Bristol Business School

Module handbook: **2005/06**

Module Code: **UPEN47-15-M**

Module Title: **Monetary Economics**

School of: **Economics**

Module Leader: **Peter Howells**

Tutor	Dr Peter Howells
Tutor's Office Hour	Tues: 11.30-12.30; Thurs: 10.30-11.30
Tutor's phone number	83684
Tutor's email address	peter.howells@uwe.ac.uk

Contents

1. Introduction

This course examines recent developments in monetary policy and the theoretical basis for those developments. In doing this, it seeks to show how the behaviour of banks, as autonomous, profit-seeking institutions, influences the conduct and outcome of monetary policy.

The best way to contact me is via email:
Peter.Howells@uwe.ac.uk
As a general rule, emails are forwarded from this address automatically, even at weekends and vacations, so you should get a fairly prompt response.
The internal phone no. is 83684.
So far as I can tell at the moment, my office hours are Tuesday 11.30 and Thursday 10.30 and my office is 4C18C.

2. Learning Outcomes

At the end of this module, students should be able:

- Show a critical awareness of the latest literature and current developments in monetary economics
- distinguish between exogenous and endogenous paradigms of money supply and show a critical awareness of the shortcomings of both
- explore critically the link between the exogenous paradigm and the demand for money literature
- appreciate the arguments underlying different views of the transmission mechanism
- take a critical view of the current policy framework including the roles of independence and transparency

3.Organisation of the Module

3.1. Teaching and Learning Methods

The basic framework is one of lecture and seminar (one hour of each per week). As a general rule, the lecture session will be one of exposition and the seminar session will offer opportunity for discussion and elaboration of material derived from the preceding lecture combined with additional reading.
However, there will be departures from this framework depending upon the part of the syllabus being covered. Some lecture slots will be interactive, giving a chance for debate on topical issues raised throughout the module while some seminars will involve exercises in calculation, interpretation and analysis of current events as reported in the financial media and the use of statistical and other web resources.

3.2. Student responsibilities

Lectures
You should be aware that lectures are designed to provide a framework for discussion and analysis. Lectures provide insights into issues and debates, as well as highlighting the importance of people, places and events. In other words, the lectures set out the context in which a more detailed examination is undertaken in the seminars. Your responsibility therefore is to attend these

lectures on a regular basis. **Failure to do so may seriously affect your ability to keep abreast of the course and hence impact on your final grade.**

Seminars

A seminar is designed to enable students to investigate an issue or theme in greater detail. The onus is on you to keep up to date with the reading on a weekly basis**. Seminars work better if everyone has done some preparatory reading, have thought about interesting questions to ask and come along prepared to discuss the theme in question.** Do not leave it to others to do the work. As you can see the reading lists for seminars are extensive. The purpose is two fold: to give an idea of what is available in our library; and to introduce various opinions expressed by a number of authors. This does not mean that just because a book is not listed here that it may not be relevant to the course. **We would encourage you from the outset to explore the wide variety of material contained in our library, which can be equally useful when preparing for a seminar or writing an essay.** Equally important, you are strongly encouraged to use journal articles, which publish the latest research. Articles are extremely useful because they concentrate on a specific issue or debate. They get to the heart of a debate and therefore provide insight into complex issues. So get into the habit of using the journals for all facets of your work.

Library

You are expected to use the full potential of the UWE library system. As a multi-campus institution, resources are scattered. Books and periodicals may be housed on only one site. So be prepared, especially when preparing essays, to use the inter-site loan system or (better still) travel to the other sites to obtain relevant material. Since this is a postgraduate course you will be expected to be aware of and make use of recent publications in the journals. It is impossible for any university these days to stock all the relevant journals but UWE has a good stock and it also subscribes to many more journals in electronic form. This means that you can download and print your own copy of papers. You should get acquainted with the procedure at the earliest opportunity.

Finally, **remember that this is a postgraduate course.** You are expected to be able to cover a lot of ground at a high level in a short space of time. Notice that the course is divided into modules which are just one semester long. This means that they last for approximately 12 weeks. This in turn makes it very difficult to recover lost time. You must be prepared to start the course promptly and to stay with it week by week.

3.3. Staff responsibilities

Staff will endeavour to produce useful, interesting and thought provoking lectures, which are well informed by up-to-date secondary literature and, where appropriate, by visual aids. In seminars tutors will help to generate and sustain discussion while at the same time recognising the students' responsibility to stimulate debate. They will also try their best to return work, with detailed feedback, within three working weeks of the submission date. Staff will be available to discuss your work on a one-to-one basis at specified times. In addition, they will make time to discuss issues raised by the group in the regular weekly seminar slot.

3.4. Facilities and Resources

The main resources for this module are books, articles, newspapers and websites. These are listed in detail the final section, 10, below. The numbers in square brackets, [ ], in the 'Reading' below identify these resources. The codes are explained in section 10. As a general rule, all lecture notes and any documents which are handed out will be made available on a website. Details will be provided later.

4. Module Programme and lecture details

We have tried to organise the course around one main textbook. This is:

Keith Bain and Peter Howells, *Monetary Economics: Policy and its Theoretical Basis* (Palgrave, 2003)

But it is impossible for textbooks to incorporate the latest developments and ideas and so this will have to be supplemented by reference to journal articles and materials on the internet.

Note: the numbers in square brackets, [ ], under 'Reading' refer to items listed in section 9 below.

Lect. no.	UWE week	w/c date	Title	Reading
1	26	23.1.06	Money, balance sheets and the flow of funds	[1] chs 2 and 3
2	27	30.1.06	Modelling the money supply	[1] ch.3; [2] §V
3	28	6.2.06	Money supply and control in the UK	[1] ch.4; [22] [20-1], [25-7], [29-30]; [33]
4	29	13.2.06	The demand for money (theory)	[1] ch.5; [4] chs 5,6; [3] chs. III + IV
5	30	20.2.06	The demand for money (evidence)	[1] ch.6 [4] ch.11
6	31	27.2.06	Instruments of monetary policy	[1] ch.7; [22]; [32]
7	32	6.3.06	The transmission mechanism	[1] ch.8; [4] ch.9; [3] ch.XII; [32]
8	33	13.3.06	Rules and discretion	[1] ch.9; [4] ch.10; [3] ch.XV
9	34	20.3.06	Inflation targeting	[1] ch.11 [28] ch.10
10	35	27.3.06	Central Bank Independence	[1] ch.11; [9]; [10]; [15-18]; [31]
11	36	3.4.06	Monetary Policy Transparency	[1] ch.11; [13]. [14], [19], [30]
12	37	1.5.06	Consolidation	

5. Seminars

W/c: 30.1.06
Using a set of 'T-accounts' to represent a central bank and commercial banking system, show the effects on (a) the liquidity of the commercial banking system and (b) the money supply of the following:

i) a sale of government bonds to the non-bank private sector (assume that the government does not spend the funds raised by the sale).
ii) the spending by government of the funds raised in (i)
iii) an increase in government borrowing from the central bank (assume that the government does not spend the funds raised by the sale).
iv) the spending of the funds raised in (iii)
v) an increase in commercial bank lending to the general public.

6.2.06
1. Outline and compare the 'base-multiplier' and 'flow of funds' models of money supply determination.
2. What would each of these models predict about the effect on the money supply of a rise in interest rates initiated by the central bank?
3. In the B-M model how would you expect the money supply curve to be affected by a change in the coefficient on the bond rate?

13.2.06
1. In what sense(s) does a central bank have the powers of a monopolist? Can you see any weaknesses in this analogy?
2. Why do central banks choose to set 'price' rather 'quantity' in their conduct of policy.
3. Why might market interest rates not change immediately and exactly in line with market rates?
4. Distinguish between interest-endogeneity and base-endogeneity (of the money supply).
5. If the money supply is endogenous, does the demand for money matter?

20.2.06
1. How is the interpretation of the Quantity Theory affected by the assumption of endogenous money?
2. Both the precautionary and speculative motives for holding money arise from uncertainty. Uncertainty about what in each case?
3. Why is the speculative demand for money a demand for idle balances? What happens to velocity when idle balances increase?
4. Both the inventory-theoretic model of the transactions demand for money and Tobin's portfolio model are commonly called 'neo-Keynesian' . Why?
5. What are the particular characteristics of monetarist models of the demand for money?

27.2.06
1. Consider the list of variables that our theoretical discussions suggest might be relevant in estimating a demand for money function.
2. How has the increased practice by banks of paying interest on demand deposits, complicated the process of testing the demand for money?
3. Why might the rate of interest charged on <u>loans</u> be relevant to the demand for money?
4. Explain Laidler's notion of money as a 'buffer stock'. To what problems in the testing of the demand for money did the idea relate?

6.3.06
1. Distinguish between the transmission mechanism of monetary policy with interest rates as the policy instrument and with the money supply as the policy instrument.
2. Why are the lags in both mechanisms long and uncertain?
3. Draw IS/LM diagrams with different slopes for the LM curve and consider the implications of different slopes. If the money supply is endogenous, does this suggest we should abandon the LM curve?
4. Outline the Bank of England's current view of the way in which policy influences aggregate demand.

13.3.06
1. Outline the policy irrelevance theorem.
2. Laidler once said (off the record) that the linking of 'rational expectations' with 'market clearing' was the worst disaster ever to have befallen macroeconomics. What do you think he meant by that?
3. Using a DAD-SAS framework, show how a cut in interest rates should affect the level of output in (a) the short-run and (b) the long-run.

20.3.06
1. How might you argue that recent developments in macro and monetary economics have made 'Tinbergen's rule' redundant.
2. Summarise the arguments in favour of limiting the discretion of monetary policy-makers.
3. Compare and contrast any two 'rules' of monetary policy with which you are familiar.
4. Interest rate setting in some countries appears to follow the pattern of a 'Taylor rule' more closely than in others. How would you explain this?

27.3.06
1. Distinguish between 'intermediate' and 'final' targets and give examples.
2. Explain Svensson's argument that 'inflation targeting' as it is generally practised at the moment is in fact inflation forecast targeting.
3. Explain the difficulties involved in setting an inflation target.

3.4.06
1. Is the argument over the independence of central banks biased by the assumption of forward-looking market agents but myopic voters?
2. What is the connection between 'independence' and credibility?
3. What are the characteristics of an independent central bank?
4. Are there other ways of acquiring 'credibility'?

1.5.06
1. What are the arguments in favour of transparency in the conduct of monetary policy?
2. What institutional features are usually regarded as essential for policy transparency?
3. Studies based on the reactions of short-term money markets suggest these features may not be necessary. Summarise this evidence and explain how transparency might be achieved without such institutional features.

6. Assessment Offences – Cheating, Collusion and Plagiarism

The university encourages the use of a wide variety of assessment methods including coursework of various kinds. Consequently, it takes a very strict view of assessment offences like plagiarism and collusion (both of which, alas, have been facilitated by recent technological developments). The penalties for infringement are draconian. Details of the rules and penalties are included in the handbook relating to this course as a whole. You should read them carefully and follow them to the letter.

7. Assessment

7.1 Regulations

Regulations governing assessment are contained in the handbook relating to the course. You are advised to study these carefully. As far as this module is concerned, there are two elements to the assessment.

'Element A ' is an unseen exam of 2 hours. You will be required to answer four questions from a list of eight. The exam will be held during the university's assessment period: 8.8.06 to 26.5.06.

'Element B' is an essay of up to 1500 words, chosen from the following list:

1. How might institutional changes ('financial innovation') disturb the demand for money? How have economists responded to the problems of financial innovation in their empirical estimations of money demand?

2. Why did the Bank of England adopt a policy of inflation targeting in 1992? How has the pursuit of inflation targeting been linked to attempts to make monetary policy-making in the UK 'transparent'.

3. 'If the money supply is endogenously determined, the demand for money is irrelevant.' Discuss.

This essay should be submitted by 2.00pm on Tuesday 2nd May 2006.

The marks from these two elements will be combined and averaged with equal weighting.

Students who fail to meet the assessment requirements at the first attempt will be offered a second assessment opportunity during which they will be required to sit another examination and/or do another essay, in both cases similar to those required at the first attempt. The essays for the second opportunity are listed below:

1. Outline the arguments in favour of transparency in the conduct of monetary policy. What does the evidence from money markets tell us about the conditions required for monetary policy to be 'transparent'?

2. Why do central banks use interest rates as the policy instrument when most macro textbooks assume it is the quantity of money?

7.2 Guidelines

The learning outcomes for this module include both a working knowledge of a range of financial techniques and the ability to understand and make judgements about the functioning of the financial system. The lecture and seminar programmes are deigned to support both of these. However, when it comes to assessment, the former, technical, skills are more easily assessed by numerical problems set within the context of a timed examination, while evaluative skills are better assessed through essays which can be written with time for reflection and access to a variety of sources. As a guide to what is required, your attention is drawn to the criteria below. These are the criteria required to complete the assessment successfully.

Exam: the emphasis here is upon being able to provide 'correct' answers to the questions, which will often be numerical. Getting the correct answers requires the use of appropriate techniques of financial analysis combined with a degree of arithmetic/mathematical competence. A satisfactory level of achievement will require:

- a demonstration that the nature of the problem is recognised and what the relevant techniques are;
- the ability to use the correct techniques to solve at least half of the problem;
- generally accurate calculations.

Some degree of trade-off is acceptable. For high marks, and the possibility of distinction, these criteria must be satisfied more completely.

Essays: **The essay** requires students to demonstrate factual knowledge and analytical skills but also skills of debate, reasoning and evaluation. In assessment of the essay points that will be credited include:

- ability to answer the question
- understanding the key issues
- evidence of research/reading
- effective use of English
- clarity of expression
- appropriate referencing of source material and a bibliography
- use of appropriate diagrams, where relevant

8. Previous Exam papers

Since this is the first time that this module has been offered, there are no previous exam papers available. However, a 'sample' paper will be published before the end of the course.

9. Source material

The numbers in brackets are those used in the week by week lecture programme (see '4' above).

<u>*A. Books:*</u>

[1] K Bain and P G A Howells, *Monetary Economics: Policy and its theoretical basis* (Palgrave, 2003)
[2] C A E Goodhart, Monetary Theory and Practice (Macmillan, 1984)
[3] C A E Goodhart, *Money, Information and Uncertainty* (Macmillan, 2e 1989)
[4] M K Lewis and P Mizen, *Monetary Economics* (OUP, 2000)
[5] C A E Goodhart, 1995, *The Central Bank and the Financial System,* Macmillan.
[6] D Laidler, 1990, *Taking Money Seriously,*Philip Allan.
[7] J Stiglitz and B Greenwald, 2001, *Towards a New Paradigm in Monetary Economics,* Cambidge UP.
[8] A S Blinder (1998) *Central Banking in Theory and Practice* (Cambridge MA: MIT Press).
[9] Cukierman A (1992) *Central bank strategy, credibility and independence*, (Cambridge MA: MIT Press).

<u>*B: Journal articles*</u>

[10] Alesina A and Summers L (1993) 'Central bank independence and macroeconomic performance,' *Journal of Money, Credit and Banking*, 25, 151-62.

[11] Arestis P and Howells P G A 'Theoretical Reflections on Endogenous Money: The Problem with "Convenience Lending"', *Cambridge Journal of Economics*, 20 (5), 539-551

[12] *Bank of England Quarterly Bulletin* (2002) 'The Bank of England's Operations in the Sterling Money Markets', 42 (2), 153-61

[13] Buiter, W H (1999), Alice in Euroland, *Journal of Common Market Studies*, 37, 2, 181-209.

[14] *The Manchester School* (supplement), 2003, 71.

[15] Forder J (1998a) 'The case for an independent European central bank: A reassessment of evidence and sources', *European Journal of Political Economy*, 14, 53-71.

[16] Forder J (1998b) 'Central bank independence - conceptual clarifications and interim assessment', *Oxford Economic Papers*, 50, 307-34.

[17] Forder J (2000) 'The theory of credibility: confusions, limitations and dangers', *International Papers in Political Economy*, 7, 1-40.

[18] Forder J (2002) 'Interests and Independence: The ECB and the Theory of Bureaucracy,' *International Review of Applied Economics*, 16 (1), 2002.

[19] Geraats, P (2001), Why adopt transparency? The publication of central bank forecasts, *ECB working paper no 41*.

[20] Goodhart C A E (1989) `Has Moore become too horizontal?' *Journal of Post Keynesian Economics*, vol. 12(1) pp. 29-34

[21] Goodhart C A E (1991) `Is the concept of an equilibrium demand for money meaningful?' *Journal of Post Keynesian Economics*, vol 14(1), pp. 134-36

[22] Goodhart C A E (1994) 'What should central banks do? What should be their macroeconomic objectives and operations?', *Economic Journal,* 104, 1424-36.

[23] Haldane, A G and V Read (2000), Monetary policy surprises and the yield curve, *Bank of England working paper no 102*.

[24] Hayo B (1998) 'Inflation, culture, central bank independence and price stability', *European Journal of Political Economy*, 14 (2), 241-63.

[25] Howells P G A (1995), `The Demand for Endogenous Money', *Journal of Post Keynesian Economics* 18(1), Fall 1995, 89-106

[26] Howells P G A (1997) 'The Demand for Endogenous Money: A Rejoinder', *Journal of Post Keynesian Economics*, Spring 1997, 429-34.

[27] Howells P G A `The Demand for Broad Money in the UK: Does Credit Matter?' *Applied Economics*, September 1998 (with K A Hussein)

[30] Issing, O (1999), The Eurosystem: Transparent and accountable or 'Willem in Euroland', *Journal of Common Market Studies*, 37,3, 503-19.

[28] King, M (1997), The inflation target five years on, *Bank of England Quarterly Bulletin*, November, 434-42.

[29] Moore B J (1988), `The Endogenous Money Supply', *Journal of Post Keynesian Economics*, vol. X(3), 372-85

[30] Moore B J (1991) 'Has the Demand for Money been Mislaid?', *Jnl of Post Keynesian Economics* 14 (1), 125-33.

[31] Posen A (1998) **'**Central bank independence and disinflationary credibility: a missing link?', *Oxford Economic Papers*, 50, 335-39

[32] *Bank of England Quarterly Bulletin*, (1999) 'The Transmission Mechanism of Monetary Policy', May

[33] 'Central Banks and Market Interest Rates', *Journal of Post Keynesian Economics* (with I Biefang-Frisancho Mariscal), 24 (4) 2002.

C: Websites

Bank for International Settlements: www.bis.org
Financial Services Authority: www.fsa.gov.uk
Bank of England: www.bankofengland.co.uk

D: General interest

The following are not directly related to issues in the course, but you may find some or all of interest:

N Ferguson, *The House of Rothschild* (Viking, 1998) 2 vols.
D Kynaston, *The City of London* (Pimlico, 1994-2003) 4 vols.
D Kynaston, *History of the Financial Times* (Viking, 1988)
N Ferguson, *The Cash Nexus* (Basic, 2001)
G Davies, *A History of Money* (Univ. Wales Press, 3e, 2002)