How Should Long-Term Monetary Policy Be Determined?

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Proposition I: Optimal tax theory is relatively uncorrelated to sensible inflation policy

Proposition II: Positive inflation rates are almost desirable

Proposition III: Institutions should solve time-inconsistency problems

Proposition IV: Zero-inflation is a good idea if not taken too seriously
Stakes in monetary policy are more important than stakes in employee fringe benefits.

Tax revenues in the US (1989) are between 0.2%-0.5% of GNP.

Deadweight loss from not taxing benefits exist— but they are small.
Inflation is costly but not correlated to optimal tax theory

- Inflation has more impact on other considerations like delay payments in the case of high inflation
  - but: hard to model

- Inflation influences the stability: high inflation rates are likely to accelerate – faster and faster acceleration ➔ recession which costs more than what is gained through the inflation
Proposition II: Positive inflation rates are almost desirable

- Optimal inflation rate is about 2-3 percent
- Losses are small
- Benefit: avoidance of zero interest trap
- Zero inflation in connection with a slow economic growth create nominal wage cuts or unemployment
- Small inflation rate is a more credible goal than zero-inflation rate
Institutions establish monetary rules and make subsequent decisions based upon them.

The dynamic consistency problem is real and the most important issue for inflation problems.

Solution: one rule with absolute commitment
- costs: contingencies may not be included in the rule
- possibility of multiple equilibria

Who should be in charge? (commitment vs population values)
Proposition III: Institutions should solve time-inconsistency problems

![Graph showing the relationship between central bank independence and inflation. The x-axis represents the index of central bank independence, ranging from 1 to 4. The y-axis represents average inflation (per annum), ranging from 3 to 9. Various countries are plotted on the graph, with markers indicating their positions. The graph is labeled: Fig. 1. Central Bank Independence and Inflation, 1951–1988.]
Proposition III: Institutions should solve time-inconsistency problems

Fig. 2. Central Bank Independence and the Variance of Economic Growth
No monetary rules
Zero inflation is a good idea if one understands it as a strengthening of the Fed’s independence.

Do not take zero-inflation too seriously because it involves large risks.
Strengths:
✓ realistic, traceable examples
✓ concentration on the long term objective of monetary policy --> few research yet

Weaknesses:
– paper just focused on the US and the Fed
– empirical evidence is still missing