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Socially optimal monetary policy institutions

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Abstract

Research on the interaction between wage setters and central banks has shown that the classical dichotomy of monetary policy models in the tradition of Barro and Gordon [Journal of Political Economy 91 (1983) 589] does not hold if an inflation motive of wage setters is introduced. In this paper, the conditions for this result are re-examined under different assumptions concerning the exact timing of the strategic game, and the consequences for the socially optimal delegation rules and incentive contracts for central bankers are derived. It is shown that the relationship between central bank conservativeness and macroeconomic performance—and hence the design of optimal monetary policy institutions—is sensitive to the modelling choice. In particular, the case for an ultra-populist central banker is valid only under assumptions that appear to be quite unrealistic.

JEL classification: E13; E50
Keywords: Central banks; Monetary policy; Neutrality of monetary policy; Wage setting

1. Introduction

Economic institutions are shaped by theoretical perceptions of the possible and proper roles they can play in society. This observation is certainly relevant for the shift of monetary policy institutions towards a more conservative stance (see Maxfield, 1998 for a comprehensive account from a political economy perspective). The desirability of conservative monetary policy follows directly from the strict dichotomy of the determination of real and nominal variables in traditional models of monetary policy (Kydland and Prescott, 1977; Barro and Gordon, 1983). In these models, real activity is exclusively

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determined by the behaviour of the private sector, whereas monetary policy is directed to the choice of the underlying inflation rate in equilibrium. "Inflation is always and everywhere a monetary phenomenon", the famous dictum of Friedman (1968a, p. 39), thus should be complemented by the statement that real variables are always and everywhere a private sector phenomenon. Friedman (1968b) coined the metaphor of the "natural rate of unemployment" to indicate this *theoretical assumption* of the independence of real activity from the conduct of monetary policy.

As it is well known, in such an environment, discretionary monetary policy leads to an inefficiently high time consistent rate of inflation because of the futile desire of central bankers to increase output above the natural rate. This line of reasoning had empirical appeal for the 1970s, when high inflation and low levels of unemployment coincided. The same methodological background has been used to explain high and persistent unemployment, especially in Europe. In the main contributions to this literature (Layard et al., 1991; Lindbeck, 1993; Phelps, 1994), wage setting is modelled as *real* wage setting, and monetary policy or anything else that could be associated with demand management has no influence on real variables in equilibrium, except in the presence of hysteresis (see e.g. Ball, 1997).[1]

The traditional approach has been challenged by models of the interaction between monetary policy and the private sector that allow for a well-defined influence of both agents on real and nominal variables (Cubitt, 1992, 1995, 1997; Gylfason and Lindbeck, 1994; Skott, 1997; Guzzo and Velasco, 1999; Cukierman and Lippi, 1999; Coricelli et al., 2000). The key to this non-neutrality result is a more careful characterization of the preferences of the private sector (wage setters), more specifically, the degree of inflation aversion.

Against this background, the purpose of this paper is twofold. First, the theoretical conditions under which the aforementioned non-neutrality of monetary policy does indeed hold are demonstrated and discussed. I will show that the traditional paradigm of the classical dichotomy does not hold if

1. wage setters are inflation averse, and
2. wage setters take into account the influence of their wage setting decision on inflation.

Second, I re-examine the normative policy implications for the optimal design of monetary policy institutions. More specifically, I reconsider the Rogoff (1985) suggestion that society should delegate monetary policy to a conservative central banker and the idea of Persson and Tabellini (1993) and Walsh (1995) proposing optimal incentive contracts for monetary policy makers. I show that—and how—the optimal design of both institutions depends on the characteristics of the wage setting process.

Both of these topics are discussed in two distinct set-ups. First, following the traditional literature on monetary policy in the spirit of Barro and Gordon (1983) and Rogoff (1985), the strategic interaction between wage setters and monetary policy makers is analyzed in the context of (symmetric) Nash models. Second, as some authors have employed the assumption of a Stackelberg leadership position of wage setters vis-á-vis the central bank

[1] It may be noted that the index of Phelps (1994) does not contain entries for "inflation", "monetary policy" or any conceivable synonym.