

Recap Information 8: Monetary policy conduct in “New Keynesian” settings: Credibility problems (II)

“Monetary Economics: Macro Aspects,” Spring 2004

www.econ.ku.dk/personal/henrikj/monec2004/

Henrik Jensen

Institute of Economics, University of Copenhagen

May 6, 2004

The lecture slides associated with this part of the course provide the most comprehensive information about what I find of relevance. Nevertheless, this note briefly lists the key concepts that you are supposed to know and be able to explain.

Key concepts you should know

A simple “New Keynesian” model of monetary policy analysis

- The intertemporal “IS-curve”
- The expectations-augmented “Phillips curve”
- The importance of forward-looking behavior
- For constant nominal interest rate, infinitely many non-explosive output and inflation paths (real indeterminacy)
- Purpose of monetary policy (nominal interest rate setting):
 - Minimize fluctuations in output gap and inflation
 - Secure a unique equilibrium for inflation and output gap

Optimal monetary policy under discretion

- The standard quadratic utility function in output gap and inflation
- The simple first-order condition for optimal policy

© 2004 Henrik Jensen. This document may be reproduced for educational and research purposes, as long as the copies contain this notice and are retained for personal use or distributed free.

- “Leaning against the wind” policy
- More nominal rigidity worsens the inflation-output gap trade off
- Characteristics of optimal policy outcomes
 - No effects of demand and technology shocks
 - The “cost-push” shock is spread out over output gap and inflation
- Characterization of associated interest rate setting
 - Formulated as function of expected future inflation, the nominal interest rate increases by more than an increase in inflation expectations => increases real interest rate => secures unique equilibrium
 - (Note that interest rate expression tells little about the preferences of the central bank.)

Optimal monetary policy under commitment

- Suboptimality of discretionary solution
- The case with positive target for output gap (inflation bias)
- The case with zero target for output gap (no inflation bias)
- Rogoff-conservatism as improvement over discretion
 - Signals future contractive behavior, which dampens current (forward-looking) inflation
 - Improves inflation-output gap trade-off and shock stabilization
- The stabilization bias of time-consistent monetary policy
- Fully optimal policy: The optimality of *inertial* policy
 - Inertia secures prolonged contractions following inflationary shocks
 - Improves inflation-output gap trade off

Delegation as means to overcome credibility problems

- Inflation targeting with conservative central bank
- Nominal income growth targeting
 - Induces inertial policy, which may improve performance relative to pure discretion
 - Improves inflation stabilization and may be better than inflation targeting

- Other approaches:
 - Interest rate “smoothing”
 - Nominal money growth targeting
 - Price level targeting
 - Real output growth targeting