

## Inflation Bias: An Appraisal

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Abstract: This short paper offers a brief appraisal of the conventional inflation bias and Cukierman's new inflation bias. It may also be seen that a lack of equilibrium in the balance of payments represents another reason for the emergence of the inflationary bias in an economy.

Key words: Inflation Bias, Rules *versus* Discretion, Inflation.

JEL Classification: E31, E52.

### 1. INTRODUCTION

Rules *versus* discretion has been a major monetary policy debate since the 1990s. One of the most relevant analyses in this debate is the belief by several economists (since Kydland and Prescott — 1977, and Barro and Gordon — 1983) that there is an inflationary bias in the conduction of the monetary policy. The conventional views point out two main motives for this:

(i) the standard analysis concerning the discretionary behavior of monetary policy implies an incentive for monetary authorities to reduce the unemployment by inflationary policies. The problem with this procedure is the disappearance of the effect of an increase of monetary supply on employment in the long run, while an increase in inflation is not eliminated. On the other hand, if rules were to be adopted, the manifestation of inflationary bias would be impeded implying an outcome more preferable than that of discretionary behavior. Under this perspective, one important institutional framework capable of avoiding the discretionary action of government is the use of independent agencies.

(ii) the political use of the monetary policy (from analysis on fiscal dominance and political electoral cycle) — an assumption that there is a distinction between the monetary and fiscal authority and that the latter is dominant (Sargent

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and Wallace, 1981); if the public does not want to pay an additional deficit, the monetary authority will be forced to finance the government by expansion of money supply. On the other hand, if the monetary authority is dominant, the fiscal authority will be forced to reduce the deficit. As far as the political electoral cycle is concerned, it is seen that governments in periods near elections prefer more employment than less inflation; believing that, in this way, they will achieve their reelections or help the election of candidates of their party. Thus, there is the tendency of governments to pressure the monetary authority to implement policies that increase the output. This implies that the presence of a subservient CB tends to increase money supply with the objective of reducing the unemployment level.

This paper offers a brief appraisal for the conventional inflation bias and Cukierman's new inflation bias. It is also suggested that a lack of equilibrium in the balance of payments represents another reason for the emergence of the inflationary bias in an economy.

## 2. A BRIEF REVIEW OF THE CONVENTIONAL VIEW

Due to an inflationary bias in the conduction of monetary policy, some authors (as Rogoff — 1985, and Lohmann — 1992) suggested conservativeness of the central banker as a solution for the dynamic inconsistency problem. Notwithstanding this proposal, this framework is not capable of achieving the optimal social welfare, because the reduction of the inflationary bias is achieved by a decrease in the stabilization output. Another weakness is the subjectivity characteristic — it is necessary to find one agent that has a greater aversion to inflation than society has.

In an attempt to eliminate the above-mentioned problems, a new generation of independent central bank models using inflation targeting emerged. Under this perspective, the analysis done by Walsh (1995) deserves attention. This interpretation incorporates the role of optimal contracts between the central bank (CB) and the government based on the theory of the principal-agent. The problem with the inflation bias is solved by the structuring of a contract that imposes costs on the CB when the inflation deviates from the optimal level. In other words, under this concept the principal (the government) makes an incentive contract with an agent (CB), wherein the agent is subject to penalties *ex-post* that would be determined according to the deviation of the inflation from the goal. The advantage of this framework is that social optimization is reached, even if the government and the CB have the same objective function and the same set of information.

Svensson (1997) argues that a linear contract, as proposed by Walsh (1995), is a very elegant form of removing the inflation bias. However, there are practical and political difficulties in implementing this structure. The practical difficulty results from the fact that the linear cost represents a monetary cost. "A political difficulty is that the contract stipulates higher monetary rewards to the

Governor or board when inflation is low, which may be provocative to the public if correlated with higher unemployment”. (Svensson, 1997, p. 105) Besides, when applied jointly, contracts and goals can remove the inflation bias of the management of the monetary policy and attenuate the possible trade-off (due to the uncertainty of the preference of the CB) between stabilization policies and inflation control. (Muscatelli, 1998)

### 3. A NEW INFLATION BIAS?

In a recent paper Cukierman (2002) launched a new interpretation on inflation bias. The core of the idea is that there is an inflation bias in the presence of asymmetries and uncertainty on the future economical environment. The reason for the presence of the inflation bias in the central bank behavior is the fear that the economy plunges into a deep recession. The interpretation is analogous to Kimball’s (1990) analysis on the precautionary saving motive in the theory of consumption under uncertainty.

The difference of this interpretation, in comparison with the conventional view, is that instead of the inflation bias being intimate with dynamic inconsistency, “the origin of the bias resides, (...), in the precautionary behavior of the CB, with respect to recessions in a world of uncertainty, in conjunction with the public’s awareness of this asymmetry in CB objectives”. (Cukierman, 2002, p. 31)

Although Cukierman offers a new motive for understanding the inflation bias in models developed in the rule *versus* discretion debate, both interpretations (conventional and new) have the same problem — the reason for the existence of the inflation bias is a bit *ad hoc*. It is easy to perceive the necessity for several particular links to validate the theory. Overall, in the conventional view, the inflationary bias is a consequence of the government using the resources from the CB (seigniorage) in the search for a level of unemployment lower than the natural. In Cukierman’s view it is necessary that the CB adopts a precautionary behavior against deep recessions. The main point for this case is how the CB knows if a particular situation will imply a deep recession or not. It is important to remember that there is a consensus among the economists that forecasting production is not an easy task.

Another point in contention of Cukierman’s interpretation is that it sounds more like an academic curiosity. Several countries, in order to inhibit the conventional inflation bias, adopted an independent CB and inflation targeting strategy in the 90s. With Cukierman’s idea, the literature returns to the question of how to inhibit this “new” inflation bias. In other words, it does not help to solve any problem in the real world. Therefore, there is no relevance in practice. We are reminded by Robert Solow in a recent interview for *The Region* (2002, p. 34) — “You’ve got to fit your model to the world, not the world to your model.”

#### 4. A REAL NEW INFLATION BIAS

Inflation bias is a problem especially in the case of developing countries. One considerable problem is the scarcity of resources for the balance of payments equilibrium. Thus, since external savings implies a high cost, one way that is attractive for governments is the surplus in trade balance. For this, governments are tempted to devalue the currency in order to give incentive to exportation. In the majority of times, the outcome is the success in reaching the balance of payments equilibrium. On the other hand, the devaluation of currency implies an increase in the prices of the imported goods. Therefore, there is a pressure on general prices that causes inflation in the country.

This version of inflation bias does not need to be understood as a bad thing in itself. The motivation for inflating the economy is a consequence of the problem in the balance of payments equilibrium. Thus, while the devaluation of currency is used for eliminating the lack of equilibrium, this type of inflation bias is not an evil. The problem emerges when the government uses this mechanism as the only impulse for the economic activity.

This reason for inflation bias is completely different from the previous analysis. It is not associated with dynamic inconsistency or fear of a deep recession. The inflation bias is a result of the real problem of countries that have an insufficient economic growth. The natural question is how to inhibit this version of the inflation bias. The answer is obvious. If the policymaker has limitations in the use of this strategy through nominal anchors (inflation targeting, exchange, etc.) the government cannot use this framework indefinitely. Therefore, it is possible to find the optimal use of this framework without damaging the economy.

Thus, this type of inflation bias suggests a different direction from that of Barro (1986) pointing out as the necessary conditions: (i) the validity of the rational expectations, that is, the inflation expectations of the economical agents are correct on average; and (ii) although the policymaker has the power to fool the public by inflation surprise, there is no motivation to use this instrument. The real new inflation bias implies that a third point need be added to the existing two: an optimal combination between inflation and growth.

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