Inflation: A case for the

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Inflation: A case for the central banks?

- The post-Bretton Woods paradigm based on the German model
 - Central bank independence
 - Price stability mandate of the central bank
 - ECB/Maastricht Treaty: ECB the most independent central bank of the world



Sources: Authors' own elaboration using the unweighted index from the data of Bodea and Hicks (2015). Notes: Values closer to 1 indicate higher levels of independence. The central banks belong to Argentina (AR), Australia (AU), Brazil (BR), Canada (CA), France (FR), Germany (DE), India (IN), Indonesia (ID), Italy (IT), Japan (JP), Korea (KR), Mexico (MX), South Africa (ZA), Turkey (TR), the United Kingdom (BR) and the United States (US). The plotted values correspond to the maximum scores registered in the 1970s and in the 1990s. Bodea and Hicks (2015) do not report 1970s data for China, Russia and Saudi Arabia or any data for the European Central Bank, which had not yet been created.

Source: Rodolfo Dall'Orto Mas, Benjamin Vonessen, Christian Fehlker, Katrin Arnold (2020), The case for central bank Independence. <u>https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op248~28bebb193a.en.pdf</u>

The pre-Bretton Woods paradigm: Government responsibility for price stability

The theory of functional finance

(Abba P. Lerner):

"The (...) responsibility of the government (...) is to keep the *total rate* of spending in the country on goods and services neither greater nor less than that rate which at the current prices would buy all the goods that it is possible to produce. If total spending is allowed to go above this there will be inflation, and if it is allowed to go below this there will be unemployment."

(Abba P Lerner (1943), Functional Finance and the Federal Debt, Social Research, Vol. 10, No. 1, pp. 38-51)

German Stability and Growth Act (1967)

§1: In their economic and fiscal policy measures, the Federal Government and the Länder shall observe the **requirements of macroeconomic equilibrium**. The measures shall be taken in such a way that, within the framework of the market economy, they contribute simultaneously to the stability of the price level, to a high level of employment and to external equilibrium with steady and appropriate economic growth Assignment problem if central bank and government are responsible for price stability: one target, but two policies

CB and FP control inflation indirectly via **aggregate demand** and directly via **inflation expectations**.

CB can control inflation indirectly via the **exchange rate**

FP can control inflation directly: VAT, price controls, incomes policies

Demand shocks: No trade-off between output stabilization and price level stabilization

- FP and CB can shift the AD-curve
- FP advantage:
 - Zero Lower Bound
 - Deep recessions with weak interest rate channel (COVID)
 - Fast and direct (Transfers)
- CB advantage:
 - Stopping inflation politically easier by an independent institution, longer time horizon
 - Lower costs if negative demand shock

• Demand shock in AS/AD model



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 - E.g. temporary reduction of indirect taxes shifts the AS-curve

Supply shock in AS/AD-model



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- Supply shock in AS/AD-model
 Positive supply shock shifts AS upwards
 P*
 AD

YF

γ

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The case for fiscal policy in a monetary union

- ECB cannot react to idiosyncratic shocks
- National fiscal policies can target national inflation rates directly
- E.g., in Germany tax reductions in the 2010s could have increased the German inflation rate



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Reduction of indirect taxes on energy

- Abolition EEG-Umlage
- Tankrabatt
- Temporary reduction of the value-added tax on energy?

Side-effects

- Substitution incentives are reduced, but still high even with VAT reduction
- Distributional effects can be compensated with temporary surcharge on income tax

Advantage over transfers

- Measured inflation rate is lower: Trade-off for central bank reduced
- Second-round effects (wage-price spiral) can be mitigated