

PRINCETON UNIVERSITY
Woodrow Wilson School of Public and International Affairs

Advanced Domestic Macro: The Political Economy of Central Banking

WWS 524

Fall 2010

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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 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:

- Why is monetary policy important—or is it?
- How do central banks make monetary policy decisions?
- To what extent are independent central banks undemocratic or unaccountable institutions?
- What sorts of decisions should be made by technocrats rather than by politicians?
- Do political or communication considerations affect central bank decisions? Should they?
- Should central banks be bank regulators? What about systemic risk regulators?
- What special issues are raised by globalization?
- How can we make political and/or economic sense of central banks’ unconventional responses to the recent financial crisis?

Textbooks

While there are no textbooks, multiple references will be made to the following five books. But don’t 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 choose the year.)

Finally, you may find the following three long papers useful, as each covers a wide variety of central banking issues. Only parts of each are explicitly assigned:

Alan S. Blinder, "It's Broke, Let's Fix It: Rethinking Financial Regulation," forthcoming in the International Journal of Central Banking (henceforth, "Blinder (forthcoming)")

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)"). The entire book is available on the Bank of Spain's website: www.bde.es/doctrab/confere/confee_9.htm.)

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)").

Exams and Assignments

There will be a regular final exam, most likely a two-part exam—in-class and take-home. Also, a few problem sets.

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, "Presidential and Congressional Vote-Share Equations," and short updates to that. (These can be accessed at fairmodel.econ.yale.edu. Click on "Presidential Vote Equation: 2008" and browse around.)

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, “Presidential and Congressional Vote-Share Equations,” January 2009, 55-72. American Journal of Political Science

*Ray C. Fair, “The Effect of Economic Events on Votes for President,” Review of Economics and Statistics, 1978, pp. 159-173.

*Don Peck, “How a New Jobless Era Will Transform America,” The Atlantic, March 2010.

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

*David Wessel, In Fed We Trust (Crown Business), 2009, Chapter 2.

*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.

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, Getting Off Track (Hoover: 2009), Chapter 1.

*Ben S. Bernanke, and Alan S. Blinder, “Credit, Money, and Aggregate Demand,” *American Economic Review* (Papers and Proceedings), May 1988, pp. 435-439.

Fischer, “Modern Central Banking,” Sects. 2.3 and 2.5.

*Tobias Adrian and Hyun Song Shin, “Financial Intermediaries, Financial Stability and Monetary Policy,” in Federal Reserve Bank of Kansas City, Maintaining Stability in a Changing Financial System (proceedings of the 2008 Jackson Hole conference), pp. 287-334.

*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.

*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, pp. 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 (and the 2009 “Postscript” posted on Council on Foreign Relations website).
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.

*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.)

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 12 below.)

*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, “Talking about monetary policy: the virtues (and vices?) of central bank communication,” BIS Working Paper No. 274, March 2009.

*Alan S. Blinder *et al.*, “Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence,” Journal of Economic Literature, December 2008, pp. 908-943.

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,” International Finance, Summer 2009, pp. 171-194.

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.)

Henry Chappell, Rob Roy McGregor, and Todd Vermilyea, “An Econometric Model of Monetary Policy Decision-making with Applications to the United Kingdom and Sweden,” processed, June 2009.

*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,” International Journal of Central Banking, December 2008, pp. 117-150.

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

8. Crisis Management and the Financial Crisis of 2007-2009

Ben S. Bernanke, “On the Implications of the Financial Crisis for Economics,” Remarks at the Conference co-sponsored by the Bendheim Center for Finance and the Center for Economic Policy Studies, Princeton, New Jersey, September 24, 2010

David Wessel, In Fed We Trust (Crown Business), 2009, Introduction, Chapter 1, pp. 54-66, pp. 87-95, Chapters 5-14.

Alan S. Blinder, “Quantitative Easing: Entrance and Exit Strategies,” forthcoming in the Federal Reserve Bank of St. Louis Review, September/October 2010 (the 2010 Homer Jones lecture).

John B. Taylor, Getting Off Track (Hoover: 2009), Chapters 2 and 3.

*Jeff Madrick, “How We Were Ruined & What We Can Do,” New York Review of Books, February 12, 2009. (Under the guise of a book review, this is a nice, short synopsis of what went wrong. But if you have another favorite version, read that instead.)

Phillip Swagel, “The Financial Crisis: An Inside View,” Brookings Papers on Economic Activity, 1, 2009. (This is a far more detailed narrative, focused much more on the policy responses.)

*Martin Baily, Robert Litan, and Matthew Johnson “The Origins of the Financial Crisis,” Fixing Finance Series Paper 3, Brookings, November 2008. (This paper has much more detail, facts, and numbers than the Madrick review. Good for browsing. You can find it at www.brookings.edu/papers/2008/11_origins_crisis_baily_litan.aspx.)

*Paul Krugman, The Return of Depression Economics and the Crisis of 2008 (Norton), 2009, Chapters 7-9. (Here is a third choice, in between the first two in terms of density.)

*Carmen Reinhart and Kenneth Rogoff, This Time is Different, Princeton University Press, 2009.

*Andrew Ross Sorkin, Too Big To Fail (Viking), 2009. (Browse; this book focuses on Lehman but is broader than that.)

*Gillian Tett, Fool’s Gold (Little Brown), 2009 (Browse; this is about JP Morgan and the development of credit default swaps.)

*William Cohan, House of Cards (Random House), 2009 (Browse; this is about the fall of Bear Stearns. In addition, if you can find it in the CNNMoney.com website archives, Cohan wrote a terrific series for them on the Lehman catastrophe, posted December 14-15, 2008.)

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

*Willem Buiter, “Central Banks and Financial Crises,” in Federal Reserve Bank of Kansas City, Maintaining Stability in a Changing Financial System (proceedings of the 2008 Jackson Hole conference), pp. 495-633. (Read selectively; this is a very long, but provocative and interesting paper. My discussion follows in the same volume.)

*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: The course focuses 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.

9. Should the Central Bank be a Bank Regulator? A Systemic Risk Regulator?

Ben S. Bernanke, “The Right Reform for the Fed,” The Washington Post, November 29, 2009.

Blinder (2006), Issue # 5.

Alan S. Blinder, “How Central Should the Central Bank Be?,” Journal of Economic Literature, March 2010, pp. 123-133, Sections 4 and 5 only.

Blinder (forthcoming), Sections I, II, and III A & B only (rest optional).

Alice Rivlin, “Systemic Risk and the Role of the Federal Reserve,” Pew Financial Reform Project, Briefing Paper # 2, 2009 (downloadable at www.pewfr.org).

Andrew Crockett, “Should the Federal Reserve be a Systemic Stability Regulator,” in J. Cioffiari and J. Taylor (eds.), The Road Ahead for the Fed (Hoover), 2009, pp. 137-50.

Allan H. Meltzer, Testimony to the Senate Committee on Banking, July 23, 2009.

*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.

10. 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.

Alan S. Blinder, "How Central Should the Central Bank Be?," Journal of Economic Literature, March 2010, pp. 123-133, Section 3.3 only.

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

*Meyer, Chapters 7-9

11. 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?," World Economic Outlook, Chapter 3, pp. 97-134, 2006.

*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.

12. Inflation Targeting (if time permits)

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.

*Lars E.O. Svensson, “The Instrument-Rate Projection under Inflation Targeting: The Norwegian Example,” in Stability and Economic Growth: The Role of Central Banks, Banco de Mexico, 2006, pp. 175-198. (downloadable at www.princeton.edu/svensson/papers/CBMex.pdf)

*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.