

Advanced Domestic Macro: The Political Economy of Monetary and Fiscal Policy

WWS 524
Fall 2007

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*“There have been three great inventions since the beginning of time:
fire, the wheel, and central banking.” – Will Rogers*

Subject Matter

This course is about the economics *and some of the politics* of macroeconomic stabilization policy. Special emphasis is given to central banks as somewhat unique policymaking institutions and, especially, to the Federal Reserve System--although other central banks are mentioned frequently. Since the focus is on monetary and fiscal policy, the course presupposes a working knowledge of the relevant macroeconomic background—e.g., WWS 512c, or the equivalent. However, Topic 3 below serves as a partial review. (*Note: Half of this course was given last year as WWS 594i.*)

A few questions—some positive and some normative—provide unifying themes for the course:

- Why is macro stabilization important—or is it?
- How do central banks make monetary policy decisions?
- What sorts of decisions should be made by technocrats rather than by politicians?
- Do political or communications considerations affect central bank decisions? Should they?
- To what extent are independent central banks undemocratic or unaccountable institutions?
- Is there still a stabilization role for fiscal policy?
- How, if at all, should monetary and fiscal policy be coordinated?

Textbooks

There are no textbooks, but multiple references will be made to the following four books. You do not have to purchase any of these, unless you wish to own them.

Alan S. Blinder, Central Banking in Theory and Practice (MIT Press), 1998.

Alan S. Blinder, The Quiet Revolution: Central Banking Goes Modern (Yale University Press), 2004.

Laurence H. Meyer, A Term at the Fed (Harper Business), 2004.

Steven Solomon, The Confidence Game: How Unelected Central Bankers are Governing the Changed Global Economy (Simon & Schuster), 1995.

The reading list also includes several speeches by Federal Reserve officials. These are available on line on the Fed's website: www.federalreserve.gov. (Click on "News and Events," then "Speeches by Federal Reserve Board members," then chose the year.)

Finally, you may find the following two recent papers useful, as each covers a wide variety of central banking issues. Parts of each are explicitly assigned:

Alan S. Blinder and Ricardo Reis, "Understanding the Greenspan Standard," in Federal Reserve Bank of Kansas City, The Greenspan Era: Lessons for the Future (proceedings of the August 2005 Jackson Hole conference), pp. 11-96 (henceforth, "Blinder (2005)").

Alan S. Blinder, "Monetary Policy Today: Sixteen Questions and about Twelve Answers," in S. Fernandez de Lis and F. Restoy (eds.) Central Banks in the 21st Century, Banco de Espana, 2006, pp. 31-72 (henceforth, "Blinder (2006)"). This book is available on the Bank of Spain's website: www.bde.es/doctrab/confere/confee_9.htm.)

Exams and Assignments

To be determined.

Syllabus and Reading List

(* connotes optional)

1. Why It Matters: The Costs of Business Cycles and Inflation

Robert E. Lucas, Jr., Models of Business Cycles (Blackwell: 1987), Chapter III.

Alan S. Blinder, "Keynes, Lucas, and Scientific Progress," American Economic Review, May 1987, pp. 130-136 (the key sections are II and VII).

Ray C. Fair, "A Vote Equation and the 2004 Election," processed, Yale University, November 2004. (This can be read or downloaded at www.fairmodel.econ.yale.edu)

Stanley Fischer, "Modern Central Banking" in Forrest Capie *et al.*, The Future of Central Banking: The Tercentenary Symposium of the Bank of England (Cambridge University Press), 1994, Section 2.4.

* Robert E. Lucas, Jr., "Macroeconomic Priorities," American Economic Review, March 2003, pp. 1-14.

* Gadi Barlevy, “The cost of business cycles and the benefits of stabilization,” Economic Perspectives, Federal Reserve Bank of Chicago, 2005:1Q, pp. 32-49.

* Ray C. Fair, “The Effect of Economic Events on Votes for President,” Review of Economics and Statistics, 1978, pp. 159-173.

2. The Culture of Central Banking

Laurence H. Meyer, “Come with Me to the FOMC,” The Gillis Lecture, April 1998. (On Fed website.)

Solomon, Chapter 9

* William Greider, Secrets of the Temple: How the Federal Reserve Runs the Country (Simon and Schuster), 1987, Chapter 2.

* Marvin Goodfriend, “Monetary Mystique: Secrecy and Central Banking,” Journal of Monetary Economics 17 (January 1986), pp. 63-92.

3. The Practical Macroeconomics of Monetary Policy: Gaps, “Neutral” Rates, Taylor Rules, and All That

Blinder (1998), Chapter 1, omitting Section 5; Chapter 2, Sections 1-3.

Fischer, “Modern Central Banking,” Sects. 2.3 and 2.5.

Meyer, pp. 36-40 and Chapters 3, 4, and 6

Blinder (2005), pp. 24-32 (on Taylor rules) and pp. 44-46 and 50-61 (on core vs. headline inflation)

* John B. Taylor, “Monetary Policy Guidelines for Employment and Inflation Stability,” in R.M. Solow and J. B. Taylor, Inflation, Unemployment, and Monetary Policy (MIT Press), 1998, Chapter 2.

* Alan S. Blinder and Janet L. Yellen, The Fabulous Decade: Macroeconomic Lessons from the 1990s, Chapters 5-9.

* N. Gregory Mankiw, “The Macroeconomist as Scientist and Engineer,” Journal of Economic Perspectives, Fall 2006, pp. 29-46.

4. Central Bank Independence—From Whom?

Blinder (1998), Chapter 3, pp. 53-66

Fischer, “Modern Central Banking,” Sections 2.7-2.9

Solomon, Chapter 2

Adam S. Posen, “Why Central Bank Independence Does Not Cause Low Inflation: There is No Institutional Fix for Politics,” in Richard O’Brien, ed. Finance and the International Economy 7 (Oxford University Press), 1993, pp. 41-54.

Blinder (2004), Chapter 3

* Henry W. Chappell, Jr. *et al.*, Committee Decisions on Monetary Policy, (MIT Press), 2005, Chapter 9, pages 139-151; Chapter 4.

* Burton Abrams, “How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes,” Journal of Economic Perspectives, Fall 2006, pp. 177-188.

5. Central Banking and Democracy

Blinder (1998), Chapter 3, pp. 66-75.

Solomon, Chapter 26

Alan S. Blinder, “Is Government too Political?” Foreign Affairs, Nov./Dec. 1997, pp. 115-126.

* Christopher J. Waller, “A Bargaining Model of Partisan Appointments to the Central Bank,” Journal of Monetary Economics, 29 (1992), pp. 411-428. (Read for the ideas, not the details.)

* Jon Faust, “Whom Can We Trust to Run the Fed? Theoretical Support for the Founders’ Views,” Journal of Monetary Economics, 37 (April 1996), pp. 267-283. (Read for the ideas, not the proofs.)

Tommaso Padoa-Schioppa, The Euro and Its Central Bank (MIT Press, 2004), pp. 27-36, 91-96 only.

Willem Buiter, “Rethinking Inflation Targeting and Central Bank Independence,” inaugural lecture, London School of Economics, October 2006, pp. 14-29 only.

6. The Trend toward Transparency

Ben S. Bernanke, “Fedspeak,” speech to the meetings of the American Economic Association, San Diego, January 3, 2004.

William Poole, “Fed Transparency: How, Not Whether,” Federal Reserve Bank of St. Louis Review, Nov./Dec. 2003, pp. 1-8.

Roger W. Ferguson, Jr., “Why Central Banks Should Talk,” speech to the Graduate Institute of International Studies, Geneva, January 8, 2002.

Blinder (2004), Chapter 1

Blinder (2005), pp. 38-44 only.

Blinder (2006), pp. 11-17 only.

* Lars E.O. Svensson, “The Instrument-Rate Projection under Inflation Targeting: The Norwegian Example,” in Bank of Canada, Inflation Targeting: Problems and Opportunities, February 2006.

* Alan Blinder *et al.*, How Do Central Banks Talk?, Geneva Reports on the World Economy 3, 2001, Section 2.7, Chapter 4, Chapter 5

* William Poole, Robert H. Rasche, and Daniel L. Thornton, “Market Anticipations of Monetary Policy Actions,” Federal Reserve Bank of St. Louis Review, July-August 2002, pp. 65-94.

* Alan S. Blinder *et al.*, “Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence,” draft discussion paper, 2007.

7. Decisionmaking by Committee

Blinder (2004), Chapter 2

Alan S. Blinder, “Monetary policy by committee: Why and how?” European Journal of Political Economy, March 2007, pp. 106-123. (Note: There is considerable duplication between this paper and the chapter just above; the new material is mainly in Section 4.)

Anne Sibert, “Central Banking by Committee,” International Finance, August 2006, pp. 145-168.

Chappell et al., Chapters 6-8 (Note: You can skim Chapter 6, but knowing what is done in Chapter 6 is necessary to understand Chapters 7 and 8.)

* Alan S. Blinder and John Morgan, “Are Two Heads Better than One?: Monetary Policy by Committee,” Journal of Money, Credit, and Banking, Oct. 2005, pp. 789-812.

* Alan S. Blinder and John Morgan, “Leadership in Groups: A Monetary Policy Experiment,” CEPS Working Paper No. 151, July 2007.

8. Inflation Targeting

Ben Bernanke, et al., Inflation Targeting: Lessons from the International Experience (Princeton: 1999), Chapters 2 and 3.

Lars E.O. Svensson, “Monetary Policy and Real Stabilization,” in Federal Reserve Bank of Kansas City, Rethinking Stabilization Policy, 2002, pp. 261-288 only.

Ben S. Bernanke, “A Perspective on Inflation Targeting,” Speech to the National Association of Business Economists,” Washington, March 25, 2003 (on Fed website).

Laurence H. Meyer, “Practical Problems and Obstacles to Inflation Targeting,” Federal Reserve Bank of St. Louis Review, July/August 2004, pp. 151-160. (available online at St. Louis Fed website)

*Lars E.O. Svensson, “Inflation Forecast Targeting: Implementing and Monitoring Inflation Targets,” European Economic Review, 41, 1997, pp. 1111-1146.

* Laurence Ball and Niamh Sheridan, “Does Inflation Targeting Matter?,” in B. Bernanke and M. Woodford (eds.), The Inflation Targeting Debate (Chicago: 2005).

* Frederic Mishkin and Klaus Schmidt-Hebbel, “Does Inflation Targeting Make a Difference?,” NBER Working Paper No. 12876, January 2007.

9. Does Globalization Change the Practice of Monetary Policy?

Ben S. Bernanke, “Globalization and Monetary Policy,” Speech to Stanford Institute for Economic Policy Research, March 2, 2007.

Blinder (2005), pp. 61-64.

* International Monetary Fund, “How Has Globalization Affected Inflation?,” Chapter 3 (pp. 97-134) of 2006 World Economic Outlook.

* Jane Ihrig, Steven Kamin, Deborah Lindner, Jaime Marquez , “Some Simple Tests of the Globalization and Inflation Hypothesis,” Board of Governors of the Federal Reserve System, International Finance Discussion Papers 2007-891 (April 2007).

* Laurence Ball, “Has Globalization Changed Inflation?,” NBER Working Paper No. 12687, November 2006.

* Robert Feenstra and J. Bradford Jensen, “Globalization’s Compositional and Distributional Implications for the US Economy,” processed, UC Davis, September 2006.

10. Asset Bubbles and Monetary Policy

Alan Greenspan, “Opening Remarks,” in Federal Reserve Bank of Kansas City, Rethinking Stabilization Policy, 2002.

Ben S. Bernanke, “Asset-Price ‘Bubbles’ and Monetary Policy,” speech to National Association for Business Economics, New York, October 15, 2002.

Stephen Cecchetti *et al.*, Asset Prices and Central Bank Policy, Geneva Reports on the World Economy 2, 2000, Sections 2.1, 2.2, Chapter 3, Sections 4.1, 4.4, 4.5.

Blinder (2005), pp. 64-70 only.

* Meyer, Chapters 7-9

11. The Two Cultures: Making Fiscal vs. Monetary Policy

[Readings to be provided]

12. Crisis Management and the Financial Panic of 2007

* Meyer, Chapter 5

* Robert Rubin and Jacob Weisberg, In an Uncertain World (2003), Chapters 8-10. You might also peruse some earlier chapters on the “Tequila Crisis” of 1994-95.

* Alan Greenspan, The Age of Turbulence (2007), pages to be assigned.

[Other readings may be provided]

13. Interactions between Monetary and Fiscal Policy

Alan S. Blinder, “Issues in the Coordination of Monetary and Fiscal Policy,” in Federal Reserve Bank of Kansas City, Monetary Policy Issues in the 1980s, 1982, pp. 8-13, 19-30 only..

Matthew Canzoneri, Robert Cumby, and Behzad Diba, “Should the European Central Bank be Concerned about Fiscal Policy?,” in Federal Reserve Bank of Kansas City, Rethinking Stabilization Policy, 2002, pp. 333-357 only. (Note: My discussion of this paper that follows in the same volume may help.)

* Christopher Sims, “The Precarious Fiscal Foundations of EMU,” De Economist, 1999, pp. 415-436 (available on his website www.princeton.edu/~sims)

14. Is There a Role for Discretionary Fiscal Policy?

Alan S. Blinder, “The Case Against the Case Against Discretionary Fiscal Policy,” in R. Kopcke, G. Tootell, and R. Triest (eds.), The Macroeconomics of Fiscal Policy (MIT Press: 2006), pp. 25-61. (Section 2 is optional.)

* Alan J. Auerbach, “Is There a Role for Discretionary Fiscal Policy?,” in Federal Reserve Bank of Kansas City, Rethinking Stabilization Policy, 2002, pp. 109-150.

* Laurence Seidman, Automatic Fiscal Policies to Combat Recessions (M.E. Sharpe: 2003).

* Olivier Blanchard and Roberto Perotti, “An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output,” Quarterly Journal of Economics, November 2002, pp. 1329-1368.

* David Johnson, Jonathan Parker, and Nicholas Souleles, “Household Expenditure and the Income Tax Rebates of 2001,” American Economic Review, December 2006, pp. 1589-1610.

* Matthew Shapiro and Joel Slemrod, “Consumer Response to the Timing of Income: Evidence from the Change in Tax Withholding.” American Economic Review, March 1995, pp. 274-283.

15. Can “Contractionary” Fiscal Policy Be Expansionary?

Blinder and Yellen, The Fabulous Decade, Chapter 4 and “Lesson 2” on page 84.

Auerbach, “Is There a Role for Discretionary Fiscal Policy?,” pp. 135-140.

Francesco Giavazzi, Tullio Jappelli, and Marco Pagano, “Searching for Non-Linear Effects of Fiscal Policy: Evidence from Industrial and Developing Countries,” European Economic Review, June 2000, pp. 1259-1269 (rest optional).

* Stephen Turnovsky and Marcus Miller, "The Effects of Government Expenditures on the Term Structure of Interest Rates," Journal of Money, Credit and Banking, 1984, pp. 16-33.

* Olivier Blanchard, "Current and Anticipated Deficits, Interest Rates and Economic Activity," European Economic Review, 1984, pp. 7-27.