



APPLIES TO ACADEMIC YEAR 2003/2004

GRA 6631 Monetary Policy

Program

N/A

Responsible for the course

Kai Leitemo

Department

Economics

Term

According to study plan

ECTS Credits

6

Objective

During the past decade monetary policy has received increasingly more attention in economic policymaking. 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 we want to stabilize inflation at the smallest cost in the form of fluctuations in inflation and output?

After the completion of the course, the student will have a very good understanding of how monetary policy works and how central banks think when setting interest rates. The course will give a very good background for students wanting to work in business and governmental institutions, where a good command of macroeconomics is required.

The course will be more mathematically oriented than its prerequisite course *Business Cycles*. The course will be taught by use of the whiteboard, and 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. Monetary-policy operating procedures
Walsh, Chapter 9 and 10.

How does the central bank operate in the money market in order to set interest rates? Should the central bank use the interest rate or base money as their instrument? How can the central bank affect the whole term structure of interest rates.

2. The monetary transmission mechanism
Walsh, Chapter 1, 5, 6 and 7.

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.

3. Discretionary policy and time inconsistency
Walsh, Chapter 8.

This part of the course discusses the pros and cons of commitment in monetary policymaking. Should the central bank announce and commit to rules or allowed to discretionary set policy in each period.

4. Monetary-policy strategy
Walsh, Chapter 11.

We discuss the design of monetary policy in order to achieve low inflation and output variability? How does different assumptions about private sector behaviour. We discuss the the role of targeting vs simple monetary policy rules. How does forecasting play a role in the design of monetary policy?

5. Coordination of macroeconomic policies
Lecture notes and Walsh, Chapter 4 and 6.

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.

6. The optimal rate of inflation and the seigniorage
Walsh, Chapter 4.

How much revenue can the government obtain by the printing of money? What is the optimal rate of inflation?

Prerequisites

GRA 6634 Business Cycles

Compulsory literature

Walsh, Carl E. 2003. *Monetary Theory and Policy*. 2nd ed. Cambridge, Mass., MIT Press. Chapter 1, 5-11.

Blejer, Ize, Leone and Werlang (2000), *Inflation Targeting in Practice: Strategic and Operational Issues and Application to Emerging Market Economies*, IMF
A compendium of articles.

Recommended literature

Course outline

1. The monetary-policy operating procedures
2. The monetary policy transmission mechanism.
3. Discretionary policy and time inconsistency
4. Monetary-policy strategy
5. Coordination of macroeconomic policies
6. The optimal rate of inflation and the seigniorage

Computer-based tools

Blackboard

Course structure

Lectures (36 hours)

Evaluation

Written exam (3 hours), and one hour mid-term exam

Evaluation code(s)

GRA 66311

Aids at the examination

No aids permitted

Makeup exam

Next ordinary exam