"Strike While the Iron is Hot - Optimal Monetary Policy with a Nonlinear Phillips Curve" by Karadi, Nakov, Nuño, Pastén and Thaler

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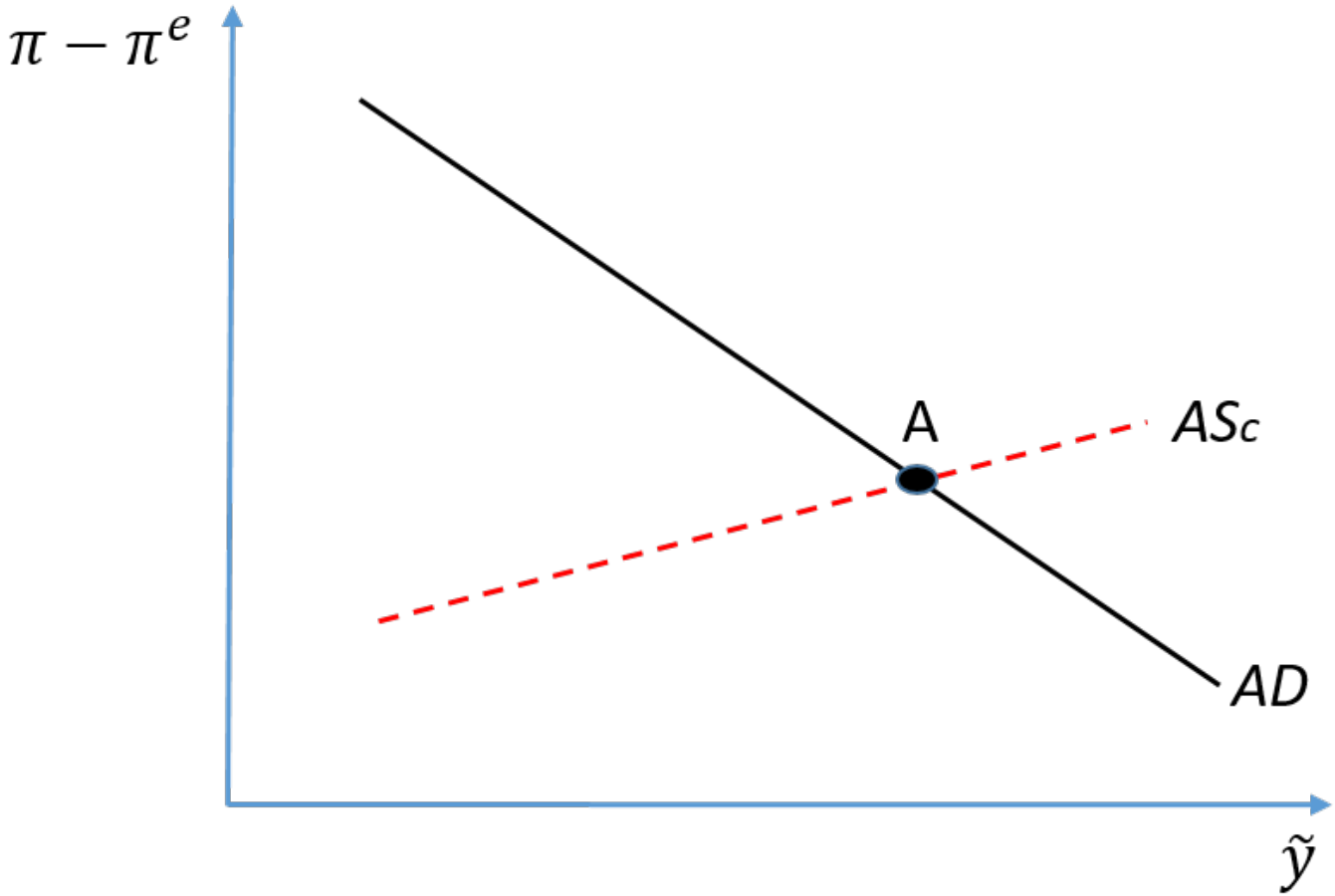
International Monetary Fund
25th Jaques Polak Annual Research Conference
November 15, 2024

Introduction

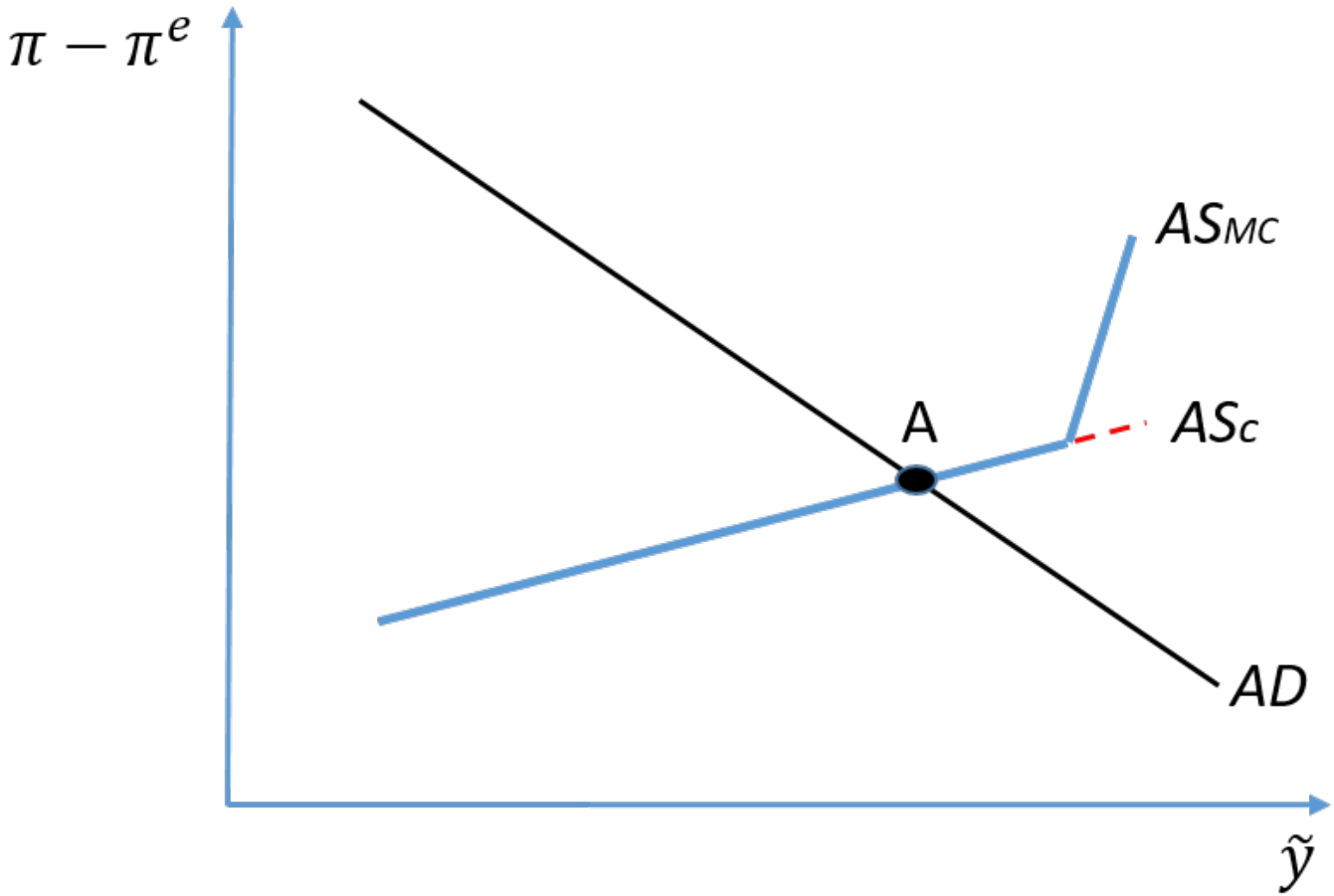
- Menu-cost economy à la Golosov-Lucas
- Goals:
  - Understand trade-off between inflation and output gap at different levels of inflation
  - Characterize optimal monetary policy

Overview: Calvo economy



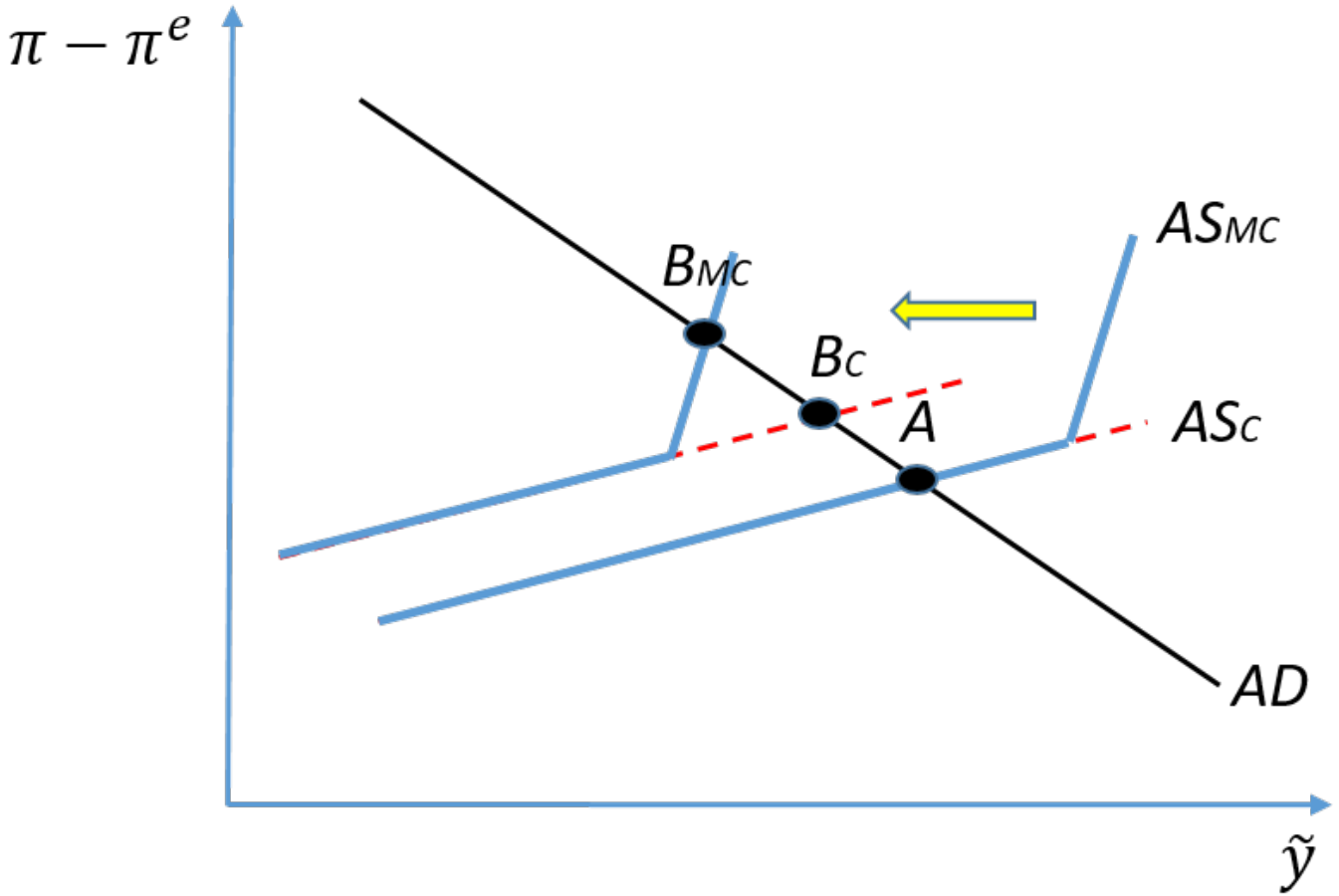
- Simple AD-AS in calvo model

Overview: menu-cost economy



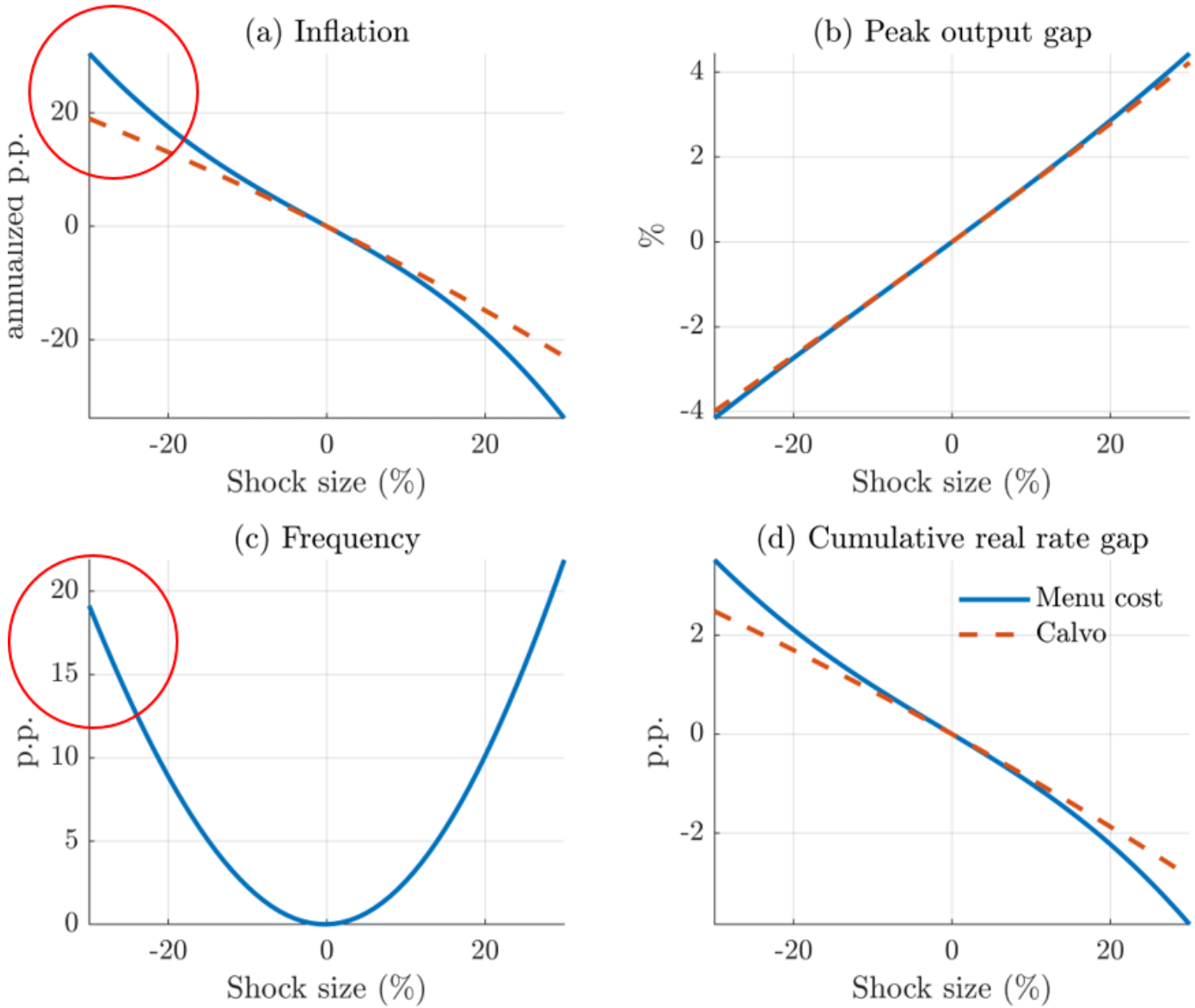
- Menu-cost economy: nonlinear AS (steeper for high levels of π)
  - Intuition: higher inflation $\rightarrow$ higher frequency of price changes

Overview: cost-push shocks

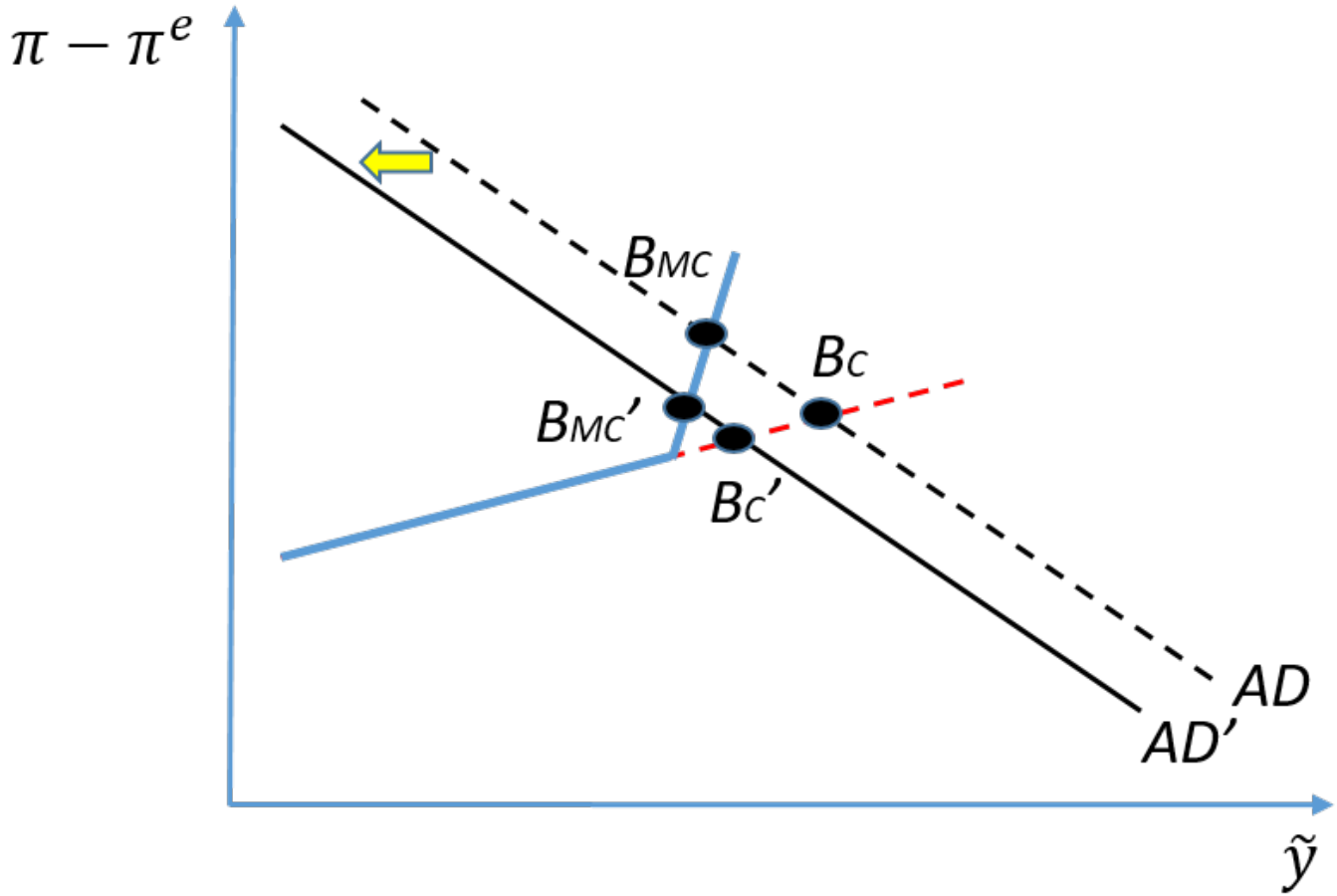


- In response to cost-push shocks, menu-cost economy features:
  - Higher inflation
  - More negative output gap

Effect of cost-push shocks (Taylor rule)

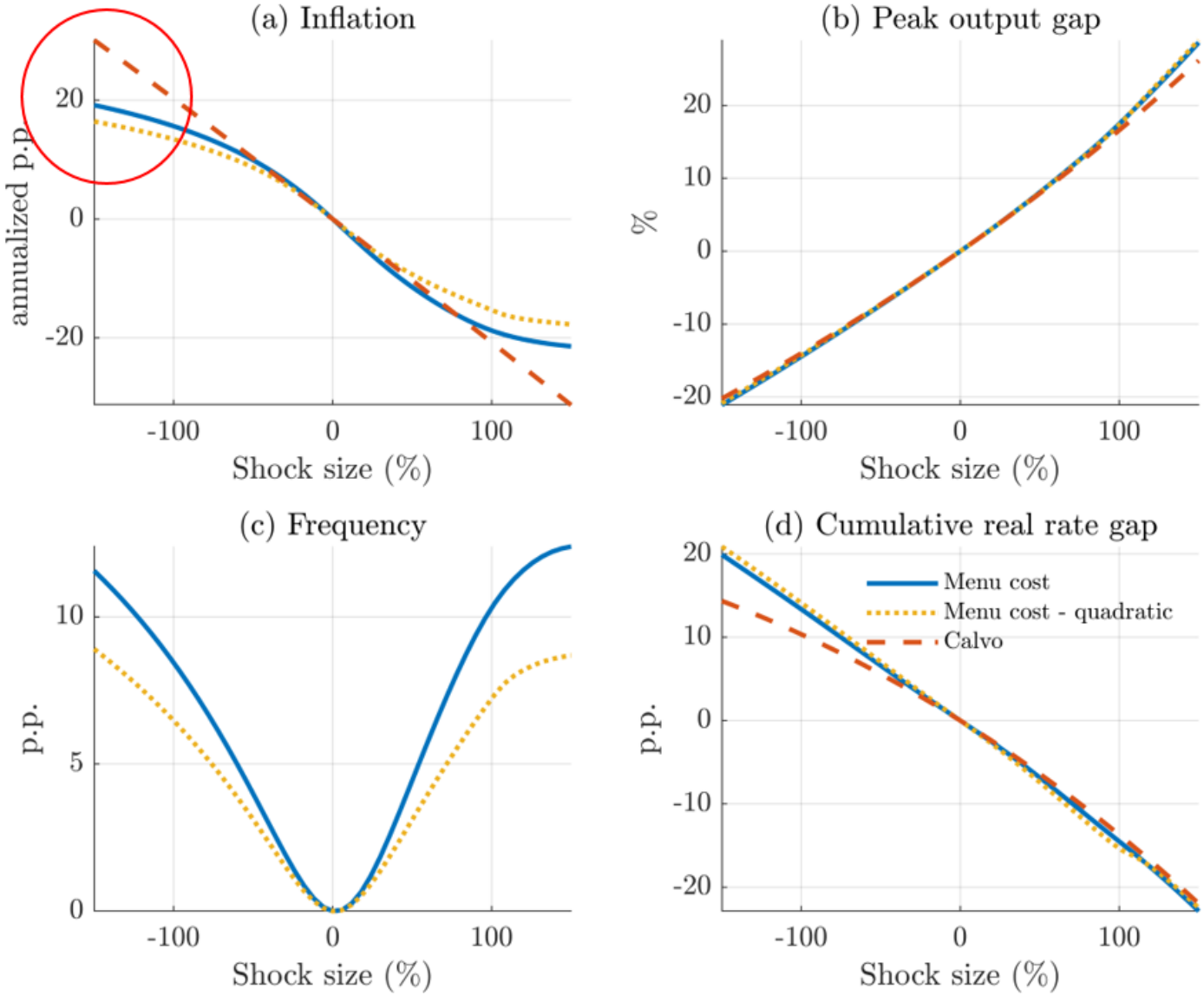


Overview: implications for monetary policy



- Less reason to "lean against the wind" in menu cost economy
  - "Sacrifice ratio" is more favorable in menu cost economy, and...
  - ...lower inflation saves on menu costs

Effect of cost-push shocks (optimal monetary policy)



General reaction

- Key takeaways: in menu-cost economy
  - Phillips curve is non-linear
  - Monetary policy responds more agressively to cost-push shocks
  - "Divine coincidence" continues to hold for demand shocks

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  - Technically impressive yet clear
    - Significant contribution to understanding this class of models
    - Other results: positive steady-state inflation rate, asymmetries, etc...
  - Bottom line sensible and intuitive

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- My discussion: how does it affect our views...
  - ...of monetary policy?
  - ...more generally, of economic policy in high inflation environments?

1. Calvo vs. menu costs (positive)

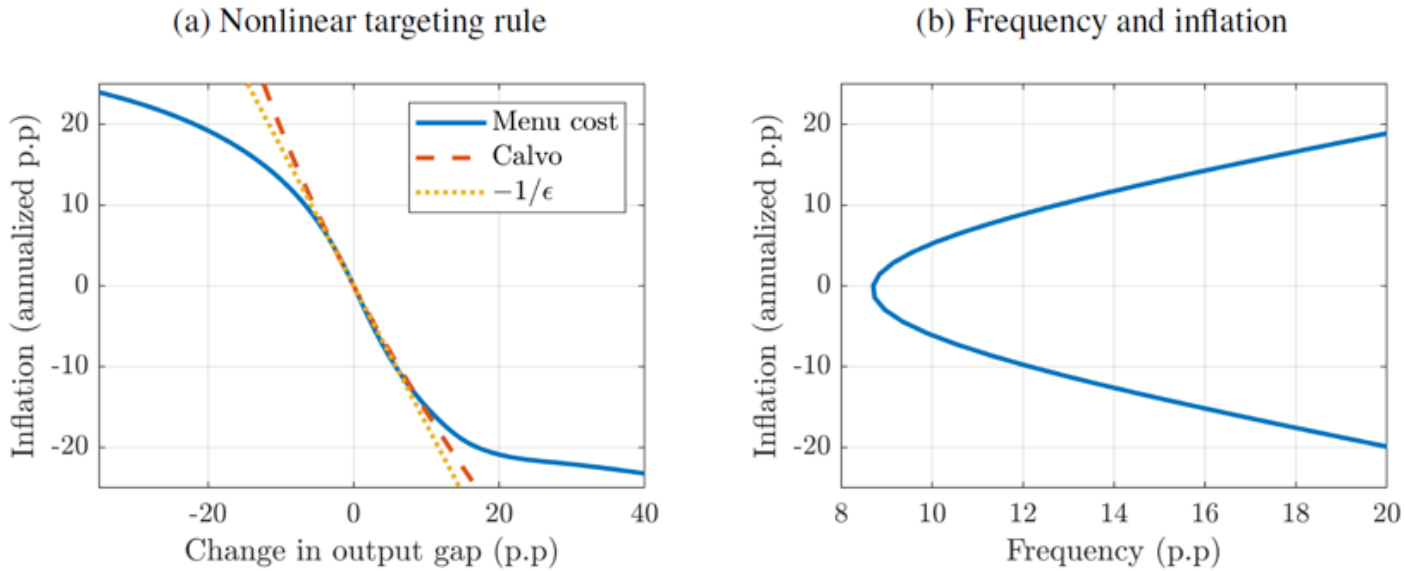
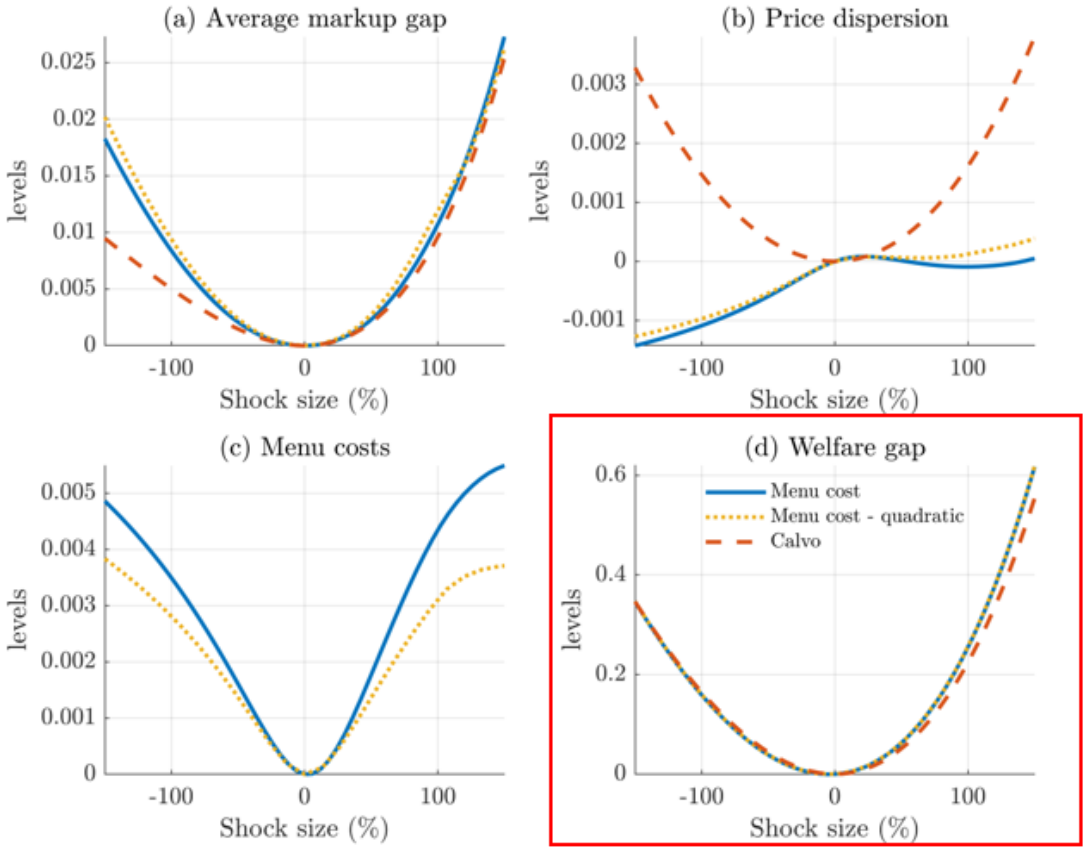


Figure 6: Optimal target rule.

- When do Calvo and menu-cost worlds differ?
  - Very large cost-push shocks (-50%) and very high levels of inflation ($\geq 15\%$)
- How relevant is the distinction in practice?
  - e.g., how often would difference have mattered in last 50 years?

1. Calvo vs. menu costs (normative)



- Perhaps optimal policy does not matter often, but effect on welfare is significant
  - Not really...gains from lower price dispersion $\approx$ losses from menu costs

2. Benefits (and costs) of striking while iron is hot

- What is the cost of doing policy as usual?
  - Suppose simple Taylor rule: nearly optimal in Calvo world
  - This paper: potentially costly in high-inflation environments
  - How high are these costs? Welfare losses (total and per cost-push "episode")?

2. Benefits (and costs) of striking while iron is hot

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  - How high are these costs? Welfare losses (total and per cost-push "episode")?
- Are there risks of "striking while the iron is hot..."?
  - Key takeaway: be aggressive on inflation when Phillips curve is steep
    - In model, trade-offs are known perfectly
    - In practice, need to assess where we are: flat or steep segment?
    - Can we know this in real tim? What data? Price-change frequency?
  - Caution under uncertainty may mitigate gains of policy

3. Alternative environments / policies

- You have the Ferrari! Drive it on other countries / policies
- High-inflation environments
  - Large shocks / high inflation are more common elsewhere
  - Worth exploring evidence from high-inflation countries
  - Widespread view: cost of disinflation is not linear
    - Less costly to reduce inflation from 20% to 10%, than from 10% to 0%
- Going beyond monetary policy
  - Mechanism emphasized in the paper has implications for other policies
  - Example: cost of fiscal consolidation
    - The fiscal multiplier should be smaller when inflation is high
    - Is this consistent with evidence? (e.g. Milei's Argentina)

Conclusions

- Technically impressive, yet clear paper
- Bound to become widely cited in the literature
- Main suggestion: stress significance for our views on monetary policy / inflation