Optimal Monetary Policy during a Cost-of-Living Crisis

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Abstract :
How should monetary policy react to aggregate and sectoral disruptions in a world in which consumption baskets and hence inflation rates vary across households? We present a multi-sector New Keynesian with generalized, non-homothetic preferences and realistic heterogeneity in wealth, income, and consumption of different goods. Despite its richness, the model is computationally tractable. We highlight two novel wedges emerging in the New Keynesian Phillips Curve, which fluctuate with the distribution of consumption expenditures. We find that these wedges can have profound implications for the joint dynamics of inflation and the output gap, and hence policy trade-offs, in particular following sectoral shocks. Moreover, shocks and policy changes are found to have vastly heterogeneous effects on different households. Finally, we find that the optimal policy reaction to negative productivity shock is relatively loose, as compared to standard policy prescriptions, due to distributional concerns. The model is applied to the United Kingdom and disciplined by micro data from the Living Costs and Food survey.