Credibility and Flexibility with Monetary Policy Committees

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Summary

Nominal wage contracting ensures that output is increasing in unanticipated inflation. This gives policy makers an incentive to create unexpected inflation, even though they dislike actual inflation. The private sector understands policy makers' incentives. Hence, it expects inflation. The outcome is too high inflation with no output gain. This is referred to in the academic literature as the *time-inconsistency* problem.

As a result of the growing belief that systematic attempts to use monetary policy to increase output leads solely to excess inflation, many countries have recently enacted legislation to prevent this. The Reserve Bank of New Zealand Act of 1989 requires the central bank to pursue price stability, the Bank of England Act of 1997 imposes an inflation target on the monetary policy committee and the Bank of Japan Act of 1997 mandates the pursuit of low inflation.

Inflation rules such as these may be feasible and can solve the problem of an inflation bias. However, society cares about output as well as inflation. Stochastic shocks that are realized after the public incorporates its inflationary expectations in wage contracts, but before monetary policy is made, provide an activist role for monetary policy. Low inflation rules solve the time-inconsistency problem at the expense of central banks being unable to respond optimally to shocks.

One way governments have attempted to solve this problem is by including opt-out clauses in their central banking legislation. Central banks are required to pursue low inflation in normal times, but the government can require them to respond to large shocks. For example, both the New Zealand and the UK governments can overrule their central banks in extreme circumstances. The problem with this is that it is not possible to precisely define the circumstances that allow government intervention. This allows opportunistic governments to override their central banks in less than extreme circumstances.

This paper suggests that independent central banks without low inflation rules may mimic central banks with low inflation rules and an opt-out clause. The intuition is as follows. We assume that some central bankers would like to use monetary policy opportunistically. Some, however, care solely about inflation. The public can only distinguish between the two types by their actions. This gives the opportunistic central bankers an incentive to mimic the inflation-averse central bankers in the first part of their term in office. If they do so, the public increases its belief that they are the inflation-averse type. This leads to lower inflationary expectations and makes future unexpected inflation less costly.

An opportunistic central banker's incentive to masquerade as an inflation-averse central banker depends on the size of the current shock. When shocks are small, it is relatively attractive to pretend to be inflation-averse. However, in the presence of large shocks, the reputational gain is not worth forsaking an activist role. Thus, the committee tends to pursue low inflation in normal times and to respond to shocks in exceptional times.

We demonstrate that for a wide range of economic environments, an independent monetary policy committee is better than either a zero inflation rule or discretionary policy made by a single opportunistic central banker. We believe that independent monetary policy committees are feasible. Even opportunistic governments can sometimes commit themselves to constitutional or quasi-constitutional arrangements. Once the committee is in place, it requires no government monitoring or intervention.