

Comments on

Changing Central Bank Pressures and Inflation

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1. The model

- A theory of long run inflation in the following context:
 - The central bank (CB) makes monetary policy under discretion (no commitment)
 - Firms have monopoly power or there are distortions in the labor market that generate low levels of employment and output
 - There are no (lump sum) subsidies to fix these inefficiencies
 - Staggered price-setting

- New Keynesian model and CB optimization:
 - Price rigidity allows for long-run non-super neutrality of monetary policy
 - Through inflation, the CB may shift relative price dispersion (higher inflation means greater price dispersion)
 - Greater relative price dispersion reduces welfare and raises the marginal utility (MU) of consumption (too much is consumed of some goods and too little of others)
 - The increase in the MU of consumption brings about greater employment (by increasing the reward from giving up leisure)
 - Hence, the discretionary CB would set inflation so as to raise aggregate employment and, consequently, offset monopoly power or other distortions that cause too low employment

- Thus, optimal inflation for the discretionary CB will increase with greater monopoly power, larger distortions in the labor market (“endogenous political economy pressures”), or anything reducing the weight the CB places on the costs of inflation (“exogenous political economy pressures”)
- The transitional dynamics after these shifts exhibit overshooting of inflation: As relative price dispersion and its effect on employment increase over time, optimal inflation falls below the level it reaches on impact
- The model is used to explain the declining trend of inflation worldwide in the last 30 years (globalization, market liberalization, fiscal discipline, de-unionization, CB reform, the zero-lower bound)...
- ... And is also used as a warning about the risk of rising inflation in the future as some of these factors are being reverted
- In this context, reinforcing CB independence and commitment to low inflation becomes important

Overall assessment

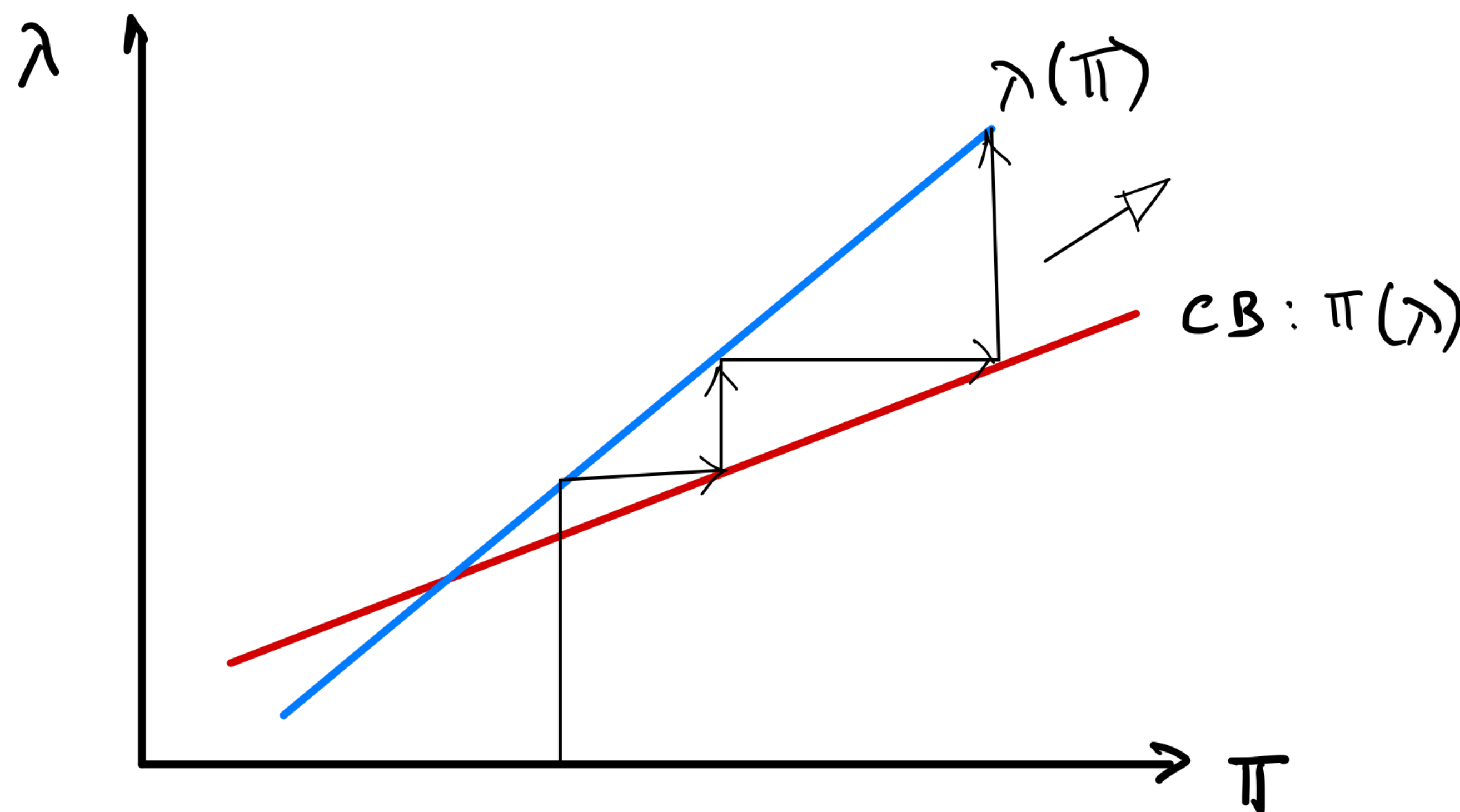
- Interesting and creative extension of a standard macro model to understand inflation in the long run and analyze relevant challenges for monetary policy
- The paper is a heuristic representation of richer and more complex models on the subject
- As such, it conveys the main messages and results of this literature
- The historical interpretation of inflation and the depiction of the risks ahead as seen through the lens of the model are appealing and convincing to a large extent
- Some specific questions and comments follow

2. Some questions about the model and its implications

A. On the role of indexation and price flexibility

- The paper states that with price flexibility or indexation to LR inflation, relative price dispersion is nil and the LRAS curve is vertical (super-neutrality is restored)
- However, the logic of the model seems to imply that, by reducing relative price dispersion, greater price flexibility or indexation would prompt the discretionary CB to raise inflation in order to increase employment and keep a labor share target
- Thus, **given the incentives of the CB, under near full price flexibility or indexation, could inflation become indeterminate?**
- Indeed, notice that when λ (the frequency of price adjustment) goes to infinity, BOTH the LRAS and the LRAD curves are vertical and would not necessarily intersect, or would intersect at an infinite number of values of inflation

- Also, intuitively one could expect that too high a long run inflation rate may induce the private sector to expand indexation (Colombia's case) or price flexibility
- If this is the case, **could the model be expanded to explain both long run inflation and the degree of indexation or price flexibility?**
- If so, depending on the shapes of the response of the CB to indexation/price flexibility (higher inflation) and the response of the private sector to inflation (higher indexation/price flexibility), **could unstable equilibria emerge?**



B. On the incentives of the CB

- The discretionary CB solves a static problem (it trades off current consumption for current leisure). This problem does not have an intertemporal dimension
- Welfare in the resulting equilibrium might be lower than in a situation with less inflation
- **Why would the discretionary CB not consider the effects of its actions on future price dispersion and welfare?** This could yield better outcomes
- In Afrouzi et al. (2023) the static nature of the CB problem stems from the Markov Perfect Competitive Equilibrium, in which firms incorporate the incentives of the CB in their inflation expectations and price setting, so current and future price dispersion is taken as given by the CB when solving its problem
- **Could the equilibrium concept change under different information structures?** For example, if firms cannot be certain about the objective of the CB and must learn about it, the CB's actions today may influence future price dispersion and this could affect its choice of inflation

C. On the interpretation of the results for IT CBs

- The model provides a theory of long term inflation determination by a ***discretionary*** CB
- How could it be applied to ***committed*** IT CBs?
- **Could it be understood as a theory of how inflation targets are set?**
- **If so, could it explain some of the variation in inflation targets across CBs?**
- For example, **could higher ITs in some EMEs with respect to AEs be attributed to less competitive environments, larger labor market distortions and greater indexation?**
- More generally, an avenue of research is open to **test the empirical implications** of the theory, beyond the stylized facts used to motivate it:
 - Explanation of variation of ITs and long term (average) inflation across countries and time
 - Explanation of the variation of the labor share across countries and time

D. On the implications of the model for future inflation

- If the risks highlighted in the paper materialize, **how would higher inflation be achieved by IT CBs?**
- In countries with weaker institutions, CB independence would be removed or severely curtailed (as it has happened in Argentina, Venezuela, Turkey),... but how about IT CBs in AEs and some EMEs?
- **Will they publicly adopt higher ITs?** Easier said than done ... Which target? Why? Will this signal future revisions of targets? How often? Is this a sign of a weaker commitment to low inflation or a long term re-optimization of a committed CB?
- This would be unlike past changes in trend inflation, which were made or allowed by non-independent or non-committed CBs

- The authors state that if political economy pressures on CBs result in higher average inflation, **“they will likely come in the form of occasional bursts of inflation, ... rather than an inflation rate that continuously exceeds the target”**
- This implies that CBs would not abandon their public targets, but would allow episodes of high inflation followed by (possibly painful) downward adjustments
- **Why would CBs opt for this choice?**
 - It is not what the theory predicts (a theory for the steady state), unless there are very strong shifts in the endogenous and exogenous political economy pressures at relatively high frequency
 - Practitioner’s POV: CBs are greatly averse to this type of volatility
- The current global disinflation process will provide some evidence in favor or against the theory... Whether inflation goes back to target (the “last mile” problem) or not will be revealing

E. A final note on political economy pressures on the CB in Colombia (and possibly other EM small open economies)

- In our disinflation experience, relevant political economy pressures on the CB came from politicians and tradable sectors to resist a real appreciation of the Colombian peso
- Those pressures were especially strong in the 1990s and part of the 2000s and 2010s, when factors like capital inflows, lower public debt ratios or the commodity price super cycle appreciated the currency
- Hence, in periods of real currency appreciation that were favorable for inflation reduction, there were political economy pressures to slow down the disinflation process