Leigh Tesfatsion
Assignment Date: 10/26/10

The Fed and U.S. Monetary Policy Today: What Now?

Assigned Moderators for Discussion Group 2 (DG2): Jeff Hodal (crowtrbt@iastate.edu), Jesse Strzok (jstrzok@iastate.edu), and Ben Main (bam036@iastate.edu)

Date of Discussion: Thursday, November 18, 2010, 11-12:20 (first 80 minutes of class)

Required Reading For In-Class Discussion:

** 1. Selections from the Federal Reserve System Homepage (Structure of the Fed, Conduct of Monetary Policy). ON-LINE

   www.econ.iastate.edu/classes/econ502/tesfation/

   www.econ.iastate.edu/classes/econ502/tesfation/
   CrisisDoesNotCallforNewMonetaryPolicy.JTaylorJune2010.pdf

** 4. Building a Science of Economics for the Real World, Committee on Science and Technology, U.S. House of Representatives, July 20, 2010, Congressional Testimony given by Brad Miller, Robert Solow, Sidney Winter, Scott Page, David Colander, and V.V. Chari ON-LINE (links at Syllabus Section I.B under “Recommended Readings”)

PLEASE NOTE: All students should prepare to participate in this discussion by studying the required [**] readings above and by considering possible answers to the discussion questions posed below. Attendance at in-class student moderated discussions is required for all students.

Specific Responsibilities of Discussion Group Moderators:

The moderators should prepare a clear concise hand-out for distribution to the class on the discussion date November 18th. The hand-out should provide suggested answers to discussion questions detailed below (to the extent that the moderators believe that definite answers can be provided) as well as pointing out any aspects of these questions that the moderators
conclude are controversial, hence difficult to answer in a definite way. If possible, the handout should also be distributed in advance using the class email list macro502@iastate.edu at least one day prior to November 18th.

The moderators should come to class on November 18th prepared to lead a class discussion on their hand-out (hence on the discussion questions below). The moderators should encourage the participation of all students in the discussion by (if necessary) calling on students to express their ideas.

**Some Suggestions:** Rather than going over all of the moderators’ responses to all of the discussion questions all at once, prior to any class discussion, I recommend that the moderators instead take up each discussion question one by one. As each discussion question is considered, the class participants should be encouraged (or called upon!) to comment on the moderators’ proposed answer as outlined in their handout. Preparation of a few transparencies/ppt slides could help to focus the discussion.

**Evaluation of Discussion Group Moderators:**
I will evaluate the performance of the moderators (as a group) on the basis of their hand-out and in-class discussion moderation. It is expected that each of the moderators will actively participate in both aspects. The judgements of all class participants will be taken into account in this evaluation through an anonymous ballot. The points earned by the moderators (up to a maximum of ten) will be included in the determination of each member’s overall course score.

**BASIC ISSUE:** As discussed in Refs.[2-3], “Taylor Rules” are simple monetary policy rules that prescribe how a central bank should adjust its interest rate policy instrument in a systematic manner in response to macroeconomic events in an attempt to achieve a combined goal of inflation rate targeting (keeping actual inflation rates close to target inflation rates) and output stability (keeping actual output close to potential output).

An important aspect of Taylor rules is that the entire focus is on short-term interest rates (e.g., the Fed funds rate), inflation rates, and output levels. Missing from such rules as standardly specified is any consideration of such aspects as “inside” credit transmission (i.e., borrowing and lending among private-sector agents) and the financial condition of major financial institutions (e.g., their risk exposure as reflected in their balance sheets and their off-balance-sheet activities).

Up until the current financial crisis, a great deal of the frontier research in monetary policy theory was centered around the specification and analysis of refinements of Taylor rules for the conduct of monetary policy by central banks.
Discussion Question 1: Using source materials available at Ref.[1] (and perhaps elsewhere), briefly but carefully summarize how the U.S. Federal Reserve System (i.e., the central bank for the U.S.) conducted U.S. monetary policy during Alan Greenspan’s Fed chairmanship and during the early years of Ben Bernanke’s Fed chairmanship up until December 2007, the start of the current financial crisis.

NOTE: The answer to Q1 should be covered in the DG2 hand-out but does not need to be discussed during the actual DG2 in-class discussion on November 18. The moderators should assume that students will have read the Ref.[1] source materials as well as the DG2 hand-out before coming to class on November 18.

Discussion Question 2: Using Ref.[2], give a concrete example of a “Taylor Rule” with all elements carefully defined and explained, and discuss what this Taylor Rule is supposed to accomplish for an economy. To what extent does it appear that Taylor Rules are in actual use today by central banks in the U.S. and elsewhere?

Discussion Question 3: In hindsight, now that the global financial crisis has ensued, does the role of central banks in modern economies as envisioned by Taylor Rules appear to be adequate? Or does it now appear that central banks should take a more pro-active interventionist role in economies? If the latter, what form should this role take? Explain carefully. Make use of the pro and con arguments given in Refs. [3-4] as appropriate.