

Harvard University: Economics 970

Spring 2014

The Political Economy of U.S. Monetary Policy

Instructor: Evan Schnidman

evan.schnidman@gmail.com

Mon/Wed 11:30-1, 1-2:30 (Robinson 205)

Course Description:

This course will utilize political economy models to help explain the relationship between politics and U.S. monetary policy. Beginning with a brief overview of the political economy literature, the course will provide a foundational understanding of how branches of the U.S. government relate to the Federal Reserve. We will explore several eras of monetary policy decisions in American history touching on the banking panics of the late 19th Century, the formation of the Federal Reserve, the Great Depression, the Great Inflation, the Savings and Loan crisis and the recent financial crisis; analysis of the recent crisis will receive the most time and attention. In addition to providing a deeper understanding of American political institutions and the history of American monetary policy, a substantial portion of the course will be devoted to exploring how the Federal Reserve operates internally and how that might impact U.S. monetary policy as well as global financial markets.

This course will employ some basic formal theory to explain economic models but will primarily rely on history, institutional analysis literature and current events sources. Upon completing this course, students will have a better grasp of how monetary policy decisions are made, what role politics plays in those decisions and how monetary policy impacts financial markets.

Although this course is not heavy on statistical or econometric methods, a strong understanding of both macroeconomics and microeconomic theory is expected. Students have completed Econ 1010a and should have taken or be concurrently taking Econ 1010b.

Course Requirements:

Class Participation (25%): Attendance is mandatory and your full participation is expected in the discussion of assigned readings and general course themes. Additionally, all students are expected to bring a discussion question to each class so as to facilitate discussion targeted at students concerns and interests.

Response Papers (25%): You are expected to turn in five (400-700 word) response papers at the beginning of class throughout the semester. Each paper must demonstrate an understanding of the assigned reading as well as personal insight on the topic. You may choose when you write these papers but at least two of them must be turned in before class # 8. These papers will be graded on a one to five scale with one being the lowest and five being the highest.

Problem Sets (10%): Four problem sets will be due throughout the semester. These assignments will be associated with work done in your Stata workshops help on 2/6, 2/18, 3/4 and 3/25; all students should read Angrist & Krueger's 1991 QJE article for background material on what they are replicating. Assignment due dates are 2/14, 2/26, 3/13 and 4/2.

Short Paper (10%): One short (1500-2000 word) paper must be turned in at the beginning of class # 13. You will be given a topic well in advance and you are expected to incorporate understanding of assigned readings as well as class discussion in your paper. Rewrites of this paper are permitted and your grades on the two drafts will be averaged.

Prospectus of Final Paper (10%): You must write a (1000 word) prospectus outlining your proposed topic for the final paper. This document must include sections on your research question, proposed methods, existing literature, and expected findings.

Final Paper (20%): You must write a (3000-4000 word) paper on a topic related to this course. The topic proposed in your prospectus must be approved before writing this paper. Suitable topics need not be original research but it is strongly encouraged.

Final Papers are Due by NOON on May 5 via email

Course Policies:

Attendance: Attendance and participation are mandatory. If students are unable to attend class they must inform the instructor ahead of time and provide a good reason for their absence. Should students be unable to attend their assigned section, they may obtain permission from the instructor to attend his other section. Classes meet from 11:30 AM to 1:00 PM and from 1:00 PM to 2:30 PM on Mondays and Wednesdays in Robinson 205.

Extensions: Extensions will be dealt with on a case by case basis. Since assignments will be given well ahead of time the instructor will typically not grant extensions except in extreme circumstances.

Office Hours: Office Hours will be announced at the beginning of the term but generally it is preferred that students wishing to meet with the instructor email him (evan.schnidman@gmail.com) to set up a time to meet. Special office hours will be arranged to provide guidance on larger assignments.

Writing: Writing is a crucial part of the sophomore tutorial and of the Harvard experience. Development of good writing skills is essential to your success as an economist, or in any other profession. A good paper has a clear thesis, is well organized, and employs solid economic analysis. A good paper will address the problem posed by the assignment. A good paper should be stylistically and grammatically correct and free of typographical and spelling errors. You should proofread your papers. Should you need additional help with your writing, please take advantage of the services of the Harvard Writing Center, on the Garden Level of the Barker Center, at 12 Quincy Street. You should read *Writing with Sources* and otherwise develop a general familiarity with the University's policies on plagiarism.

Academic Honesty: Please review the Harvard College Handbook's stated policy on academic honesty:
<http://isites.harvard.edu/icb/icb.do?keyword=k69286&pageid=icb.page355695>

Readings: Reading for this class may seem heavy at times but every effort has been made to keep assignments as short as possible. Optional or supplementary readings will often be cited; students should feel no obligation to read these sources but they may be referenced in class.

Assignments: All assignments listed below are due the day indicated. This means you must complete readings prior to that class period and hand in all written work at the beginning of class that day.

Required Books: Every effort has been made to keep costs down by requiring few books (although many are recommended), nevertheless four books will be read during the course of the semester; they are on reserve and can all be purchased online. If you should have trouble obtaining the books, please let the instructor know immediately. The four books are:

- Axilrod, Stephen H. *Inside the Fed: Monetary Policy and Its Management, Martin through Greenspan to Bernanke*. MIT Press, 2011.
- Morris, Irwin L. *Congress, The President, and The Federal Reserve: The Politics of American Monetary Policy Making*. University of Michigan Press, 2002.
- Wessel, David. *In Fed We Trust: Ben Bernanke's War on the Great Panic*. Three Rivers Press, 2010.
- Woolley, John T. *Monetary Politics: The Federal Reserve and The Politics of Monetary Policy*. Cambridge University Press, 1986.

Key Dates:

February 3: First seminar meeting

March 3: Second short memo due by this date

March 26: Short Paper due

April 14: Final Paper Prospectus due

April 28: Final Class, fifth short memo due by this date

May 5: Final Paper due via email by NOON

Course Plan:

Class # 1 Introduction to the Federal Reserve (February 3)

What is the Fed? Who are they? What do they do? Why do some people fear them?

Reading:

Follow these links and feel free to explore the Fed website further.

- <http://www.federalreserve.gov/aboutthefed/mission.htm>
- <http://www.federalreserve.gov/aboutthefed/currency.htm>
- <http://www.federalreserve.gov/aboutthefed/ombudsman.htm>
- <http://www.federalreserve.gov/otherfrb.htm>

Read all 4 sections of this page:

- <http://www.federalreserve.gov/pubs/frseries/frseri.htm>

Class # 2 Political Economy and relations between branches of government (February 5)

What is Political Economy?

Reading:

- Maser, Steven, and Fred Thompson. "The Fox and the Henhouse: On the Wisdom of GAO Audits of the Federal Reserve." *The Economists' Voice*, 2010.
- Axilrod "Inside the Fed"—Chapter 1
- Given the breadth of the overview this week you are required to educate yourself on the following broad terms via use of an economic dictionary or other academic sources.
 1. Political Economy
 2. Collective Action
 3. Social Choice Theory
 4. Public Choice Theory
 5. Principle-Agent Problem
- The following books may also be helpful as reference if necessary:
 Kenneth Arrow "Social Choice and Individual Values"
 Mancur Olson "The Logic of Collective Action"
 Anthony Downs "An Economic Theory of Democracy"
- The following articles may also be helpful as reference if necessary:
 Amartya Sen "Social Choice Theory, A Re-examination" (*Econometrica* 1977)
 Richard McKelvey "Intransitivities in Multi-Dimensional Voting Models and some Implications for Agenda Control" (*Journal of Economic Theory* 1976)

Class # 3 Understanding the Branches of Government (February 10)

How does Congress work? How do Judges make decisions? What is Presidential power? How do the branches relate to one-another? And how do they relate to the Fed?

Reading:

- Groseclose, Timothy and David King. "Committee Theories Reconsidered." Congress Reconsidered. CQ Press, December 2000.
- Robert Dahl. "Decision-Making in a Democracy: The Supreme Court as a National Policy-Maker. *Journal of Public Law*, 1957. 6: 279-295.
- Brandice Canes-Wrone, "The President's Legislative Influence from Public Appeals." *American Journal of Political Science*, 2001. 45 (2): 313-329.
- Mathew McCubbins and Thomas Schwartz, "Congressional Oversight Overlooked," *American Journal of Political Science*, 1984. 28: 165-79.

Class # 4 How branches of government relate to one another and to Macroeconomic Policy (February 12)

How does politics affect the economy broadly? What does that mean for Fed policy?

Reading:

- Douglas Hibbs “Political Parties and Macroeconomic Policy.” The American Political Science Review, 1977. 71 (4), 1467-1487.
- Krause , George A. “Federal Reserve Policy Decision Making: Political and Bureaucratic Influences.” American Journal of Political Science, 1994. 38(1): 124-144.

President’s Day: No Class on February 17

Class # 5 Pre-Fed American Financial History (February 19)

How did the U.S. economy operate in the 18th and 19th Centuries? What caused us to have a Federal Reserve? What did the Fed originally look like?

Reading:

- Binder, Sarah and Mark Spindel “Monetary Politics: Origins of the Federal Reserve.” Studies in American Political Development, 2013.
- Fed’s Formative Years:
<<http://www.federalreservehistory.org/Events/DetailView/60>>
- Federal Reserve Act Signed:
<<http://www.federalreservehistory.org/Events/DetailView/10>>
- Reserve Bank Organization Committee:
<<http://www.federalreservehistory.org/Events/DetailView/16>>
- Reserve Banks Open:
<<http://www.federalreservehistory.org/Events/DetailView/18>>

Class # 6 The Fed and the Depression (February 24)

Did the Fed behave properly in the Depression? What would you have done differently? What were the institutional pressures that caused them to act as they did?

Reading:

- Harvard Business School Case on The Federal Reserve and The Banking Crisis of 1931 (will be distributed by instructor)
- Bernanke, Ben S. "The Macroeconomics of the Great Depression: A Comparative Approach," Journal of Money, Credit and Banking, 1995. 27(1), 1-28.
- Examine The Fed’s Own History of The Great Depression:
< <http://www.federalreservehistory.org/Events/ListView/10>>

Optional Reading:

- Barry Eichengreen “Golden Fetters: The Gold Standard and The Great Depression.”
- Milton Friedman and Anna Jacobson Schwartz. “A Monetary History of the United States”

Class # 7 WWII and the Fed (February 26)

What changed as a result of the Depression and wars? What did the changes mean for the Fed?

Reading:

- Angrist, Joshua and Alan Krueger “Does Compulsory School Attendance Affect Schooling and Earnings? Quarterly Journal of Economics, 1991. 106 (4), 979-1014.
- Bretton Woods Creation: <<http://www.federalreservehistory.org/Events/DetailView/28>>
- WWII to the Treasury-Fed Accord: <<http://www.federalreservehistory.org/Events/DetailView/71>>
- Treasury-Fed Accord: <<http://www.federalreservehistory.org/Events/DetailView/30>>

Class # 8 The Fed-Treasury Accord (March 3)

Did politics play a role in the origin of the Accord? What did the Accord actually say? Did the Accord create peace between the Fed and Treasury or did other factors play a role?

Reading:

- Axilrod “Inside the Fed”—Chapter 2
- “Federal Reserve Independence and the Accord of 1951” <<http://www.frbsf.org/publications/economics/letter/1993/el93-21.pdf>>
- Treasury/Fed Accord to the Mid-1960s: <<http://www.federalreservehistory.org/Events/DetailView/63>>

Class # 9 (March 5) → CANCELLED

Short paper topics announced via email

Class # 10 Overview of Fed Chairmen AND The Great Inflation (March 10)

What is the role of the Chairman? How do different individuals play this role differently? What caused elevated inflation? Did politics play a role? How did Arthur Burns and Paul Volcker differ as Chairmen? Was the Volcker Fed deliberative or dictatorial?

Reading:

- Knott, Jack. “The Fed Chairman as a Political Executive.” Administration and Society, 1986. 18(2): pp. 197-231.
- Axilrod “Inside the Fed”—Chapters 3-5
- Bailey, Cheryl Schonhardt and Andrew Bailey. “Does Deliberation Matter in FOMC Monetary Policymaking The Volcker Revolution of 1979.” Political Analysis, 2008. 16(4): 404-427.

Recommended Reading

- Gold Convertability Ends: <<http://www.federalreservehistory.org/Events/DetailView/33>>
- Smithsonian Agreement: <<http://www.federalreservehistory.org/Events/DetailView/34>>
- Oil Shock of 1973-1974: <<http://www.federalreservehistory.org/Events/DetailView/36>>
- Oil Shock of 1978-1979: <<http://www.federalreservehistory.org/Events/DetailView/40>>
- Humphrey Hawkins Act: <<http://www.federalreservehistory.org/Events/DetailView/39>>
- Anti-Inflation Actions: <<http://www.federalreservehistory.org/Events/DetailView/41>>
- Recession of 1981-1982: <<http://www.federalreservehistory.org/Events/DetailView/44>>

Class # 11 Regulation, The S&L Crisis and The Great Moderation (March 12)

Should the Fed have power over both regulation and monetary policy?

Reading:

- FDIC Chrono-bibliography on S&L crisis: <<http://www.fdic.gov/bank/historical/s&l/>>
- Savings and Loan Crisis: <<http://www.federalreservehistory.org/Events/DetailView/42>>
- Stock Market Crash of 1987: <http://www.federalreservehistory.org/Events/DetailView/48>
- Great Moderation: <<http://www.federalreservehistory.org/Events/DetailView/65>>
- Axilrod “Inside the Fed”—Chapter 6

Spring Break: No Classes March 15-23**Class # 12 A Wholesale Look at the Fed as an Institution (March 24)**

What do you think of this study of the Fed? Is it really comprehensive? Is it outdated?

Reading:

- John Woolley “Monetary Policy: The Federal Reserve and The Politics of Monetary Policy.”
(*Read Chapter 8, Skim the rest of the book*)

Class # 13 A Second Look at the Fed (March 26)

What do you think of this study of the Fed? Is it really comprehensive? Is it outdated? How does it compare to the Woolley book?

Reading:

- Irwin Morris “Congress, The President and The Federal Reserve: The Politics of American Monetary Policy Making”
(*Read Chapters 1-4, Skim the rest of the book*)

*Short Papers Due***Class # 14 The International Perspective (March 31)**

How does the Fed look compared to other central banks? How do the decision processes differ? What is the result?

Reading:

- Bernhard, William. "A Political Explanation of Variations in Central Bank Independence." *American Political Science Review*, 1998. 92.
- Copelovitch, Mark S. and David A. Singer. 2008. “Financial Regulation, Monetary Policy, and Inflation in the Industrialized World.” *Journal of Politics*, 2008. 70, 663-680.

Class # 15 Inflation Targeting (April 2)

Should the Fed target a specific inflation rate? What does this mean for Fed independence, credibility and transparency?

Reading:

- Mishkin, Frederic. "Why the Federal Reserve Should Adopt Inflation Targeting." *International Finance*, 2004. No. 1.
- Benjamin Friedman “Why the Federal Reserve Should Not Adopt Inflation Targeting.” *International Finance*, 2004. No. 1.

Class # 16 Individual Meetings (April 7)

No reading but each student will meet with me individually to discuss their final papers.

Reminder: Prospectus is due in one week

Class # 17 A Simple Credibility Game? (April 9)

Is the Fed structure just a device to prove credibility or is it something more? Is forward guidance a policy signal or is it policy in and of itself?

Reading:

- Keefer, Phil and David Stasavage. "The Limits of Delegation: Veto Players, Central Bank Independence, and the Credibility of Monetary Policy." *American Political Science Review*, 2003. 97: pp. 407-423.
- Romer and Romer "Federal Reserve Information and the Behavior of Interest Rates." *American Economic Review*, 2000. 90 (3): 429-457.
- Holmes, Douglas. "Economy of Words." *Cultural Anthropology*, 2009. 24: 381-419.

Class # 18 The Modern Fed Inching Toward Transparency (April 14)

Why does the Fed continue to make more public pronouncements and produce more published papers? Why are minutes and transcripts more readily available than ever? What are the incentives for these moves toward transparency? Does a more transparent institution make better or worse policy?

Reading:

- Eijffinger, Sylvester and Petra Geraats "How Transparent Are Central Banks?" Working Paper, 2005.
- Swanson, Eric T. "Have Increases in Federal Reserve Transparency Improved Private Sector Interest Rate Forecasts?" *Journal of Money, Credit, and Banking*, 2006. 38 (3): 791-819
- Ben Bernanke Speech at At the Cato Institute 25th Annual Monetary Conference <<http://www.federalreserve.gov/newsevents/speech/bernanke20071114a.htm>>

Prospectus Due by the start of Class

Class # 19 The Great Recession (April 16)

How has the Fed's history played a role in its handling of the recent crisis?

Reading:

- Axilrod "Inside the Fed"—Chapter 7
- Subprime Mortgage Crisis: <<http://www.federalreservehistory.org/Events/DetailView/55>>
NOTE: We will be screening the film "Money For Nothing" in class.

Class # 20 The Great Recession (April 21)

What have the last 5+ years meant for the Fed? Do you think the Fed handled policy appropriately in the throes of the crisis?

Reading:

- Axilrod "Inside the Fed"—Chapter 8 and 9
NOTE: We will be screening the film "Too Big to Fail" in class.

Class # 21 The Great Recession (April 23)

What could the Fed have done differently during the crisis?

Reading:

- David Wessel “In Fed We Trust” (*Please read ENTIRE book*)

Class # 22 Semester Recap and The Fed’s Future (April 28)

What will be the lasting effect of the financial crisis on the global economy, central banking, economics and finance? What do we expect from the Fed in the post-crisis era? Is politics affecting Fed policy?

Reading:

- Fed Credit Programs: <<http://www.federalreservehistory.org/Events/DetailView/70>>
- Great Recession and Its Aftermath:
<<http://www.federalreservehistory.org/Events/DetailView/66>>
- Dodd-Frank Act: <<http://www.federalreservehistory.org/Events/DetailView/59>>