

Central bank's conservativeness and transparency

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Abstract

In a setting with a risk-averse union, we study the effects of central bank's political transparency on wage level and inflation volatility according to its degree of conservativeness. We obtain some results that contrast with those obtained in the same kind of model or in a Rogoff type model of a conservative central banker. For high (low) degree of conservativeness, more transparency may lead to more (less) wage discipline. When the degree of conservativeness is high, inflation volatility decreases with transparency, independently of the initial degree of transparency. In the contrary, inflation volatility could increase or decrease with transparency. © 2008 University of Venice. Published by Elsevier Ltd. All rights reserved.

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1. Introduction

Central bank independence and transparency have actually become best practice in monetary policy. Independence is justified as a way of permitting the appointment of central bankers who are more conservative than the median voter in order to offset the inflationary bias that results in inability to pre-commit. With independence, come demands for adequate accountability and hence more transparency. Nonetheless, the behaviour of independent central banks is quite heterogeneous in information disclosure (Eijffinger and Geraats, 2006; Demertzis and Hughes Hallet, 2007).

Most researchers agree that greater transparency in monetary policy is desirable because it allows the private sector to make Pareto-improving forecasts and decisions (Blinder, 1998; Blinder et al., 2001). But not everybody agrees. Some argue that information disclosure reduces the possibility for central banks to strategically use their private information. For example, information asymmetries between central banks and the public about the weight of each target in the central bank's loss function may affect trade union behaviour, induce wage moderation (Sorensen, 1991) and decrease both the level and the variance of inflation (Grüner, 2002). It can be shown that incomplete transparency is optimal as a result of a trade-off between the effect on the central bank's reputation and its consequent ability to control inflation on one hand, and the private sector's wish to see output, employment and prices stabilised on the other hand (Faust and Svensson, 2001; Jensen, 2002). For others, certain restrictions on transparency are important for operational reasons in order to reinforce the central bank's credibility (Eijffinger and Hoerberichts, 2002).

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Empirically, it is not clear whether transparency strongly affects the average level of inflation and output gap, while it remains difficult to establish its effects on output and inflation variability. According to [Chortareas et al. \(2002\)](#), disclosure of inflation forecasts reduces inflation volatility at the expense of a rise in output volatility. [Demertzis and Hughes Hallet \(2007\)](#) have found that an increase of transparency benefits inflation variability, but has a less clear effect on output volatility and no effects on average levels of inflation and output. One explanation is that a conservative (inflation-averse) central bank will have to put up with higher output variability if it is to retain lower inflation on average ([Rogoff, 1985](#)). On the other hand, [Kuttner and Posen \(1999, 2000, 2001\)](#) argue that inflation-targeting central banks display higher flexibility (less conservatism) in responding to shocks without reducing their ability to respond to output volatility. [Gruner et al. \(2005\)](#) find that higher monetary policy uncertainty has a disciplinary effect on wage inflation in the some European economies and in Japan but are unable to detect such an effect in the UK and the US. Explaining this result by difference in the degree of wage coordination, they conjecture that the degree of conservatism of monetary policy may be associated with the size of nominal wage claims. The most convincing evidence suggests however that conservative and transparent central banks are able to reduce both levels and variances of output gap and inflation ([Posen, 2003](#)). The analysis of [Dincer and Eichengreen \(2007\)](#) suggests broadly favourable if relatively weak impacts on inflation and output variability.

The theme of this paper is related to some recent studies on the relationship between the central bank's conservatism and transparency. [Di Bartolomeo and Marchetti \(2004\)](#) suggest that optimal degree of transparency depends on that of conservatism. [Hughes Hallett and Weymark \(2005\)](#) have shown that, because public support is likely to diminish as the perceived conservatism of the central bank increases, relative to public preferences, central banks that are less independent have an incentive to limit policy transparency. However, our paper is focused on the interaction effects of central bank's conservatism and transparency on macroeconomic variables. We base our analysis on a model of two-stage game in which a monopoly union² interacts with a central bank. Similar models could be found in [Sorensen \(1991\)](#), [Cukierman and Lippi \(1999\)](#), [Grüner and Hefeker \(1999\)](#), [Grüner \(2002\)](#). We assume that the public is uncertain about the weight that the central bank puts on its various objectives (political transparency in the terminology of [Geraats \(2002\)](#)). In so far as uncertainty about central bank objectives affects risk-averse trade unions behaviour, it may also have a positive or negative impact both on price stability and on inflation uncertainty. Our results depend on the average degree of conservatism, in contrast to these found by [Sorensen \(1991\)](#) who assumes that the union cares only about inflation volatility or by [Grüner \(2002\)](#) who uses a simpler method of approximation to calculate the union's expectations. Our result conflicts these of other models (see for example, [Demertzis and Hughes Hallet \(2007\)](#)) that found no effect for transparency on average wage and inflation due to the absence of risk-averse unions.

In the next section, we present the model. In the third section, we solve for equilibrium wage and inflation. The equilibrium properties of the economy are studied in the fourth section. We conclude in the last section.

2. The model

Our analysis is based on a two-stage game model ([Grüner, 2002](#)) in which nominal wage, w , is fixed by the monopoly union before the central bank fixes inflation rate, π . Unemployment, u , is related to real wage $W (W \equiv w - \pi)$ in a simple way with $u = a \cdot W$, where it is assumed $a = 1$. The central bank cares about inflation and unemployment by maximizing the following quadratic utility function:

$$C(\pi, u) = -I\pi^2 - u^2 \quad (1)$$

where I is the weight assigned to inflation target. It can be interpreted as central bank's inflation aversion or degree of conservatism. The disclosure of the information about I is imperfect, so that it is a random variable in the perception of the union. The union's objective is to maximize the following utility function:

$$U(w, u) = W - \frac{A}{2}u^2, \quad (2)$$

² We can use an alternative model with n unions, which allow studying the effects of different degree of wage coordination. But this is not central to our study.

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