**EC321 Money and Banking**

Course outline

**Lecturers**

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# Objectives

How does the recent financial turmoil affect the economy? What are the causes of inflation and deflation? Why do some countries experience sharp swings in exchange rates? What should central banks do in such circumstances? In order to answer these and related questions, this course provides a set of tools to analyse the interaction between monetary policy, the real economy and the financial sector. The course will combine a study of the relevant theory with applications to recent events and policy debates.

Topics to be covered include:

* The transmission mechanism of monetary policy
* Monetary policy strategies
* The liquidity trap and policy responses: quantitative easing, credit easing, and other unconventional policies
* Financial markets
* Fiscal and monetary policy linkages: government debt and inflation risks
* Banking and financial intermediation
* Current account dynamics
* Exchange rates and currency crises
* Deleveraging crises
* Policy responses to the financial crisis
* Sovereign debt crises

# Structure

The course consists of 12 lectures (3 hours each) and 12 classes (1 hour each).

# Assessment

This course is assessed by two written examinations, a mid session examination and a final examination. Each will account for 50% of the mark.

# Texts

The course is based on lecture notes, but the following texts are useful references:

* Walsh (2003), *Monetary Theory and Policy*, MIT Press 3rd edition
* Obstfeld & Rogoff (1996), *Foundations of International Macroeconomics*, MIT Press

**Prerequisites**

Intermediate Macroeconomics

# Syllabus

**Monetary policy**

Evidence on the transmission mechanism of monetary policy. Monetary policy operating procedures and strategies.

* Walsh, chapters 1, 8, 9 & 11.
* Bernanke & Mishkin (1997), “Inflation targeting: A new framework for monetary policy?”, Journal of Economic Perspectives, 11(2): 97—116
* Christiano, Eichenbaum & Evans (1999), “Monetary policy shocks: What have we learned and to what end?”, Handbook of Macroeconomics, vol. 1, pp. 65—148
* Clarida, Gali & Gertler (1999), “The science of monetary policy: A New Keynesian perspective”, Journal of Economic Literature, 37(4): 1661—1707

**Liquidity trap**

The zero lower bound on interest rates. Quantitative easing, credit easing, and other unconventional monetary policies.

* Walsh, chapter 10.
* Krugman (1998), “It’s baaack: Japan’s slump and the return of the liquidity trap”, Brookings Papers on Economic Activity, 1998(2): 137—205
* Eggertsson & Woodford (2003), “The zero bound on interest rates and optimal monetary policy”, Brookings Papers on Economic Activity, 2003(1): 139—211

**Fiscal and monetary policy linkages**

The government budget constraint. Fiscal dominance versus monetary dominance. The fiscal theory of the price level.

* Walsh, chapter 4
* Christiano & Fitzgerald (2000), “Understanding the fiscal theory of the price level”, Federal Reserve Bank of San Francisco Economic Review, 36(2)
* Cochrane (1998), “A frictionless view of U.S. inflation”, NBER Macroeconomics Annual

**Banking**

Banks as providers of liquidity insurance. The problem of “bank runs”. Banking and financial intermediation.

* Diamond & Dybvig (1983), “Bank runs, deposit insurance, and liquidity”, Journal of Political Economy, 91:401—419
* Williamson (1987), “Recent developments in modeling financial intermediation”, Federal Reserve Bank of Minneapolis Quarterly Review 1132
* Woodford (2010), “Financial intermediation and macroeconomic analysis”, Journal of Economic Perspectives

**Credit**

The distinction between internal and external finance. The role of collateral, net worth and leverage. Interest rate spreads and the “external finance premium”.

* Walsh, chapter 7
* Carlstrom & Fuerst (1997), “Agency costs, net worth, and business fluctuations: A computable general equilibrium analysis”, American Economic Review, 87(5): 893—910
* Kiyotaki & Moore (1997), “Credit cycles”, Journal of Political Economy, 105: 211—248

**The intertermporal approach to the Current account**

The determinants of current account dynamics in the context of an intertermporal model.

* Obstfeld and Rogoff “Foundations of International Macroeconomics” chapter 1
* Is the US current account sustainable? Implications for the foreign exchange market?

Tille: The impact of Exchange Rate Movements on U.S. foreign Debt

Doley, M., D. Folkerts Landau and P. Garber (2003), “An essay on the revived Bretton Woods System” NBER W.P. No. 9971

**Models Of Exchange Rate Determination and Currency Crisis**

Exchange Rate determination in the context of flexible and sticky prices models.

* Obstfeld and Rogoff “Foundations of International Macroeconomics” chapter 8
* Krugman “A Model of Balance of Payment Crisis” Journal of Money Credit and Banking, 1979.

**Financial crisis, Deleveraging Crisis and Policy Responses**

Overview and analysis of the recent financial crisis and analysis of models with borrowing limits.

* Taylor, J. (2009) “The Financial Crisis and Policy Responses: An Empirical analysis of what went wrong”
* Eggertsson, G. and P. Krugman (2010): “Debt, Deleveraging and Liquidity Trap”
* Mendoza, E. (2005) “Real Exchange Rate Volatility and the Price of Non-tradable goods in Economies Prone to Suddent Stops”. Economia 2005
* Bianchi, J. (2010) “Overborrowing and Systemic Externalities”

**Sovereign Debt Crises**

Review of a classical model of sovereign debt crisis and its relation with the recent events in Europe

* Calvo, G. (1988) “Servicing the Public Debt: the role of Expectations”. American Economic Review.