Discretionary policy and Time Inconsistency: Theory and Empirical Evidence

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The goal of this short course is to provide students with a guide to the current state of the debate over rules versus discretion in monetary policy. By focusing on models of time inconsistency, the course provides the theoretical framework and analytical tools to understand the incentives faced by central banks, the nature of the decision problems they face and the policy outcomes. Course contents: i) Discretionary policy, time inconsistency and inflation bias; ii) Solutions to inflation bias: a) reputational solutions and the credibility of trigger strategies; b) the delegation of monetary policy to a conservative central banker; c) the contracting approach; d) flexible and strict targeting rules; iii) The time-consistency problem and the behavior of inflation: empirical evidence.

No. hours: 8

Readings:

1. *Walsh C. E. Monetary Theory and Policy, MIT press, Third edition (Chapter 7-Discretionary Policy and time Inconsistency)*

2. *Barro, R. J., and D. B. Gordon. 1983a. ''A Positive Theory of Monetary Policy in a Natural-Rate Model.'' Journal of Political Economy 91(4): 589–610.*

3. ———. *1983b. ''Rules, Discretion, and Reputation in a Model of Monetary Policy.'' Journal of Monetary Economics 12(1): 101–121.*

4. *Romer, D. H. 1993. ''Openness and Inflation: Theory and Evidence.'' Quarterly Journal of Economics 108(4): 869–903.*

5. *Ireland P.N. 1999. ''Does the Time-Inconsistency Problem Explain the Behavior of Inflation in the United States?'' Journal of Monetary Economics 44: 279–292.*