Why does the problem of time-inconsistency arise in the implementation of monetar...

Literature, Russian Literature

Why does the problem of time-inconsistency arise in the implementation of monetary policy and how can it be mitigated? The time-inconsistency problem is a problem that is well documented in literature, and is related to policy making and inflation. Time-inconsistency has often been considered to be the cause of the so-called great inflation of the 1970’s in the US, as well as the decrease in inflation that has lasted from the 1980’s to the present day (Surico, 2003). Time-inconsistency is related to the change in apparent value of policies as time progresses, with decisions being made at one point in time due to the situation then, but changed later as the situation changes. In simplistic terms, time-inconsistency is where policies were considered to be optimal at one point, are no longer considered to be so with the passing of time and so are not implemented (Federal Reserve Bank of San Francisco, 2003). If those that are involved in making policy cannot commit to policies for the future, then this leads to higher inflation rates than if they can commit. The consequence of this is an inflation bias that occurs systematically (Albanesi et al., 2001). Therefore, time-inconsistency occurs because policy makers work off present knowledge, rather than attempting to make policies that will also be effective in the future. The problem of time-inconsistency arises because of the interplay between costs and benefits of inflation, and it can occur in a number of different models of the economy (Albanesi et al., 2001). As a consequence it becomes important for the government to make its monetary policy known and credible to the public (Mersch, 2006). Making policy clear and transparent is important, as part of the way that time-inconsistency arises is through expectations, particularly those of the private sector (Surico, 2003). There is also a strong connection

between the time-inconsistency problem, unemployment and inflation bias. This is because many central bankers’ attempt to control unemployment through monetary policies by using incentives to achieve a lower level of unemployment. These plans are generally not time-consistent, and are adjusted as time changes the perceived benefits to the policies. The consequence of which is a similar level of unemployment as previously, but a higher level of inflation (Surico, 2003). Despite widespread theory and evidence of the prevalence of time-inconsistency, Albanesi et al. (2001), showed that for two models of the economy: the cash-credit good model and the limited participation model under a wide range of parameters there was no time-inconsistency problem even though the manager in the models could not commit to policies in the future. They concluded that the time-inconsistency problem is not severe in monetary policy and that there was no inflation bias in the models studied. This result was extended to conclude that time-inconsistency does not play as big a role in the economy as other studies argue. There are suggestions that while inflation bias may have been important during the inflation increase in the 1970’s, it is not important under today’s society (Surico, 2003). One method of mitigating the problem of time-inconsistency was tried in a New Zealand bank, where the government employment contract contained the clause that the Governor could be dismissed if the inflation rate was more than a certain amount above the government’s target. In the Euro system, the problem of time-inconsistency has been solved by banking strategy and transparency to the public about policy and expectations (Mersch, 2006). Mitigating the time-inconsistency problem appears to involve making policy decisions clear to

the public and the private sector, as well as making policy decisions predictive, taking into account both events that may happen, and the situation when policy decisions were originally made. Time-inconsistency is a problem that is thought to have been the cause of the great inflation of the 1970's, and caused by policy makers changing policies as time progresses, rather than making policies that take future situations into account. This consequently causes an increase in inflation. Methods to mitigate this have been found, including making policy decisions transparent, managing the expectations of the public and the private sector and using forward thinking banking strategy. Bibliography ALBANESI, S., CHARI, V. V. & CHRISTIANO, L. 2001. How Severe is the Time Inconsistency Problem in Monetary Policy? : National Bureau of Economic Research Cambridge, Mass., USA. FEDERAL RESERVE BANK OF SAN FRANCISCO 2003. FRBSF Economic Letter - Time-Inconsistent Monetary Policies: Recent Research. MERSCH, Y. 2006. Monetary policy and time inconsistency in an uncertain environment [Online]. Available: http://www. bis. org/review/r060915a. pdf [Accessed September 2 2011]. SURICO, P. 2003. Measuring the time-inconsistency of US monetary policy. European Central Bank Working Paper Series.