The main topic of my dissertation is studying the optimal long-run inflation rate in economies featuring various types of frictions, and the role of asymmetries in the determination of the optimal inflation target. The focus of previous literature has been typically on either the short-run dynamics of inflation and/or the deterministic steady state inflation rate rather than on the optimal long-run inflation rate when the economy is subject to shocks. These two essays try also to quantify the optimal long-run inflation target to be set in the U.S.

The first paper, “Optimal Monetary Policy and Downward Nominal Wage Rigidity in Frictional Labor Markets” studies the optimal inflation target under the presence of downwardly rigid nominal wages in a labor search and matching model. The paper shows that the optimal inflation rate is around 2%, considerably higher than the optimal inflation rate in an economy with frictionless labor markets and DNWR. The study points to the potential role of inflation in greasing the wheels of the labor market in the realistic world where labor markets are indeed subject to frictions; this happens by allowing for real wage adjustments which ease job creation and prevent substantial increase in unemployment. This result also suggests a theoretical setup where about 2% inflation rate might be optimal to target in the United States (the average in the last two decades has been around 2.5%).

The second paper, “The Optimal Long-Run Inflation Rate in Frictional Credit Markets”, studies the optimal inflation target in an economy where borrowers face collateral constraints, which is the source of the credit friction in this environment. A key assumption in this model is that the borrowing constraint on entrepreneurs only occasionally binds. This assumption is the source of asymmetry in the model: the constraint may bind more often after negative shocks than after positive shocks. An earlier version of this paper has shown that the optimal inflation target is indeed positive; around 1% in the benchmark calibration of the model. Also, the long-run inflation rate is decreasing in the degree of price stickiness, reflecting a tension between the “credit friction” channel and the “nominal distortion” channel.