Aggregate Supply and Potential Output

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Summary

The New-Keynesian aggregate supply derives from micro-foundations an inflation-dynamics model very much like the tradition in the monetary literature. Inflation is primarily affected by: (i) economic slack; (ii) expectations; (iii) supply shocks; and (iv) inflation persistence. Typically, only cyclical macroeconomic fluctuations appear in the aggregate supply relationship. This paper extends the New Keynesian aggregate supply relationship to include fluctuations in potential output as an additional determinant of the relationship.

The paper finds that potential output improves the inflation-output gap trade-off. Thus, the task of the monetary authority, which trades off inflation and output gaps, is facilitated if they target potential output as well as the inflation fluctuations and the output gaps. Therefore, a Taylor-like interest rule which targets not only the fluctuations in inflation rates and output gaps, but also the fluctuations in potential output is bound to raise the measure of consumer's welfare.