

**Advanced Domestic Macro:
The Political Economy of Monetary Policy**

WWS 524
Fall 2008

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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 central banking, especially monetary 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 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.

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

- Why is monetary policy 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?
- What special issues are raised by crisis management?
- What special issues are raised by globalization?

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 "Testimony and Speeches." Then select "Speeches" and chose the year.)

Finally, you may find the following two review 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

There will be a regular final exam, most likely a take-home. Others to be discussed.

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, "The Effect of Economic Events on Votes for President: 2004 Update," November 2006. (This can be accessed at www.fairmodel.econ.yale.edu. Click on "Presidential Vote Equation: 2008.")

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)

*Tobias Adrian and Hyun Song Shin, “Financial Intermediaries, Financial Stability and Monetary Policy,” paper presented at the Jackson Hole conference, August 2008.

*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.

*Albert Alesina and Lawrence Summers, “Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence,” Journal of Money, Credit and Banking, May 1993, pp. 151-162.

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.

Ben S. Bernanke, “Federal Reserve Communications,” speech delivered on November 14, 2007.

*Michael Woodford, “The Case for Forecast Targeting as a Monetary Policy Strategy,” Journal of Economic Perspectives, Fall 2007, pp. 3-24. (This paper appears again under Topic 8.)

*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, “Central Bank Communication and the Financial Markets,” paper prepared for Sveriges Riskbank conference, September 2008.

*Alan S. Blinder *et al.*, “Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence,” NBER Working Paper No. 13932, April 2008 (to be distributed in class).

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.)

Alan S. Blinder, “Making Monetary Policy by Committee,” paper presented at Bank of Canada conference, Ottawa, July 2008. (available online at <http://econ2008.bankofcanada-conference.ca/wp-content/blinder.pdf>)

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.

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

8. Inflation Targeting

Michael Woodford, “The Case for Forecast Targeting as a Monetary Policy Strategy,” Journal of Economic Perspectives, Fall 2007, pp. 3-24.

Carl Walsh, “Inflation targeting: What have we learned?,” paper presented at Bank of Canada conference, Ottawa, July 2008. (available online at <http://econ2008.bankofcanada-conference.ca/wp-content/walsh.pdf>)

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

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

*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. 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.

Frederic Mishkin, “How Should We Respond to Asset Price Bubbles?,” speech at Wharton School, Philadelphia, May 15, 2008.

*Alan S. Blinder, “Two Bubbles, Two Paths,” The New York Times, June 15, 2008, p. B6.

*Meyer, Chapters 7-9

10. Crisis Management and the Financial Crisis of 2007-2008

Note: Up-to-date and required readings will be assigned latter.

*Robert Shiller, The Subprime Solution (2008), Chapters 3 and 5.

*Willem Buiters, “Central Banks and Financial Crises,” paper presented at the Jackson Hole conference, August 2008, selected pages to be assigned.

*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), Chapter 20.

*Franklin Allen and Douglas Gale, Understanding Financial Crises (Oxford UP, 2007), Chapter 1. (Note: I focus on the role of central banks and treasuries in reacting to

crises, which is not the focus of this book). But you might find this chapter a useful overview of the history and some facts.)

*Roger Lowenstein, When Genius Failed (Random House, 2000), Chapter 10 and Epilogue

*Paul Blustein, The Chastening (Public Affairs, 2001), Chapters 1, 5, 9, 10, 11.

11. Should the Central Bank be a Bank Regulator?

Blinder (2006), Issue # 5.

*Charles Goodhart, “The Organizational Structure of Bank Supervision,” Financial Stability Institute occasional paper 1, Basle, November 2000.

*Roger Ferguson, “Alternative Approaches to Financial Supervision and Regulation,” Journal of Financial Services Research, 2000, pp. 297-303.

12. 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.

Alan Greenspan, The Age of Turbulence, Chapter 20.

Frederic Mishkin, “Globalization, Macroeconomic Performance, and Monetary Policy,” speech given on September 27, 2007.

*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.