Optimal simple and implementable monetary and fiscal rules.

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Abstract

Welfare-maximizing monetary- and fiscal-policy rules are studied in a model with sticky prices, money, and distortionary taxation. The Ramsey-optimal policy is used as a point of comparison. The main findings are: the size of the inflation coefficient in the interest-rate rule plays a minor role for welfare. It matters only insofar as it affects the determinacy of equilibrium. Optimal monetary policy features a muted response to output. Interest-rate rules that feature a positive response to output can lead to significant welfare losses. The welfare gains from interest-rate smoothing are negligible. Optimal fiscal policy is passive. The optimal monetary and fiscal rule combination attains virtually the same level of welfare as the Ramsey-optimal policy.

JEL classification

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E52; E61; E63

Keywords

Policy evaluation; Optimal policy; Nominal rigidities

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