

**Department of Economics
University of Toronto
ECO2500H1F – Monetary Theory
Fall 2013**

Instructor:

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Office Hours: Monday 2:30-3:30PM or by appointment

Course objectives:

This course explores a wide range of topics on monetary theory. The strategy of the course is to examine simple models to explore the importance of money, banks, and other financial institutions in the way economies work. The topics examined in this framework include: role of money, determination of the medium of exchange, effects of inflation, role of banks, control of the money supply, and effect of the National Debt on saving and investment.

Course materials:

The topics of the course do not follow a textbook. However, the following book covers the first part of the course:

Bruce Champ and Scott Freeman, “Modeling Monetary Economies,” Cambridge University Press. Second edition. (2001)

This book has been republished as:

Bruce Champ, Scott Freeman, and Joseph Haslag “Modeling Monetary Economies,” Cambridge University Press. Third edition. (2011)

The second part of the course will be based on original articles. Sets of slides, posted in the course web pages, will summarize the main ideas from these articles.

Grade allocation:

Test 1	Sep. 24	10 %
Test 2	Oct. 15	10 %
Test 3	Nov. 5	10 %
Test 4	Dec. 3	10 %
Problems		8 %
Final Exam		52 %

The four tests will be conducted in class at the beginning of a lecture and will take 10 to 15 minutes. Each test will ask questions related to a problem set which will be due at the beginning of the test. Your answers to the problem sets will be collected, and credit will be given for their completion. However, they will not be graded. There will not be make-up tests. If students miss a test, they should provide me with proper justification during the week following the test. If this justification is well documented and compelling, the weight of the missed test will be transferred to the final exam.

Announcements:

Please, make it a habit of checking the course web page for announcements.

Academic misconduct:

Students should note that copying, plagiarizing, or other forms of academic misconduct will not be tolerated. Any student caught engaging in such activities will be subject to academic discipline ranging from a mark of zero on the assignment, test or examination to dismissal from the university as outlined in the academic handbook. Any student abetting or otherwise assisting in such misconduct will also be subject to academic penalties.

List of Topics

1 - Money and Inflation in the Overlapping Generations Model

- The seminal contribution for this material goes back to Samuelson (1958).
- Many textbooks have excellent expositions. The terminology and notation used in the class is basically that of Chapters 1 and 3 in Champ and Freeman (2001). Blanchard and Fisher (1989) and Ljungqvist and Sargent (2000) are good alternatives at a higher level.
- References:
 - Blanchard, O. and S. Fischer (1989), *Lectures on Macroeconomics*, MIT Press.
 - Champ, B. and S. Freeman (2001), *Modelling Monetary Economies*, 2nd edition, Cambridge Univ. Press.
 - Ljungqvist L. and T.J. Sargent (2000), *Recursive Macroeconomic Theory*, MIT Press.
 - Samuelson, P.A. (1958) "An Exact Consumption-Loan Model of Interest With or Without the Social Contrivance of Money," *Journal of Political Economy* 66, pp. 467-82.
- Policy paper (required pp. 41- 56 of the original paper, the rest are recommended):
 - Sargent, Thomas J. (1982), "The Ends of Four Big Inflations," in *Inflation: Causes and Effects* edited by Robert E. Hall. University of Chicago Press.
(<http://www.nber.org/chapters/c11452.pdf>)

2 - Money and Capital in the Overlapping Generations Model

- The original contribution for the model covered in this topic is from Diamond (1965).
- Many textbooks have excellent expositions. The presentation in class borrows heavily from Blanchard and Fischer (1989). An alternative exposition is Ljungqvist and Sargent (2000).
- References:
 - Diamond, Peter (1965), "National Debt in a Neoclassical Growth Model," *American Economic Review* 55, pp. 1126-1150.
 - Blanchard, O. and S. Fischer (1989), *Lectures on Macroeconomics*, MIT Press.
 - Ljungqvist L. and T.J. Sargent (2000), *Recursive Macroeconomic Theory*, MIT Press.
- Policy paper (required):

- Bernanke, Bertant, De Marco, and Kamin, (2011) "International Capital Flows and the Returns to Safe Assets in the US, 2003-2007," *International Finance Discussion Papers* 1014.
(link: <http://www.federalreserve.gov/pubs/ifdp/2011/1014/default.htm> and click on "full paper".).

3 - Liquidity Role of Banks

- The seminal contribution on the issues dealt in this topic is due to Diamond and Dybvig (1983).
- After Diamond and Dybvig there has been several papers dealing with the optimal demand deposit contract that prevents bank runs when t is stochastic. A good example among those is Green and Lin (2003).
- References:
 - Diamond, Douglas W. and P. H Dybvig (1983), "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy* 91, pp. 401-419.
 - Green, Edward, and Ping Lin (2003), "Implementing Efficient Allocations in a Model of Financial Intermediation," *Journal of Economic Theory* 109, 1–23.
- Policy paper (required):
 - Bernanke, Ben, (2011) "The Effects of the Great Recession on Central Bank Doctrine and Practice," Address at the Federal Reserve Bank of Boston 56th Economic Conference, Boston, Massachusetts October 18, 2011.
(<http://www.federalreserve.gov/newsevents/speech/bernanke20111018a.htm>).

4 - Monitoring Role of Banks

- Seminal work on this area of research goes back to Diamond (1984). The model presented here was developed by Williamson (1986, 1987a, and 1987b) in a series of papers in 1980's.
- References:
 - Diamond, Douglas W. (1984), "Financial Intermediation and Delegated Monitoring," *Review of Economic Studies* 51, 393-414.
 - Williamson, Stephen D. (1986), "Costly Monitoring, Financial Intermediation, and Equilibrium Credit Rationing" *Journal of Monetary Economics* 18, pp. 159-179.
 - Williamson, Stephen D. (1987a), "Financial Intermediation, Business Failures, and Real Business Cycles," *Journal of Political Economy* 95, pp. 1196-1216.
 - Williamson, Stephen D. (1987b), "Costly Monitoring, Loan Contracts and Equilibrium Credit Rationing," *Quarterly Journal of Economics* 102, 135-146.

- Policy paper (required):
 - Bernanke, Ben, (1988) "Monetary Policy Transmission: Through Money or Credit," *Business Review*, Federal Reserve Bank of Philadelphia, issue Nov, pages 3-11. (<http://www.phil.frb.org/research-and-data/publications/business-review/> once at the link enter year 1988).

5 - Financial Intermediation and Business Cycles

- The idea developed in this topic goes back to the work by Bernanke and Gertler (1989). The presentation here uses some of the tools introduced in the previous topic.
- References:
 - Bernanke, Ben, and Mark Gertler (1989), "Agency Cost, Net Worth, and Business Fluctuations," *American Economic Review* 79, pp. 14-31.
- Policy paper (required):
 - Chatterjee, Satyajit (2013), "Debt Overhang: Why Recovery from a Financial Crisis Can Be Slow," *Business Review*, Federal Reserve Bank of Philadelphia, issue 2nd quarter, pages 3-11. (<http://www.phil.frb.org/research-and-data/publications/business-review/>)

6 - Adverse Selection in Financial Markets

- The models presented here originated in the work of Akerlof (1970), and were developed in financial markets by Stiglitz (1984).
- References:
 - Akerlof, George, "The Market for 'Lemons': Quality, Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84 (1970): 488-500.
 - Stiglitz, Joseph, and Andrew Weiss, "Information Imperfections in the Capital Market and Macroeconomic Fluctuation," *American Economic Review* 74 (1984): 194-199.
- Policy paper (recommended):
 - Gertler, Mark, "Financial Structure and Aggregate Economic Activity: An Overview," *Journal of Money, Credit, and Banking* 20 (1988): 559-588.