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Monetary policy with uncertain central bank preferences

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Abstract

This paper considers monetary policy when policy makers' preferences are private information. I show that in the first period of a two-period term, all policy makers but the least inflation averse inflate less – but respond more to shocks – than if there were no private information. Moderately inflation-averse policy makers may reduce their inflation most. A tendency toward increased conservatism in their second period increases inflation in the first. With $T < \infty$ period terms, inflation depends solely on the policy maker's time left in office. With unchanging preferences and no discounting, inflation is lower the longer he has left. © 2002 Published by Elsevier Science B.V.

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1. Introduction

An important factor in monetary policy is how averse policy makers are to inflation relative to their dislike of output loss. Their preferences are their private information and this has implications for their behavior. The intent of this paper is to analyze the effect of unobservable preferences on policy makers' incentives to inflate.

In the basic model, policy makers serve two periods and each period they minimize a loss function which is decreasing in output and increasing in squared inflation. Output is increasing in unexpected inflation. Stochastic shocks, realized after the public's expectations are formed but before monetary policy is made, provide a role for activist monetary policy. Policy makers vary by the weight they put on output loss, relative to

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inflation. This weight is a policy maker's private information and there is a continuum of policy maker types.¹

The policy maker takes current expected inflation as given when he chooses current inflation. The public has rational expectations. If it knew the policy maker's preferences, then on average it would predict inflation correctly in equilibrium. If it knew the policy maker's preferences, then on average there could be no unexpected inflation in equilibrium. Thus, he does not take into account the rise in equilibrium current expected inflation associated with a higher current inflation choice. As a result, inflation is too high. This is the familiar time-inconsistency problem.

If, however, the public believed the policy maker to be more inflation averse than he actually is, then its expectation of inflation would be too low and on average unexpected inflation would be strictly positive. Thus, output would be higher than it would be if preferences were guessed correctly. Thus, policy makers have an incentive to increase the public's perception of their inflation aversion. The public realizes this and knows the inflation the policy maker would pick, given its type. I show there exists a unique separating perfect Bayesian equilibrium, where the policy maker's type is revealed by his inflation choice.²

I show that all but the least conservative policy maker (that is, the one who puts the most weight on output) inflate less during their first period in office than they would with known preferences. This is because at their within-period optimal inflation, current welfare is insensitive to small changes in inflation. But, a small decrease in inflation raises the public's perception of their inflation aversion and increases welfare in their second period in office. The least conservative policy maker does not inflate less. His type is revealed in equilibrium and inflationary expectations are as bad as they can be. Thus, he has no incentive to signal and chooses his within-period optimal inflation. This result is similar to Vicker's (1986).

Two novel results are derived in the basic model. First, policy makers with intermediate preferences may lower their inflation the most as a result of their private information. The very conservative place little weight on output and, thus, put little weight on future expected inflation and have relatively little incentive to signal. The less conservative care more about future expected inflation. However, because the least conservative policy maker does not lower his inflation, relative to what he would do with known preferences, slightly less conservative policy makers do not have to reduce their inflation by much to distinguish themselves.

Second, unknown preferences make policy makers less inflationary in their first period in office, but *more* responsive to shocks than they otherwise would be. A shock increases within-period optimal inflation and the increase is larger the less conservative the policy maker. Thus, for all but the least conservative policy maker, inflation increases by more than within-period optimal inflation does because more conservative

¹ The model builds on Vicker's (1986) framework where two types of policy makers inhabit a two-period model without output shocks.

² Other signaling models include Spence (1973) and Milgrom and Roberts (1986), both of which have two types of agents with private information. Milgrom and Roberts (1982) and Rogoff and Sibert (1988) consider a continuum of types.

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