



APPLIES TO ACADEMIC YEAR 2011/2012

GRA 6631 Monetary and Fiscal Policy

Programme

Master of Science in Business and Economics, Master of Science in Business and Economics (Economics), Master of Science in Financial Economics, Specialization Course

Responsible for the course

Kai Leitemo

Department

Department of Economics

Term

According to study plan

ECTS Credits

6

Language of instruction

English

Introduction

This course gives you an advanced introduction to the art and science of macroeconomic policy. Monetary policy is about setting the short-term interest rates in order to keep inflation low and stabilizing the business cycle. Fiscal policy is about determining the size and composition of government expenditure and about the overall principles of how to finance these expenditures. Monetary and fiscal policymaking influence private consumption and investment decisions - and thereby the overall demand for goods and services in the economy. A good understanding of how monetary policy works and how the interest rate is set must be considered a great advantage to decision-makers in private enterprises and households.

It is now common to consider monetary policy as the main policy tool for providing macroeconomic stability. Many central banks have become independent of the government and have switched from strategies of targeting the exchange rate or money growth to targeting inflation and the business cycle directly. Through inflation targeting, monetary policy has been de-mystified 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.

Fiscal policy influences the business cycle and is both a source of shocks to the business cycle and a tool for stabilizing it. Moreover and depending on the way pension retirement benefits are being financed, it influences private sector savings decisions.

Learning outcome

In this course, participants will learn about the instruments and objectives of monetary policy. How does the central bank think when setting the interest rate? How does the central bank operate in the money market and what consequences does this policy have for long-term interest rates? How does monetary policy affect the macroeconomy? How can monetary policy best be 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? The analysis is carried out within a model framework in which agents are rational and optimizing and prices are subject to being inertial.

The participants will be introduced to different ways of financing public pension retirement benefits and the principles of optimal taxation.

After the completion of the course, the student is expected to have obtained a good understanding of how monetary and fiscal policy works, how central banks think when setting short-term interest rates and principles of good fiscal policymaking. The course will be suitable for students wanting to work in business and governmental institutions where a good understanding of stabilization policy and monetary policy is required, or students that simply want to read the financial newspapers with greater ease and interest.

Monetary and fiscal policy is more mathematical demanding than its prerequisite course *Business Cycles/ Business Cycle Theory*. The course will be taught by use of the whiteboard, and lecture notes will be provided when the textbook does not cover the topics adequately. The course sets high requirements for student involvement for successful completion of the course. At the end of the course, the students are expected to make a group presentation on a given topic related to a monetary or fiscal policy issue.

Prerequisites

GRA 6634 Business Cycles/ Business Cycle Theory (or a similar graduate introduction to macroeconomics and business cycles.)

Compulsory reading

Books:

Obstfeld, Maurice and Ken Rogoff. 1996. Foundations of international macroeconomics. MIT Press. Section 3.2

Obstfeld, Maurice and Kenneth Rogoff. 1996. Foundations of international macroeconomics. MIT Press. Section 3.2

Romer, David H. 2006. Advanced macroeconomics. 3rd ed. McGraw-Hill/Irwin. Selections from Chapter 11

Walsh, Carl E. 2010. Monetary theory and policy. 3rd ed. MIT Press. Chapters 1, 5, 6, 8, 9, 10 and 11.

Articles:

Ireland, Peter N. 2005. The Monetary Transmission Mechanism. Manuscript, Boston College. <http://www2.bc.edu/~irelandp/mtm.pdf>

Leitemo, Kai. 2004. A Game Between the fiscal and the monetary authorities under inflation targeting. European Journal of Political Economy. 20. pp. 709-724

Journals:

Clarida, Gali and Gertler. 1999. The Science of Monetary Policy: A new Keynesian perspective. Journal of Economic Literature. 37 (4). pp. 1661-1707

Collection of articles:

Diverse. 2005. Reflections on Monetary Policy 25 Years After October 1979. The Federal Reserve Bank of St. Louis Review, MARCH/APRIL 2005 Vol. 87, No. 2, Part 2.. 2 (2).

The Federal Reserve Bank of St. Louis Review. Available at <http://research.stlouisfed.org/publications/review/05/03/part1/ReviewMarApr05.pdf>

Other:

Kai Leitemo. A list of compulsory readings will be provided on It's learning or in class.

During the course there may be hand-outs, articles and other material on additional topics relevant for the course and the examination.

Recommended reading

Course outline

Monetary policy

1. Introduction: Indicators, targets and operating procedures in monetary policymaking. The monetary transmission mechanism and stylized facts of the effects of monetary policy. Walsh (2003), chapters 1 and 9.

2. New Keynesian economics and optimal monetary policy. Walsh, Chapter 5, 6, 10 and 11. Clarida, Gali and Gertler (1999).

The New Keynesian models for both the closed and the open economy are derived from microfoundations. We discuss optimal monetary policy under various forms of uncertainty, commitment versus discretion, and for different extensions to the basic model.

Fiscal policy

3. Coordination of macroeconomic stabilization policies

How is fiscal and monetary policy coordinated? Does inflation targeting have any implications for the role fiscal policy plays in stabilization policy?

Leitemo (2004). Lecture notes.

4. Pension reform and optimal taxation – fiscal policy for the long run

We discuss the fund-based versus “pay-as-you-go” retirement schemes in an overlapping-generation for a small open economy. Debt build-up and tax-smoothing. Erling Steigum (1994). Romer (2006), chapter 11. Obstfeld & Rogoff (1995), chapter 3.2.

5. Issues in the practical implementation of monetary and fiscal policy..

Computer-based tools

It's learning

Learning process and workload

A course of 6 ECTS credits corresponds to a workload of 160-180 hours.

Please note that while attendance is not compulsory in all courses, it is the student's own responsibility to obtain any information provided in class that is not included on the course homepage/It's learning or text book.

Examination

A group project/presentation (30%) and written final exam (3 hours, 70%)

Specific information regarding student evaluation beyond the information given in the course description will be provided in class. This information may be relevant for requirements for term papers or other hand-ins, and/or where class participation can be one for several elements of the overall evaluation.

This is a course with continuous assessment (several exam elements) and one final exam code. Each exam element will be graded using points on a scale (e.g. 0-100). The elements will be weighted together according to the information in the course description in order to calculate the final letter grade for the course. You will find detailed information about the point system and the cut off points with reference to the letter grades on the course site in It's learning.

Examination code(s)

GRA 66311 accounts for 100 % of the final grade in the course GRA 6631.

Examination support materials

Bilingual dictionary. Exam aids at written examinations are explained under exam information in our web-based Student handbook. Please note use of calculator and dictionary.
<http://www.bi.edu/studenthandbook/examaids>

Re-sit examination

It is only possible to retake an examination when the course is next taught.

The assessment in some courses is based on more than one exam code.

Where this is the case, you may retake only the assessed components of one of these exam codes.

Where this is not the case, all of the assessed components of the course must be retaken.

All retaken examinations will incur an additional fee.

Additional information

Honor Code

Academic honesty and trust are important to all of us as individuals, and represent values that are encouraged and promoted by the honor code system. This is a most significant university tradition. Students are responsible for familiarizing themselves with the ideals of the honor code system, to which the faculty are also deeply committed.

Any violation of the honor code will be dealt with in accordance with BI's procedures for cheating. These issues are a serious matter to everyone associated with the programs at BI and are at the heart of the honor code and academic integrity. If you have any questions about your responsibilities under the honor code, please ask.