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A simple model of disinflation and the optimality of doing nothing

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Abstract

This paper analyses the optimal monetary policy of a government facing an election, whose disinflationary 'abilities' are uncertain, under the assumption that reducing inflation is costly because of backward-looking contracts. It is shown that if the government likes to be in power it can choose to 'do nothing' on the inflation front in order to avoid risking electoral defeat should disinflation prove too costly. The costs of inflation reduction are worth bearing if initial inflation is sufficiently high: therefore it is possible to observe quick disinflations that however stop short of low inflation.

Keywords: Disinflation; Inertia; Time consistency; Elections

JEL classification: D72; E31

1. Introduction

The presence of inertial factors in wage and price formation, such as lagged wage indexation, is mentioned as a main obstacle to disinflation and as a cause of output decline in many studies of disinflationary attempts. This paper addresses the issue of the optimal speed of disinflation when such inertial factors are present,

[1] This paper is based on chapter V of my Harvard Ph. D. dissertation and was completed while I was affiliated with the Centre for Economic Performance of the London School of Economics. I am very grateful to my advisors Alberto Alesina and Maury Obstfeld, and to José De Gregorio and two referees for useful suggestions. Seminar participants at the Centre for Economic Performance, IGIER, the European Econometric Society 1992 Winter Meetings and the IMF gave me useful comments. The views expressed are mine and do not necessarily reflect those of the International Monetary Fund.

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and studies how electoral uncertainty affects the determination of monetary policy. The interaction between inertial factors and political uncertainty provides a possible explanation as to why disinflation may proceed too slowly, and why a disinflation program may be stopped, postponed or not adopted at all. In particular, the analysis provides one rationale for the stylized fact that successful inflation reduction plans often stop short of full disinflation, so that the inflation rate remains in double-digits. [2] In practice, the factors highlighted in this paper are likely to interact with the credibility of disinflation plans (not explicitly considered here) since credibility may depend on whether the government is perceived to be able to reduce inertial factors.

It is often argued that governments may refrain from embarking on anti-inflationary programs for fear of the short-run economic costs that these programs might entail. It is possible that in the long run these costs are worth bearing in exchange for a lower inflation regime; therefore a government which takes a sufficiently 'long-term' view would not be discouraged by the presence of short-run costs of adjustment. A common explanation of why governments do not take this long-term view is that in a democratic regime with frequent elections the government in power is not sure of reappointment. If voters dislike high unemployment the government may choose not to implement a disinflationary program close to an election year, for fear that a recession would cause its electoral defeat. [3] This explanation seems to rely on voters being myopic; if it is common knowledge that a disinflationary program is costly but voters agree that the long-run benefits exceed the costs then there is no reason why – in a situation of temporarily high unemployment – rational forward-looking voters should throw the incumbent out of office.

In this paper I construct a simple model in which it may be rational for a government facing an election not to embark on a disinflationary program, even though voters' behaviour is forward-looking. Three key assumptions are behind this result. First, disinflation entails unavoidable output costs, but these costs are uncertain. Second, the government stakes political capital when it starts a disinflationary program: voters are likely to interpret unsuccessful or costly programs as a signal of government's incompetence. By devoting political capital to inflation reduction, the government forgoes the option of exploiting an incumbency bias. [4]

[2] This is the case, for example, in Bolivia, Israel and, until 1993, Mexico. For recent analyses on this topic, see Dornbusch and Fischer (1993) and Dornbusch et al. (1990).

[3] For example Blanchard (1985) constructs a simple model in which a conservative government chooses a gradual disinflation for fear of self-fulfilling prophecies of high unemployment and electoral defeat should it adopt a 'cold turkey' policy.

[4] An extensive political science literature documents the existence of an incumbency bias in elections. Calvert (1986) surveys arguments supporting such finding. The assumption that this incumbency bias disappears if the government undertakes a stabilization program seems reasonable: a failed or excessively costly program is likely to doom the electoral chances of the government because it reveals information about the government's ability to effectively face the inflation problem.