

Practical aspects of credibility theory

Note that there are relevant lectures by Richard Mash and James Forder.

The 'time consistency problem' as that expression is used in the discussion of monetary policy originates in Kydland and Prescott (1977), which is a very hard to follow paper. Barro and Gordon (1983) tends to be regarded as the key early development, introducing the issue of 'reputation'. However, an arguably much more intuitive conception of reputation emerges from Backus and Driffill (1985). The point of Kydland and Prescott, the development of their idea into a perceived problem of 'credibility' and the approach of Backus and Driffill are considered exegetically in the first part of Forder (2001), which also questions the practical relevance of the problem.

One view of importance of the problem leads to the consideration of alternative ways of appointing or regulating policymakers. The relationship between Rogoff (1985) and Walsh (1995) – a central matter in the Mash lectures – is a principal line of thinking. Thinking more diagnostically, Barro and Gordon (1983), Lohmann (1992) and Forder (1998) consider the consequences the theory might have for analysis and behaviour of central banks. The first in effect takes it for granted that the theory is relevant to policy analysis, the last seeks to call this into question, and the middle treats it as relevant, but explores the consequences for the behaviour of central banks with some subtlety. These papers might be set beside Taylor (1993) – another important paper on policymaking from the same sort of time. The question would be: What is the relevance of the theory of credibility to his analysis?

On the empirical side, Alesina and Summers (1993) is widely cited, but should be read with a critical eye. One might feel there are a number of weaknesses on the face of the paper. Forder (1996) considers the general approach deployed in that paper (and others of a similar kind), arguing that the approach adopted is inappropriate to the question being addressed. A different sort of evidence is available from sources such as Vickers (1998), or King (2002). Blinder (1998) is another, longer work of the same sort, which directly addresses issues of credibility. The question of the extent to which the theory of credibility affects the thinking of policymakers can be considered in the light of these papers. And the question of central bank independence can be addressed without reference to the issue of credibility along, for example, the lines of Nordhaus (1975).

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Essay questions

What difference should the theory of credibility make to the formulation of monetary policy?

Does the theory of credibility make a case for central bank independence? If so, what is that case?

Questions for discussion

How are the 'time consistency' and 'credibility' problems distinguished?

How convincing is the evidence of Alesina and Summers?

In what ways does the theory of credibility influence the accounts of central bankers of their policymaking?

Is there a case for central bank independence which does not rely on the theory of credibility? Does it matter if the two arguments are confused?

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