Policy Delegation: Inflation Bias and Central Bank Independence

Macroeconomics 2: Monetary Policy

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What can the government do to eliminate/reduce the inflation bias?

Rules versus discretion –

- discretion is **flexible**
- rules are **credible**

- The reason why the government is able to diverge from its announcements is that it implements policy by discretion.

- What if the policy maker was able to pre-commit to zero inflation?

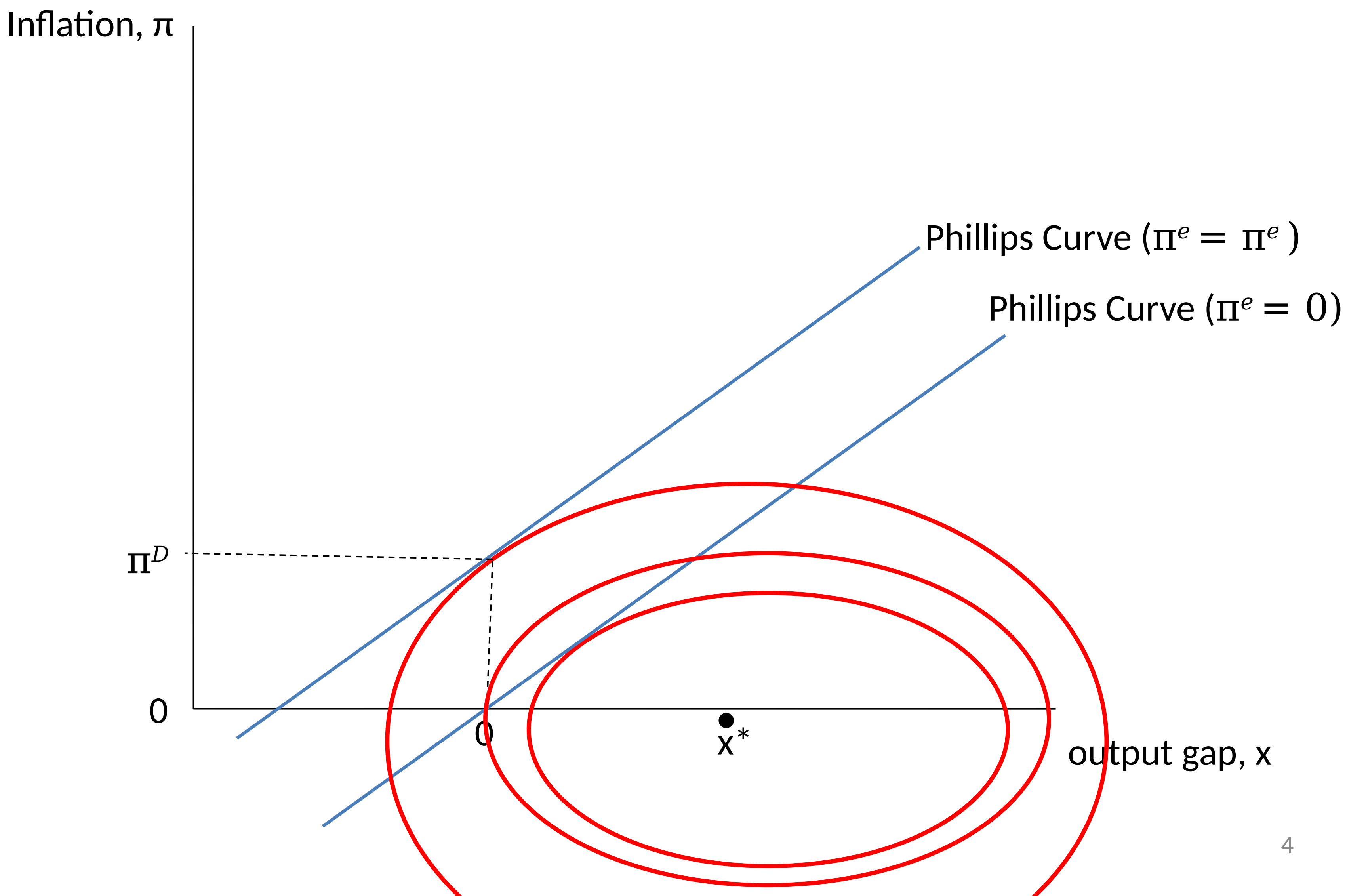
Policy under *commitment*

- Returning to the above problem with commitment, the policymaker commits to $\pi = \pi^e = 0$, and if credible then:

Which is the best feasible outcome (see next slide)

- In practice, however, commitment is not easily established. In particular, it may not be credible.

Model with commitment



Delegation

Independent central banks (CB)

Instrument independence (e.g. FRB, BoE, ECB): CB sets monetary policy – i.e. can set short term interest rates and/or set the money supply.

Objective independence: CB determines policy goals – e.g. chooses price stability/inflation target/output stabilisation.

The ‘Conservative Central Banker’

Rogoff (1985)

Suppose that monetary policy is made by an independent CB whose preferences are given by

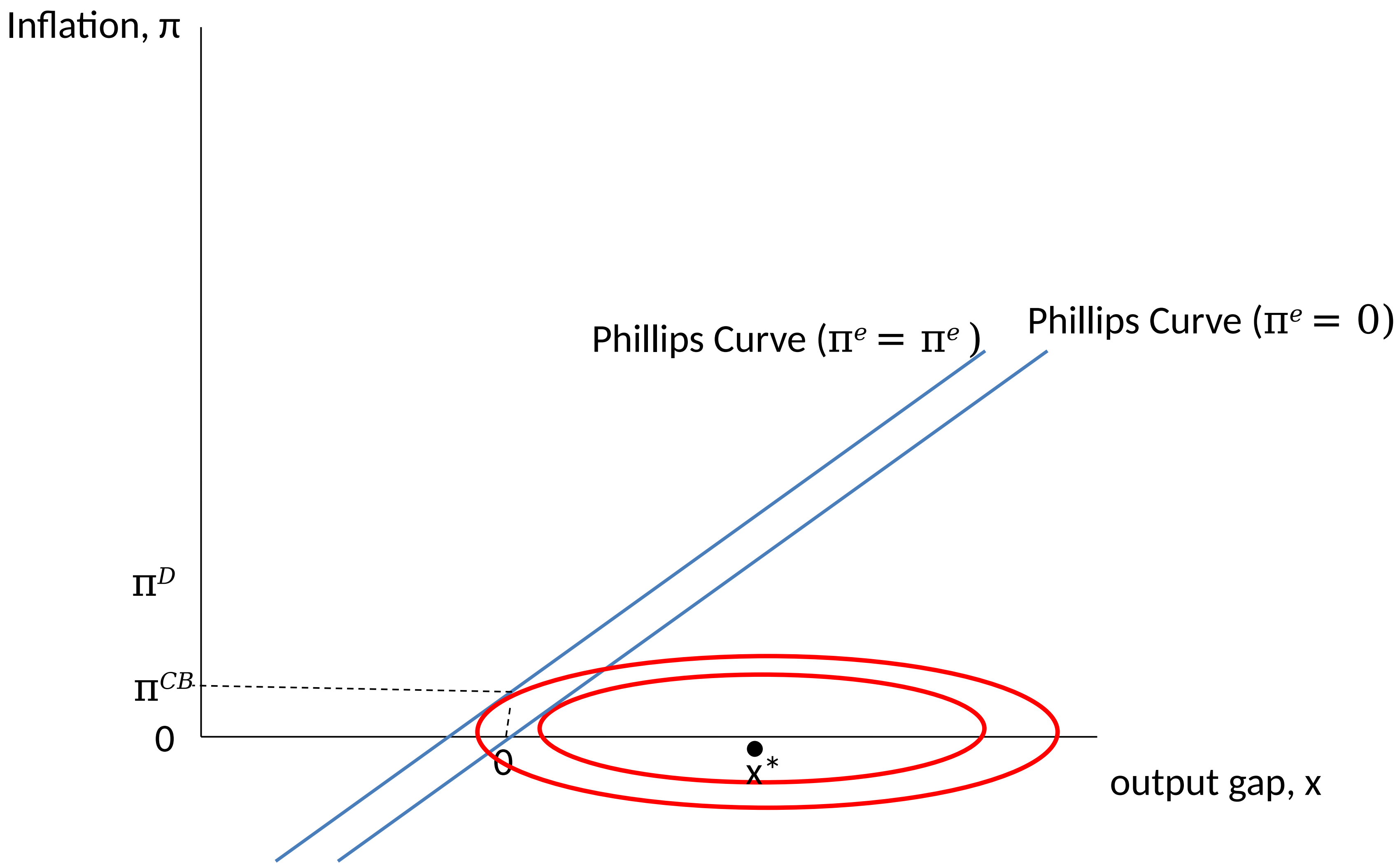
$$L^{CB}=\mu\pi^2+(x-x^*)^2$$

where μ > λ. This means greater inflation aversion and more elliptical loss funcions (see next slide).

The outcome is now

$$\pi^{CB}=\alpha x^*/\mu \qquad x^{CB}=0$$

The ‘Conservative’ Central Banker



The ‘Conservative Central Banker’

- Given that $\mu > \lambda$ - CB is more conservative than the government - inflation under an independent CB is lower than when monetary policy is made by the government itself.

- Evidence?