

10.2: Why Have Central Bankers So Often Gotten It Wrong?

learning objectives

1. Given the analysis in this chapter, why do central bankers sometimes allow inflation to occur year after year?
2. What are lags and why are they important?

If the link between money supply growth and inflation is so clear, and if nobody (except perhaps inveterate debtors) has anything but contempt for inflation, why have central bankers allowed it to occur so frequently? Not all central banks are independent of the fiscal authority and may simply print money on its behalf to finance budget deficits, the stuff of hyperinflations. In addition, central bankers might be more privately interested than publicly interested and somehow benefit personally from inflation. (They might score points with politicians for stimulating the economy just before an election or they might take out big loans and repay them after the inflationary period in nearly worthless currency.) Assuming central bankers are publicly interested but far from prescient, what might cause them to err so often? In short, lags and high-employment policies.

A lag is an amount of time that passes between a cause and its eventual effect. Lags in monetary policy, Friedman showed, were “long and variable.” Data lag is the time it takes for policymakers to get important information, like GDP (Y) and unemployment. Recognition lag is the time it takes them to become convinced that the data is accurate and indicative of a trend and not just a random perturbation. Legislative lag is the time it takes legislators to react to economic changes. (This is short for monetary policy, but it can be a year or more for fiscal policy.) Implementation lag refers to the time between policy decision and implementation. (Again, for modern central banks using open market purchases [OMPs], this lag is minimal, but for changes in taxes, it can take a long time indeed.) The most important lag of all is the so-called effectiveness lag, the period between policy implementation and real-world results. Business investments, after all, typically take months or even years to plan, approve, and implement.

All told, lags can add up to years and add considerable complexity to monetary policy analysis because they cloud cause-effect relationships. Lags also put policymakers perpetually behind the eight-ball, constantly playing catch-up. Lags force policymakers to forecast the future with accuracy, something (as we’ve seen) that is not easily done. As noted in earlier chapters, economists don’t even know when the short run becomes the long run!

Consider a case of so-called cost-push inflation brought about by a negative supply shock or wage push. That moves the AS curve to the left, reducing output and raising prices and, in all likelihood, causing unemployment and political angst. Policymakers unable to await the long term (the rightward shift in AS because Y^* has fallen below Y_{nr} , causing unemployment and wages to decline) may well respond with what’s called accommodative monetary policy. In other words, they engage in expansionary monetary policies (EMPs), which shift the AD curve to the right, causing output to increase (with a lag) but prices to rise. *Because prices are higher and they’ve been recently rewarded for their wage push with accommodative monetary policy, workers may well initiate another wage push, starting a vicious cycle of wage pushes followed by increases in P^* and yet more wage pushes.* Monetarists and other nonactivists shake their heads at this dynamic, arguing that if workers’ wage pushes were met by periods of higher unemployment, they would soon learn to stop. (After all, even 2-year-olds and rats eventually learn to stop pushing buttons if they are not rewarded for doing so. They learn even faster to stop pushing if they get a little shock.)

An episode of demand-pull inflation can also touch off accommodative monetary policy and a bout of inflation. If the government sets its full employment target too high, above the natural rate, it will always look like there is too much unemployment. That will eventually tempt policymakers into thinking that Y^* is $< Y_{nr}$, inducing them to implement an EMP. Output will rise, temporarily, but so too will prices. Prices will go up again when the AS curve shifts left, back to Y_{nr} , as it will do in a hurry given the low level of unemployment. The shift, however, will again increase unemployment over the government’s unreasonably low target, inducing another round of EMP and price increases.

Another source of inflation is government budget deficits. To cover their expenditures, governments can tax, borrow at interest, or borrow for free by issuing money. (Which would you choose?) Taxation is politically costly. Borrowing at interest can be costly too, especially if the government is a default risk. Therefore, many governments pay their bills by printing money or by issuing bonds that their respective central banks then buy with money. Either way, the monetary base increases, leading to some multiple increases in the MS, which leads to inflation. Effectively a tax on money balances called a currency tax, inflation is easier to disguise and much easier to collect than other forms of taxes. Governments get as addicted to the currency tax as individuals get addicted to crack or meth. This is especially true in developing countries with weak (not independent) central banks.

Stop and Think Box

Why is central bank independence important in keeping inflation at bay?

Independent central banks are better able to withstand political pressures to monetize the debt, to follow accommodative policies, or to respond to (seemingly) “high” levels of unemployment with an EMP. They can also make a more believable or credible commitment to stop inflation, which is an important consideration as well.

key takeaways

- Private-interest scenarios aside, publicly interested central bankers might pursue high employment too vigorously, leading to inflation via cost-push and demand-pull mechanisms.
- If workers make a successful wage push, for example, the AS curve will shift left, increasing P^* , decreasing Y^* , and increasing unemployment.
- If policymakers are anxious to get out of recession, they might respond with an expansionary monetary policy (EMP).
- That will increase Y^* but also P^* yet again. Such an accommodative policy might induce workers to try another wage push. The price level is higher after all, and they were rewarded for their last wage push.
- The longer this dynamic occurs, the higher prices will go.
- Policymakers might fall into this trap themselves if they underestimate full employment at, say, 97 percent (3 percent unemployment) when in fact it is 95 percent (5 percent unemployment).
- Therefore, unemployment of 4 percent looks too high and output appears to be $< Y_{nrl}$, suggesting that an EMP is in order.
- The rightward shift of the AD curve causes prices and output to rise, but the latter rises only temporarily as the already tight labor market gets tighter, leading to higher wages and a leftward shift of the AS curve, with its concomitant increase in P^* and decrease in Y^* .
- If policymakers' original and flawed estimate of full employment is maintained, another round of AD is sure to come, as is higher prices.
- Budget deficits can also lead to sustained inflation if the government monetizes its debt directly by printing money (and deposits) or indirectly via central bank open market purchases (OMPs) of government bonds.
- Lags are the amount of time it takes between a change in the economy to take place and policymakers to effectively do something about it.
- That includes lags for gathering data, making sure the data show a trend and are not mere noise, making a legislative decision (if applicable), implementing policy (if applicable), and waiting for the policy to affect the economy.
- Lags are important because they are long and variable, thus complicating monetary policy by making central bankers play constant catch-up and also by clouding cause-effect relationships.

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