

PRINCETON UNIVERSITY
Department of Economics
Woodrow Wilson School of Public and International Affairs

The Political Economy of Central Banking

ECO315 and WWS 594i
Spring 2006

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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*—both internal and external—of central banks as policymaking institutions. Since the focus is on monetary policy, the course presupposes a working knowledge of the relevant macroeconomic background—e.g., ECO 311, WWS 512c, or the equivalent. (However, Topic 2 below serves as a partial review.) The greatest emphasis will be on the Federal Reserve System, although other central banks will be mentioned frequently.

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

- What do central banks do? How do they make monetary policy decisions?
- What *should* central banks do—that is, what sorts of decisions should be made by central bankers rather than by politicians?
- Do political or communications considerations affect central bank decisions? Should they?
- To what extent are central banks undemocratic or unaccountable institutions?

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. But only a few pages 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. (This book is also available on the Bank of Spain's website: www.bde.es/doctrab/confere/confee_9.htm.)

Exams and Assignments

For all students: There will be one or two problem sets during the half-term, and a take-home exam (that is, a paper) at the end of the six weeks.

For WWS graduate students: There will also be one special discussion session (to be scheduled during the half-term) and an additional short essay focusing on central banks as governmental institutions, due at the end of the six weeks.

Syllabus and Reading List

(* connotes optional)

1. 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 in Central Banking," Journal of Monetary Economics 17 (January 1986), pp. 63-92.

2. 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.

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, Sects. 2.3, 2.4, 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.

3. Central Bank Independence—From Whom?

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

Fischer, 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: The AMEX Bank Review Prize Essays in Memory of Robert Marjolin (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.

4. 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.

5. 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.

* Donald I. Kohn and Brain P. Sack, “Central Bank Talk: Does It Matter and Why?,” FEDS Discussion Paper 2003-55 (November), Board of Governors of the Federal Reserve System.

6. Decisionmaking by Committee

Blinder (2004), Chapter 2

Alan S. Blinder, “Monetary policy by committee: Why and how?” European Journal of Political Economy, forthcoming 2006. (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,” unpublished manuscript, 2007.

7. 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

8. If we have time, I will add another topic:

- (a) inflation targeting
- (b) Should central banks also be bank regulators?
- (c) Does globalization change the practice of monetary policy?