Jordi Galí: Monetary Policy, Inflation, and the Business Cycle: An Introduction to the New Keynesian Framework

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The magician of monetary economics, Jordi Galí, has been impressing us with his tricks for more than a decade now. Without any doubt, he is one of the most influential architects of the New Keynesian or New Neoclassical Synthesis literature (for two representative examples of his influential work, see Clarida, Galí and Gertler, 1999, and Galí, 2003), which has started to bridge the gap between ad hoc macroeconomic models (which are subject to the Lucas critique) and the optimizing real business cycle (RBC) world (which has some counterfactual implications and assigns no role to monetary policy). Galí's recent book is a major step toward making his work more accessible to graduate students and policymakers at central banks.

His book is very concisely written and it succeeds in presenting the most important insights brought to light by the new Keynesian literature during the last ten years, whereby it draws heavily on papers that were (co)authored by the magician himself. Each chapter in the book is followed by technical details, exercises that can be used for teaching purposes, and literature references. The appeal of Galí's book is that it is kept analytically simple enough to be tractable and that numerical illustrations are given.

Chapter 2 presents a classical monetary model with perfect competition and flexible prices, a model that not only serves as a bridge to the RBC world, but it also provides a nice introduction to the households' optimization problem and some important technical tools, such as log-linearization.

Chapters 3 to 6 can be considered the core of the book and draw heavily on Galí (2003). Chapter 3 presents the basic New Keynesian model with monopolistic competition and inflexible price adjustment à la Calvo, and uses numerical simulations to illustrate the model's behavior in response to various macroeconomic shocks. Chapter 4 presents the notion of optimal monetary policy. It explains the linear quadratic approach (leaving the technical details to the Appendix) and the performance of various monetary policy rules. Chapter 5 first explains how cost-push shocks lead to meaningful policy trade-offs and then goes on to explain the concepts of discretion and commitment. Chapter 6 enhances the baseline sticky price model by factoring in sticky wages (also modeled à la Calvo) and discusses the implications of doing so.

Chapter 7 shows how the basic model can be extended to an open economy model. It draws heavily on Galí and Monacelli (2005), which has come to be considered one of the workhorses of open economy models.

Chapter 8 lays out the main lessons to be gained from New Keynesian model and suggests promising current and future avenues for research. In this chapter, Galí emphasizes the role of expectations and the importance of the natural levels of output and the interest rate in monetary policymaking. His strategy to provide a glimpse of promising areas of research, such as labor market frictions, is very smart for two reasons: (i) it keeps the book very concise and readable and, (ii), the book will likely not become outdated soon.[1]

[1] Most monetary economists would, for example, agree that the integration of labor market frictions and unemployment into the existing model framework is a promising route of research. However, at this stage it is

If there is anything to be criticized in Galí's book, it is its lack of (more) empirical material. What does the model have to do with the real world? How relevant is it? And how does it fit the empirical evidence? Students who use the book would, for example, appreciate a graphical illustration of the Fed's behavior in setting interest rates, as shown in Taylor's (1993) seminal work. A more critical assessment of the fit of the New Keynesian Phillips curve is also warranted. Unfortunately, Galí mentions (p. 60/61) only the findings in the literature on marginal costs and inflation dynamics that corroborate the New Keynesian model, while ignoring the findings that contradict the model (see, e.g., Rudd and Whelan, 2007).

How does the book compare to its two most important competitors, namely Walsh (2003) and Woodford (2003)? Walsh (2003) takes a much broader view than Galí. He also includes empirical evidence and such frictions as the credit channel. Woodford (2003) digs much deeper into many of the topics than Galí (e.g., by including capital accumulation and habit formation). However, both Walsh and Woodford can only do what they do by using many more pages than Galí, the result being that their books are not as streamlined and sexy as Galí's book.

To conclude, Galí closes an important gap in the book market. His book is concisely written and intriguing. It will become a standard textbook for monetary economics classes all over the world (it is particularly suitable for Master's and introductory Ph.D. classes). The shortage of empirical material in the book can easily be compensated for by supplementing it with journal articles. It will also be widely used among central bankers and economists at policy institutions. It may help them to move from more traditional modeling tools to the new state-of-the-art tools.

With this book, magician Galí has pulled another important rabbit out of his hat. The book will help to increase the popularity of the New Keynesian model with graduate students, tomorrow's policymakers, and today's policymakers alike. Therefore, it can be considered a real grassroots initiative.

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unclear which of the competing modeling strategies is the most promising one (for different approaches see, e.g., Alexopoulos, 2007, Blanchard and Galí, 2008, Lechthaler, Merkl, and Snower, 2008).

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