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Monetary Theory II Summer 1999

II. Macroeconomic policy debate

a. The original debate: Rules vs discretion, Monetarists vs Keynesians

Both camps agree that money affects real economic activity in the short run (but only prices in the longer run).

Keynesians favor the use of activist, discretionary policy to fine tune the economy.

Monetarists oppose the exercise of macroeconomic stabilization policy because:

1. Lack of effectiveness due to lack of appropriate information

a) Information lags regarding the state of the economy

b) Long and variable lags between monetary policy actions and their results.

Leading indicators

2. Scope for policy manipulation to satisfy political goals (the political business cycle).

    Incompetence

According to M. Friedman monetary policy has been the main source of macroeconomic instability. Monetarists advocate the adoption of a rule (such as constant growth of the money supply). Keynesians believe that the CB has either superior information or greater flexibility than the private sector.

b. Rational expectations and macroeconomic policy:

Complete ineffectiveness of systematic policy

Lucas policy critique

c. Has the macroeconomy become more stable after WWII ?

(as a result of stabilization policies)

Statistical artifacts

d. The modern controversy for rules vs discretion in the conduct of monetary policy: The credibility issue

Examples: Being tough parents

Building in areas susceptible to flooding Dynamic inconsistency

A. Why did we get <u>high inflation in the 70s</u>? In addition to the inflationary impact of higher oil prices, monetary policy was too loose (expansionary). Why?

a) Money financed budget deficits NO in the industrial countries

b) Inflation bias. If the government attempts to systematically keep the unemployment rate below its natural rate and if expectations are rational then the only effect will be an excessively high rate of inflation. The natural rate had gone up as a result of the supply (oil) shocks.

c) Ignorance of the correct macroeconomic model (believing in a non vertical long term Phillips curve and trying to exploit this in order to keep unemployment low)

Time inconsistency:

. The Barro-Gordon model

The objective function U(p,y-yn)

The constraint (Phillips curve): y = yn +a(p-pe) + e

The technology: p = f(m)

Myopic behavior: Suboptimally high rate of inflation without any employment gains (Inflation bias)

Solving the inflationary bias of discretionary policy

1. Reputational considerations: Trigger strategy. Smaller (but still nonzero) inflation bias

Problems with trigger strategies

a. Asymmetric information. Observing the outcome (inflation) but not the policy action (Canzoneri).

b. Limited (finite) terms

Uncertainty about central bank preferences (type)

I. Sequential games (Backus+Driffill)

II. Signalling games (Vickers)

2. Appoint a central banker with the right preferences (conservative)

3. Central bank contracts (optimal incentive structure)

Central bank independence and inflation bias. Is central bank independence important for price stability?   Mixed evidence

Measuring independence   Causality

IS THE INFLATION BIAS EMPIRICALLY IMPORTANT

It does not appear to be an issue in industrial countries.

DISINFLATION

How to lower a high rate of inflation: <u>Disinflation and credibility</u>

$\pi(t) \longrightarrow E\pi(t)$, AD(t)

Sacrifice ratio

The percentage of a year's real GDP that must be sacrificed to reduce inflation by 1%

(typical estimate: 5 or 2.5% of unemployment)

The loss depends on the credibility of the policymakers. It can be zero when the disinflation announcement is fully credible

Key issue: How fast to disinflate (gradualism vs cold turkey)?

1. How big will the employment loss will be?

a) Slope of short run Phillips curve (type of labor market rigidities)

b) How fast people learn (type of expectations mechanism)

2. How much can the authorities tolerate?

Policymaker preferences. The political business cycle

Gaining credibility: a) Pursuing a tough line

b) Creating appropriate institutions (independent central bank, adoption of a fixed exchange rate regime..)