended literature

Lewis, Mervyn K. and Paul D. Mizen. 2000. *Monetary economics*. New York, NY.: Oxford University Press. Chapter 10,13,14 and 16.

Course outline

1. The money market: Interest rates and money
2. The instruments and objectives of monetary policy
3. Central Bank independence
4. The monetary transmission mechanism
5. Monetary-policy strategy
6. Coordination of macroeconomic policies
7. The optimal rate of inflation

Computer-based tools

Blackboard

Course structure

Lectures (30 hours)

Evaluation

Written exam (3 hours)

Evaluation code(s)

GRA 66311

Aids at the examination

Calculator, which students cannot program

Makeup exam

Next ordinary exam