

Monetary policy, inflation and the business cycle

Jordi Galí i Garreta, *catedràtic de fonaments de l'anàlisi econòmica de la Universitat Pompeu Fabra*

Abstract

Using a canonical version of the New-Keynesian model as a reference framework, Galí explores relevant topics in the design of monetary policy, including optimal monetary policy as well as the desirability of several simple policy rules. Galí analyses various extensions of the basic model including cost collisions, payroll inflexibilities and factors of the open economy. For each case, the implications are presented for monetary policy, emphasising the advantages of policies focusing on price stability.

Resum

Utilitzant com a marc de referència una versió canònica del model neokeynesià, Galí explora temes rellevants per al disseny de la política monetària, incloent la determinació de la política monetària òptima i la desitjabilitat de diferents regles de política senzilles. Galí analitza diferents extensions del model bàsic, que incorporen successivament xocs de costos, rigidesses de salaris nominals i factors d'economia oberta. Per a cada cas, es presenten les implicacions per a la política monetària, tot emfatitzant la desitjabilitat de polítiques centrades en l'estabilitat de preus.

This article seeks to provide the reader with an overview of modern monetary theory. Over the past decade, monetary economics has been one of the most fruitful research areas within macroeconomics. The effort of many researchers to understand the relationship between monetary policy, inflation and the business cycle has led to the development of a framework (the so-called New Keynesian model) that is widely used for monetary policy analysis.

The need for a framework that can help us understand the links between monetary policy and the aggregate performance of an economy seems self-evident. On the one hand, citizens of modern societies have good reason to care about developments in inflation, employment and other economy-wide variables because such developments affect, to an important degree, people's opportunities to maintain or improve their standard of living. On the other hand, monetary policy, as conducted by central banks, has an important role in shaping these macroeconomic developments, both at a national and supranational level. Changes in interest rates have a direct effect on the valuation of financial assets and their expected returns, as well as on the consumption and investment decisions of households and firms. In turn, these decisions can have consequences for gross domestic product (GDP) growth, employment and inflation. It is therefore not surprising that the interest rate decisions taken by the Federal Reserve System (Fed), the European Central Bank (ECB) or other prominent central banks around the world are given so much attention, not only by market analysts and the financial press but also by the general public. It would therefore

seem important to understand how such interest rate decisions end up affecting the various measures of an economy's performance, both nominal and real. One key goal of monetary theory is to provide us with an account of the mechanisms through which these effects arise; i.e. the transmission mechanism of monetary policy.

Central banks do not change interest rates in an arbitrary or whimsical manner. Their decisions are meant to be powerful; i.e. they seek to attain certain objectives while taking as given the constraints posed by the workings of a market economy in which the vast majority of economic decisions are made in a decentralized manner by a large number of individuals and firms. Understanding what should be the goals of monetary policy and how the latter should be carried out in order to achieve those goals constitutes another important aim of modern monetary theory in its normative dimension.

The framework is, admittedly, highly stylised and should be viewed more as a pedagogical tool than a quantitative model that can be readily applied to the data. Nevertheless, and despite its simplicity, it contains the key elements (though not all the bells and whistles) found in the medium-scale monetary models that are currently being developed by the research teams of many central banks.

The monetary framework that constitutes the focus of this article has a core structure that corresponds to a Real Business Cycle (RBC) model, on which a number of elements characteristic of Keynesian models are superimposed. This confluence of elements has led some authors to label the new paradigm the New Neoclassical Synthesis.