Recession Aversion, Output and the Kydland-Prescott
Barro-Gordon Model

by

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Abstract

This paper explores the relationship between the Kydland-Prescott Barro-Gordon model and models with asymmetric policy preferences. While both yield an inflation bias, recession aversion dampens the output effects of contractionary supply shocks. Some inflation may therefore reflect policy preferences.

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1. Introduction

The sources of the dramatic increase in inflation in many OECD countries in the late 1960s and 1970s remain contentious. Following the analysis of Kydland and Prescott (1977) and Barro and Gordon (1983) (KPBG hereafter), it is commonly believed that this episode resulted from systematic efforts of policy makers to raise output above its steady-state level. While this interpretation of events may be correct, there are theoretical, practical and empirical reasons to doubt the explanatory power of the KPBG hypothesis.

First, McCallum (1997) shows that while the incentive structure studied by KPBG may lead the central bank to attempt to stimulate the economy excessively, this does not on average raise the level of output. Since the expansionary policy leads to no extra benefits, only costs, policy makers could simply refrain from playing the game the public expects them to engage in. From a theoretical perspective, there is thus no inherent reason why the inflation bias must arise. Second, Blinder (1998) in reviewing central bank practice argues that policy makers do not systematically attempt to raise output above potential precisely because they know that doing so is inflationary. Third, in formal econometric work Ireland (1999) shows that while the long-run behaviour of inflation and unemployment in the US is compatible with the KPBG analysis, the short-run dynamic behaviour is not. Thus, the empirical evidence does not appear to support the KPBG explanation for the inflation experienced in the 1970s.

This note presents a competing model for why excessive inflation, as defined below, may arise. I show that the KPBG loss function is isomorphic to the non-linear loss function for a recession-averse central bank, and that both loss functions lead to a positive average inflation rate. However, the assumption of recession aversion implies that the level of economic activity is higher than in the KPBG analysis in face of large contractionary supply shocks. Depending on their preferences, it may therefore be fully rational for policy makers to generate some inflation.

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1 Recently several authors have demonstrated that an inflation bias could arise as a consequence of asymmetric policy reactions on the part of central banks to economic activity or unemployment (e.g., Cukierman (2000) and Ruge-Murcia (2000)). In contrast to this paper, they do not focus on the relationship to the KPBG model and do not discuss the implications for output.
2. **The KPBG Model**

Suppressing time subscripts, output, $y$, is given by a traditional Phillips curve:\(^2\)

\[
y = \alpha(\pi - \pi^e) + u,
\]

where $\pi$ denotes inflation, $\pi^e$ expected inflation, $\alpha > 0$ and $u$ is a supply shock, which we assume is a normally distributed zero-mean random variable. Thus, $Eu = 0$ and $Eu^2 = \sigma^2$. Equation (1) implies that potential output, defined as the level of output when actual and expected inflation coincide, equals $u$, and that the average output level is zero.

Policy makers minimise the expected loss, which is given by:

\[
E\lambda = E\left[\chi\pi^2 + (y - y^T)^2\right],
\]

where $\chi$ measures the relative importance that policy makers attach to stabilising inflation, where $y^T$ is the target level for output and where it is assumed for notational simplicity that policy makers’ inflation target is zero. In the KPBG analysis policy makers try systematically to raise output to the level $y^T > 0$ by producing unexpected inflation. Since the public understands policy makers’ incentive to inflate, expected inflation also rises. In equilibrium, actual and expected inflation rates are both positive, but the average level of output is zero. With a positive level of inflation but an average output level of zero, it is clear from equation (2) that inflation is excessive; that is, there is an inflation bias.

Note that while the KPBG model explains why excessive inflation rates may be observed, it requires policy makers systematically to aim to raise output above what is feasible. Next we study the determination of inflation in a model of recession aversion.\(^3\)

3. **Recession aversion**

Instead of assuming that the output target is a positive constant, we assume that it is a function of the supply shock.\(^4\) This allows for the possibility that policy makers raise their output target in response to contractionary supply shocks. Specifically, we assume that:

\[\]

\(^2\) While KPBG study deterministic models (and measure economic activity by unemployment), I follow the rest of the literature and assume that there is a stochastic shock in equation (1).

\(^3\) The notions of excessive inflation and recession aversion are defined below.

\(^4\) To understand how this model can explain the high inflation in the 1970s and early 1980s, think of the central bank as minimising equation (2), but having a politically determined subsidiary objective given by equation (3). The subsequent
Equation (3) nests several plausible loss functions.

- **Case 1**: If $0 < k_0$ and $k_1 = k_2 = 0$, we have the standard KPBG case in which policy makers aim to raise the average level of output above zero, irrespectively of the realisation of the supply shock.

- **Case 2**: If $k_0 = k_2 = 0$ and $k_1 \neq 0$, policy makers’ output target depends linearly on the supply shock. The subcase in which policy makers target potential output, $k_1 = 1$ so that $y^T = u$ is of particular interest and is discussed below.

- **Case 3**: If $k_0 = k_1 = 0$, and $k_2 > 0$, policy makers adjust their output target asymmetrically to contractionary supply shocks.

To understand the last case, assume that $k_2 = 1$ and note that $\partial y^T / \partial u = -e^{-u} < 0$. Policy makers consequently attempt to offset the contractionary effects of negative supply shocks ($u < 0$) by raising the output target. Note also that $\partial^2 y^T / \partial u^2 = e^{-u} > 0$, so that they respond more strongly to large than to small negative $u$ shocks. This specification of the output objective captures recession aversion.

Note that the output target is a random variable since it depends on $u$. Because the public must form expectations of inflation before the $u$ shock is realised, they must compute the expected value of $y^T$.

To do so, use a Taylor-series approximation to arrive at $e^{-u} - 1 \approx u^2 / 2 - u$, and take expectations of both sides of equation (3). We then have that $Ey^T = k_0 + k_2 \sigma^2 / 2 > 0$. This establishes that the loss function in the KPBG case is isomorphic to that of the recession aversion case. It follows immediately that excessive inflation can arise either because $k_0 > 0$ or because $k_2 > 0$. Note that there is a difference between the two notions of excessive inflation. In the KPBG literature, inflation is excessive in the sense that since aiming to raise output increases $E\pi$ without influencing $Ey$, policy makers should resist the temptation of trying to do the impossible. In the asymmetric reaction case, inflation is excessive in the sense that $E\pi(u) > \pi(Eu)$.
4. Solution

Next we characterise the equilibrium more fully. Solving the first-order condition associated with equation (2) for inflation we obtain (using the Taylor-series approximation noted above):

\[
\pi = \left( \frac{1}{\chi + \alpha^2} \right) \times \left\{ \alpha^2 \mathbb{E}\pi + \alpha \left( k_0 + (k_1 - 1)u + k_2 \left( \frac{u^2}{2} - u \right) \right) \right\}
\]

so that:

\[
\pi' = \frac{\alpha}{\chi} \left( k_0 + k_2 \frac{\sigma^2}{2} \right).
\]

Equation (4) states that the expected rate of inflation depends positively on \( k_0 \) and, for the reasons already discussed, \( k_2 \) times the variance of supply shocks. Using (4) and (4'), we can then solve for inflation and output:

\[
\pi = \frac{\alpha}{\chi + \alpha^2} \left( \frac{\chi + \alpha^2}{\chi} \right) \left( k_0 + \frac{\alpha^2 k_2}{\chi^2} \frac{\sigma^2}{2} + (k_1 - k_2 - 1)u + k_2 \frac{u^2}{2} \right)
\]

\[
y = \frac{\alpha^2 k_2}{\chi + \alpha^2} \left( \frac{u^2}{2} \frac{\sigma^2}{2} \right) + \frac{\alpha^2 (k_1 - k_2) + \chi u}{\chi + \alpha^2}.
\]

In interpreting the solutions to (5) and (6), three cases are particularly interesting.

Targeting potential output, \( y^T = u \). Thus, the solutions for inflation and output are \( \pi = 0 \) and \( y = u \), that is, policy makers hold inflation constant and let output fluctuate in response to supply shocks.

The KPBG case, \( y^T = k_0 > 0 \). The solutions are in this case are given by:

\[
\pi' = \frac{\alpha}{\chi + \alpha^2} \left( \frac{\chi + \alpha^2}{\chi} \right) \left( k_0 - u \right)
\]

\[
y = \frac{\chi}{\chi + \alpha^2} u.
\]

As is well known, supply shocks elicit smaller output responses than when policy makers target potential output. Thus, there is stabilisation bias. By contrast, inflation responds by more than when the central bank targets potential output. Furthermore, policy makers’ desire to raise output leads to an inflation bias, which is proportional to \( k_0 \), but does not influence the average level of output. The attempts to expand economic activity thus lead to increased inflation, which is welfare reducing, without influencing output.
Recession aversion, \( y^T = k_2(e^{-u} - 1) \). In this case policy makers respond more to contractionary than to expansionary disturbances. The solutions for inflation and output are given by:

\[
\begin{align*}
\pi &= -\frac{\alpha}{\chi + \alpha^2} \left( \frac{\alpha^2 k_2}{\chi} \frac{\sigma^2}{2} - (1 + k_2)u + k_2 \frac{u^2}{2} \right), \\
y &= \frac{\alpha^2 k_2}{\chi + \alpha^2} \left( \frac{u^2}{2} - \frac{\sigma^2}{2} \right) + \frac{u}{\chi + \alpha^2} \left( \chi - \alpha^2 k_2 \right).
\end{align*}
\]

These expressions warrant two comments. First, note that inflation is on average positive. The reason for this is that the public expects policy makers on average to have a positive output target despite the fact that the output target is zero when the supply shock is at its expected value (that is, \( \mathbb{E} y^T(u) > y^T(\mathbb{E} u) = 0 \)). Second, for large contractionary supply shocks (defined such that \( u < -\sigma \)), output will be higher when policy makers respond asymmetrically. The asymmetric behaviour thus leads to greater economic activity in bad states at the cost of higher inflation on average. In contrast to KPBG models, there is a trade-off between average inflation and the behaviour of output, which implies that a positive average inflation rate may simply reflect policy makers’ preferences.

5. **Conclusions**

This paper has shown that there is a relationship between the KPBG analysis of the inflation bias and the literature of asymmetric policy reactions. In particular, the central assumption of the KPBG analysis that \( y^T > 0 \) can be thought of as capturing asymmetric policy reactions. However, the assumption of recession aversion implies that the level of economic activity is higher than in the KPBG model in face of large contractionary supply shocks. Depending on their preferences, it may therefore be fully rational for policy makers to generate an on average positive inflation rate.
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