Teaching Inflation Targeting

Carl Walsh

**Key Points**

1. Purpose – many central banks have switched to inflation targeting. Walsh’s analysis extends IS-LM analysis to this setting.

2. Three key components:
   - B. Policymaker preferences: Quadratic in deviations of inflation from target inflation and output from potential output. Critical parameters of $k$ and $\lambda$.
   - C. The optimal policy represented by the Monetary Policy Rule.

3. Economy is represented by the PC and MPR curves.

4. Exogenous elements:
   - $\pi^T$ = inflation target
   - $\pi^e$ = inflationary expectations
   - $e$ = shock to inflation
   - $u$ = shock to demand.
5. Short run equilibrium – intersection of PC and MPR curves.

6. Long run equilibrium - $\pi^T = \pi^e$.


8. Deriving the MPR from the IS curve – the Taylor rule.