

Monetary Policy and Inflation-Unemployment Variability in a New Keynesian Model

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Abstract

This paper uses a New Keynesian model with unemployment to analyse the effects of explicit inflation targeting on the inflation-unemployment variability trade-off. We argue that adopting an inflation targeting framework provides clarity and transparency to the inflation stabilisation objective of the central bank, thus improving monetary policy efficiency. On the other hand, increasing the policy weight on achieving an inflation target with less clear monetary policy objectives merely moves an economy along the variability frontier. Empirically, several key explicit inflation targeters show reduced variability in both inflation and unemployment. In contrast, non-inflation targeting economies that have seen reduced inflation variability do not display a decline in unemployment variability. These suggest that in terms of the inflation-unemployment variability trade-off, explicit inflation targeting could result in a superior outcome, lending support to the findings of our theoretical model.

Keywords: Inflation, inflation targeting, monetary policy, unemployment, variability trade-off

JEL Classification: E24, E32, E52, E58

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