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Optimal Monetary Policy with Staggered Wage and Price Contracts*

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Abstract

We formulate an optimizing-agent model in which both labor and product markets exhibit monopolistic competition and staggered nominal contracts. The unconditional expectation of average household utility can be expressed in terms of the unconditional variances of the output gap, price inflation, and wage inflation. Monetary policy cannot achieve the Pareto-optimal equilibrium that would occur under completely flexible wages and prices; that is, the model exhibits a tradeoff in stabilizing the output gap, price inflation, and wage inflation. We characterize the optimal policy rule for reasonable calibrations of the model. We also find that strict price inflation targeting generates relatively large welfare losses, whereas several other simple policy rules perform nearly as well as the optimal rule.

Keywords: Monetary policy; Inflation targeting; Nominal wage and price rigidity; Staggered contracts

JEL classification: E31; E32; E52

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