

Finance 416
Monetary Theory and Policy
Spring 2008

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Office Hours: Tuesday and Thursday, 12:35 - 1:15, and by appointment

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Overview of Course: This course aims to study the development of the banking and monetary systems in the United States. In addition, the course examines the design of monetary policy. It will be both descriptive and theoretical.

In particular, the course studies:

1. The political and economic implications of the design of central banking systems.
2. The goals of monetary policy along with an investigation of the various policy tools used by the Federal Reserve.
3. The macroeconomic impact of monetary policy. In particular, how private sector expectations play a role in the effectiveness of monetary policy.
4. Recent economic events in the United States.

Economics is a science--a study of behavior. In order to understand the implications of monetary policy and the design of central banking systems, we will develop formal models to analyze behavior. This will require us to describe various economic frameworks in which each group of individuals has objectives. We proceed by analyzing how each group achieves these objectives and the resulting predictions of the model. You will be expected to use economic analysis such as graphs and mathematical tools to do well.

Grades: Semester grades will be based on the following scale: A+ (97-100), A (92-96.9), A- (90-91.9), B+ (87-89.9), B (82-86.9), B- (80-81.9), C+ (77-79.9), C (70-76.9), D (60-69.9), F (0-59.9). If the class average for an exam is less than 75%, I will multiply the score of each exam by a scaling factor so that the average is 75%.

Bonus points are awarded in *addition* to your final course average.

Your course average will be determined based on the following:

1. Quizzes (20%)

I will occasionally give quizzes throughout the course which will be based on *any* of the following depending on the subject matter: (i) multiple-choice questions, (ii) short answer questions, (iii) brief essays, and/or (iv) problems. You should expect a minimum of 4 quizzes throughout the semester. *I will announce the dates of quizzes one week in advance.*

You can drop one quiz grade this semester. Therefore, if you should miss a quiz for any reason, I will count that as your dropped quiz. If you should miss a second quiz due to an **excused absence** (see below), I will use your average grade for the remaining quizzes as your score for your missed quiz.

Since I will be announcing the dates of the quizzes one week in advance and it is *your* responsibility to attend class and be aware of class discussions, then it is *your* responsibility to be aware of the quiz dates.

2. Exam 1 (30%)

The date of the first exam is Tuesday, March 4th. The format of the exam will consist of *any* of the following depending on the subject matter: (i) multiple-choice questions, (ii) short answer questions, (iii) brief essays, and/or (iv) problems.

If the class average (the average for the combined scores from Economics 416 and Finance 416) for the exam is less than 75%, I will multiply the score of each exam by a scaling factor so that the average is 75%. For example, if the class average is 68%, then I will multiply everyone's score by 1.11. If your original score is 80%, your score with the curve will be 89%. However, if your original score is 60%, your grade on the exam will be only 67%.

Makeup examinations will be given only for **excused absences**. I define an excused absence as: illness of the student or serious illness of a member of the student's immediate family; death of a member of the student's immediate family; University sponsored trips; or major religious holidays. Since employment can be an important goal following graduation, I will also count job interviews as an excused absence. However, if you currently have a part-time job, being scheduled for work is NOT valid for an excused absence. The exam dates are listed directly above – if you decide to remain in this course, then you are obligated to be here on these dates.

In each case, you are required to provide documentation (a note from the University Health Service, for example). Makeups will not be identical to the original exam and may be more difficult. **If you have not scheduled your makeup examination before the scheduled date, you must contact me within 48 hours of the examination date by e-mail.** Otherwise, you will not be allowed to take a make-up exam.

If you do not have an excused absence, then a score of 0% will be assigned for your grade.

After the exams have been graded, I will briefly review them in class. **After the review, I will collect them.** If, after taking a look at your exam and your grade, you would like to request your exam to be graded again, you must provide a request **in writing** during class. If you feel an error was made in the grading of a question, you should indicate the *precise* reasons for why you believe your answer deserves

more credit. If you write “I did not get enough credit on question 2”, then I will not regrade your answer.

3. Exam 2 (30%)

I do not give a cumulative final exam. The second exam will be given during finals week as determined by the Registrar. The Registrar has scheduled our exam for Friday, May 9th from 8:00 a.m. to 10:30 a.m. You will have the entire two and a half hours for the second exam since it is given during finals week. ***Again, make-up examinations will only be provided if you have an excused absence.***

A note on exams and quizzes: The course is cumulative in the sense that much of the material covered builds upon what we have done up to that point. Simply because we have already taken an exam on a topic does not relieve you from understanding that material.

Because economics is a problem-solving discipline, the only way to enhance your understanding of the material will be through hands-on experience. Simply listening to the lectures, reading the text, and reviewing your notes will ***NOT*** be enough to master the techniques presented in class. To do well in this course you will **need to spend time outside of class** solving problems and extending what has been discussed in class.

4. Federal Open Market Committee Presentations (20%)

Towards the end of the course, we will take a “hands-on” approach to better understand how the Federal Reserve chooses its policy actions along with recent events in the economy. In order to do this, we will hold a mock Federal Open Market Committee meeting. I will arrange members of the class into small groups of around 3 students, depending on your interests. Each group will be expected to imitate a specific aspect of the decision-making process at the FOMC. For example, one group will collect data on recent employment figures since 2004. You will be expected to tell the class how the data are measured and compiled as well as a survey of what has developed over the past 4 years.

Each group will make a formal presentation to the class that will take approximately 20 minutes. In addition, presentations will be made available to the class to use in order to study the material for the second exam in the course. Each group will also be responsible for writing three multiple choice questions that could appear on an exam. I will provide more details after the midterm test.

4. Bonus Points: Attendance

Bonus points may come from attendance along with class participation. These will be added to your total score at the end of the course. A maximum contribution of three percentage points will be allowed. Thus, you may be able to raise your grade if your score is on the borderline at the end of the semester.

Attending class and being actively involved in class discussions will enhance your understanding of the course material. This means, among a number of things, that you are prepared for class to begin as scheduled and are actively following class discussions. In other words, my class is to begin at 11:00 a.m. on Tuesday and Thursday. Therefore, you should be *prepared for class to begin at 11:00*. Arriving in the classroom at 11:00 automatically implies that you are not prepared for class. So, to be clear: I do not give partial credit for attendance. If you are late or leave early for an unexcused reason, you will not receive credit for attending class.

The following is the grading scale for your attendance grade:

Lectures Missed and Grade: 0-2 (3%), 3-4 (2%), 5-6 (1%), 7 or more lectures missed (0%).

I will begin taking attendance for the course on Tuesday, January 15th. If you have an excused absence (see below), I will give you credit for missing a lecture.

If you impose costs on your classmates and me by negatively contributing to the learning environment in class, I will deduct points from your score. I subsidize a fun, interactive learning environment, but I will also tax poor effort in the classroom.

When I come to class, I am focused on presenting the course material. I expect you to be completely focused on learning it. You will find that I arrive respecting the educational process - that comes with giving you the attention you deserve. I expect the same in return.

Examples of Inappropriate Behavior:

1. Allowing your cell phone to ring.
2. Reading newspapers and doing crossword puzzles.
3. The only discussion that should occur in class is when you are asking me a question. This is my classroom - thus, unless solicited, I don't expect to hear you. Quickly asking your classmates a clarifying question here or there is acceptable.

If you should engage in any form of inappropriate behavior, then you cannot expect to learn the material very well. That's your choice - I assume that you will engage in self-interested, utility-maximizing behavior. However, inappropriate behavior is also distracting. Thus, it imposes negative externalities on me and your classmates. If you have taken courses in microeconomic analysis before, then you know that to correct negative externalities, the optimal public policy is to tax them. If you engage in poor classroom behavior, expect to be taxed. This will automatically imply loss of bonus points for attendance. If you work on crossword puzzles or allow your cell phone to ring in my class, then expect to be taxed.

Since this course is designed to be accessible to both undergraduate and graduate students, I will occasionally provide additional lectures (outside of class) on advanced topics concerning monetary theory and policy. Your attendance will not be required and the materials will not intentionally be part of any examination. If you think that the topic sounds interesting, you are encouraged to join us. If not, that's o.k. too. If you attend a meeting, then I will include your participation as part of the bonus points that are awarded at the end of the semester.

Readings: The following is the main written resource for the course:

Money, Banking, and Financial Markets (1st edition), Stephen G. Cecchetti, McGraw-Hill, 2006.

Although the book is the main resource for the course, I will frequently reference other reading materials during the semester. In particular, I will use articles published by Federal Reserve Bank economists as reference material. I will announce the web address for these articles in class. Other readings will be

available in the business school library.

The following additional references will occasionally be used and are available in the library:

The Theory of Monetary Institutions, Lawrence H. White, Blackwell Publishing, 1999.

A History of Money From Ancient Times to the Present Day, Glyn Davies, University of Wales Press, 1994.

Secrets of the Temple: How the Federal Reserve Runs the Country, William Greider, Simon and Schuster, Inc., 1987.

The assigned readings are intended to **compliment** the lectures. **You should not treat the textbooks as substitutes for attending class.** In addition to the texts, selected readings will also be used throughout the course. Any additional reading beyond those listed on the syllabus will be announced in class.

Finally, since we will discuss ongoing economic issues and policy debates during the course, it would be a good idea to review the business section of the newspaper and pay close attention to current events.

Office Hours: I will routinely be available during office hours to discuss the material with you. You are welcome to discuss questions in groups. If I am currently meeting with one of your classmates, please come in and join us!!! There is no point in wasting time just to ask the same question. Furthermore, you can learn a lot by listening to questions from other students. You are welcome to stop by during office hours even if you do not have any immediate questions. Please send me an email if you have a quick question and do not want to wait until the next class.

Academic Integrity

I will not tolerate cheating in any form. Be aware of this. If I find evidence of academic dishonesty, I will notice the Dean's office immediately.

Exams: You may have a pen or pencil, a ruler or straightedge, and a nonprogrammable hand-held calculator at your desk while taking an exam. Note that calculators **must** be non-programmable. Any other forms of assistance or sources of information are prohibited unless announced in class. **If you do not have a nonprogrammable hand-held calculator, let me know at least 48 hours prior to the exam and I will provide one for you.**

ONE MORE TIME:

My class begins at 11:00 on Tuesday and Thursday -- be prepared for class to begin on time.

Disability Message

The University of Alabama encourages qualified persons with disabilities to participate in its programs and activities. If you anticipate needing any type of accommodation in this course or have questions about physical access, please register with the Office of Disability Services (348-4285). Please let me know as soon as possible if you will be requesting special arrangements during the semester.

Important Dates:

Tuesday, March 4

Exam 1

Wednesday, March 26

Last Day to Drop with a grade of “W”

Friday, May 9

Exam 2

Course Outline

I. The Development of the Financial System and the Role of the Federal Reserve

1. The Current Structure of the Federal Reserve System

A. What is the structure of the Federal Reserve System and what are the goals of the Federal Reserve System? How should the nation’s central bank be designed to achieve its goals?

Cecchetti, Ch. 15 “Central Banks in the World Today”

Ch. 16 “The Structure of Central Banks: The Federal Reserve and the European Central Bank”

B. What are the tools of the Fed?

In order to achieve these goals, how should the Federal Reserve intervene in the Financial System? As we will see, this has evolved over time.

Cecchetti, Chapter 18: The Federal Reserve’s Monetary Policy Toolbox

Hein, Scott E. and J.D. Stewart, “Reserve Requirements: A Modern Perspective,” *Federal Reserve Bank of Atlanta Economic Review*, 4th Quarter 2002.

Bennett, Paul and S. Peristiani, “Are U.S. Reserve Requirements Still Binding?” *Federal Reserve Bank of New York Economic Review*, May 2002, pp. 53-68.

2. The Development of the Payments System

The beginnings of the payments system. The evolution of money and the essential functions of money in the economy. From commodity money to electronic cash. The Search Model of Acceptability of Money. The Baumol-Tobin Model of Money Demand.

Cecchetti, Chapter 2 “Money and the Payments System”

Cecchetti, Chapter 20 “Money Growth, Money Demand, and Modern Monetary Policy”

Weiner, Stuart E. “Electronic Payments in the U.S. Economy: An Overview,” *Federal Reserve Bank of Kansas City Economic Review*, Fourth Quarter 1999.

3. Origins of Central Banking in the United States

Experiences with Banking Panics and Bank Runs in the United States. The Diamond-Dybvig Model of Bank Runs. The Need for a Lender of Last Resort and the Creation of the Federal Reserve System in 1913. Risk in the Financial System.

Cecchetti, Chapter 5 “Understanding Risk”

White, Chapter 6: “Should Government Play a Role in Banking?”

Application: The Federal Reserve actively serves as a Lender of Last Resort. Federal Reserve actions in response to the damage to the financial system are documented in the following article:

McAndrews, J. and S. Potter, “Liquidity Effects of the Events of September 11, 2001,” *Federal Reserve Bank of New York Economic Review*, November 2002.

II. The Macroeconomic Effects of Monetary Policy

A. The Effects of Inflation

One of the Federal Reserve’s primary objectives is to promote an economy that has low inflation. Why? What are the economic costs of inflation? What are the appropriate tradeoffs between inflation and unemployment?

Aiyagari, R., “Deflating the Case for Zero Inflation,” *Federal Reserve Bank of Minneapolis Quarterly Review*, Summer 1990, pp. 2-11.

B. Survey of Recent Macroeconomic Conditions and Monetary Policy

Kliesen, Kevin L., “The 2001 Recession: How Was It Different and What Developments May Have Caused It?” *Federal Reserve Bank of St. Louis Economic Review*, September/October 2003.

Schreft, Stacey L. and A. Singh, “A Closer Look At Jobless Recoveries,” *Federal Reserve Bank of Kansas City Economic Review*, Second Quarter 2003.

C. The Transmission Channel for Monetary Policy: How does monetary policy affect real GDP (unemployment) and inflation in the economy?

Cecchetti, Ch. 21 “Modern Monetary Policy and Aggregate Demand”

a. Aggregate Supply and Monetary Policy under Price Flexibility: The Classical Model

b. Aggregate Supply and Monetary Policy with Labor Contracts: The New Keynesian Model

D. Conducting Monetary Policy in Practice: Federal Open Market Committee Meetings and the Direction of Monetary Policy

At this point, I will break the class into groups. You will each report on a particular aspect of macroeconomic data. The class as a whole will be responsible for making policy recommendations about the Federal Funds Rate.

Cecchetti, Ch. 16 “The Structure of Central Banks: The Federal Reserve and the European Central Bank”

Meyer, Laurence H. “Come with Me to the FOMC,” *Federal Reserve Bank of Minneapolis*, June 1998.

III. Design of Monetary Policy and the Role of Expectations

What is the role of credibility for policy? How do expectations affect the effectiveness of monetary policy?

Topics: Monetary Policy Rules, the Taylor Rule, Credibility, Rules vs. Discretion in Policy-making, Central Bank Independence