

The New Keynesian Transmission Mechanism

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Two main questions for the introduction

- ▶ Why is 3-equation model important?
 - ▶ Minimal model designed to capture the intuition of demand-driven fluctuations in output and inflation through intertemporal substitution
 - ▶ Main vehicle for discussions centered around this intuition
 - ▶ Monetary policy (including forward guidance)
 - ▶ Determinacy and stabilization
 - ▶ Benchmark for adding other demand-channels: Most notably distribution of MPC
 - ▶ McKay and Reis (2014), Auclert (2015)
 - ▶ Accordingly, it is what we teach students
- ▶ Why is the profit channel in the 3-equation labor market model important?
 - ▶ It tells us that when augmenting the minimal model with a labor market things get complicated
 - ▶ With supply-determined labor, the model needs a countercyclical response of profits
 - ▶ With demand-determined labor, the model cannot produce much movement in inflation
- ▶ Hence, do we need other transmission channels?
 - ▶ Capital formation

Intro 1: Motivation

- ▶ The New Keynesian 3-equation model is the minimal model designed to capture the intuition of demand-driven fluctuations in output and inflation through intertemporal substitution
- ▶ Main vehicle for discussions centered around this intuition, e.g. monetary policy
- ▶ Benchmark for adding other demand-channels, such as heterogeneity in MPC
- ▶ Teaching device

Intro 2: Result

- ▶ Claim: The 3-equation model IR results are a consequence of profits being large and countercyclical
- ▶ We show this by comparing the IRs of the 3-equation model to a model where workers must not consume any profits in equilibrium: The WC model
- ▶ Channels:
 - ▶ Profits being large depresses relative income effect of wages
 - ▶ Profits being countercyclical forms a countercyclical income effect in itself
- ▶

Intro 3: Related literature



Models

- ▶ Presentation of the similarity and difference between the standard and WC model