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The Journal of Socio-Economics 37 (2008) 1797–1802
The Journal of Socio-Economics
www.elsevier.com/locate/soceco

Jealousy and monetary policy

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Received 10 January 2007; received in revised form 30 November 2007; accepted 11 December 2007

Abstract

The purpose of this paper is to examine the implications of jealousy for the welfare effects of monetary policy. Jealousy implies that consumption is like pollution: overconsumption may occur because households do not internalize the costs of their consumption to others. This externality opens the door for a beneficial monetary policy intervention. I show that the welfare effects of monetary policy depend on jealousy, the monopolistic distortion and the utility of real balances. If households are "too jealous," a rise in the money supply reduces welfare by increasing consumption that is already inefficiently high.
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JEL classification: E50; E60

Keywords: Monetary policy; Jealousy; Consumption externality

1. Introduction

The purpose of this paper is to analyze the implications of jealousy for monetary policy. Jealousy and the desire to "keep up with the Joneses" imply that consumption is like pollution: overconsumption may occur because households do not internalize the costs of their consumption to others. A household that increases its consumption does not take into account the effect on the aggregate desire by other households to "keep up." However, in imperfectly competitive economies, production tends to fall below the social optimum. Jealousy and monopolistic competition create distortions that can be potentially corrected by monetary policy intervention.

The introduction of jealousy into a model enables identification of additional features that govern the welfare effects of monetary policy. The implications of jealousy for asset-pricing and optimal taxation have attracted attention earlier,[1] but the implications for monetary policy have attracted very little notice. Pierdzioch (2003) analyzed the implications of jealousy for the welfare effects of monetary policy, using a two-country model. He found that if households' preferences feature a "keeping up with the Joneses" effect, a rise in the money supply can be a beggar-thyself policy. In his model, a rise in the money supply has an effect on welfare by affecting the terms of trade and the level of output. It is not completely clear when a rise in the money supply reduces domestic welfare. Virtually all other monetary policy models have shown that a rise in the money supply always increases welfare. The intuition behind this result is that, under monopolistic competition, an increase in output is welfare-improving because the level of production is inefficiently low.

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[1] Important contributions include, but are not limited to, Dupor and Liu (2003); Gali (1994); Guo (2005), and Ljungqvist and Uhlig (2000).

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doi:10.1016/j.socec.2007.12.009

Pierdzioch and Yener (2004) extended the analysis of Pierdzioch (2003) by assuming that preferences feature a "keeping up with the rest of the world" effect, i.e., domestic households' utility is a decreasing function of population-weighted world consumption. The authors showed that the welfare effects of monetary policy depend on the relative strength of the consumption externality caused by jealousy and the monopolistic distortion. If the former dominates, a rise in the money supply is welfare-reducing because an increase in output is not desirable. If households are "too jealous," the economy suffers from overproduction. Therefore, a rise in the money supply is not welfare-improving, because it increases consumption that is already inefficiently high.

In this paper, I analyze the implications of jealousy for the welfare effects of monetary policy using a simple, closed economy model. The use of a closed economy implies that the model is easily extended to take into account the welfare effect of real balances. Pierdzioch (2003) and Pierdzioch and Yener (2004) ignored this effect. In their studies, the welfare analysis takes into account only the flow of consumption and the utility of leisure. If real balances are important in determining the allocations of households and if the government maximizes the welfare of households, then it is useful to include real balances in the welfare criterion.

I show that the welfare effect of a monetary policy shock depends significantly on jealousy and on whether the utility of real balances is included in the welfare criterion. If the welfare effect of real balances is ignored, then the relative magnitude of the monopolistic competition and the consumption externality determine whether a rise in the money supply is welfare-improving. This is the same result found by Pierdzioch and Yener (2004). Thus, the finding of this paper generalizes the result of Pierdzioch and Yener (2004). The interplay between the consumption externality and the monopolistic competition determines the sign of the welfare effect of monetary policy even though households are envious of consumption of those living in the same country.

If the welfare effect of real balances is included in the welfare criterion, then a rise in the money supply can be beneficial, even though the economy suffers from overconsumption. In this case, the welfare benefits from an increase in real balances more than offset the welfare losses from an inefficiently high level of output and consumption. If, however, households are "too jealous" and thus the economy suffers from a serious overconsumption problem, then the welfare losses from a higher level of consumption dominate the welfare benefits of an increase in real balances. If this is the case, a monetary authority can increase welfare by decreasing the money supply. This decreases output and real balances but nonetheless increases overall welfare as it reduces overconsumption. A policy implication of this study is that governments should take into account households' preferences with respect to jealousy (or altruism) and real balances in deciding on the implementation of monetary policy.

The rest of the paper is organized as follows: in Section 2, I present the model. In Section 3, I examine the implications of jealousy for the welfare effects of monetary policy. Section 4 concludes the paper.

2. The model

2.1. Preferences and market structure

In this section, I develop a simple model for analyzing the implications of jealousy. The economy is inhabited by a continuum of households. The size of the economy is normalized to unity. The households are indexed by $z \in [0, 1]$. The economy is monopolistically competitive, and each household produces a single, differentiated commodity. For simplicity, labor is the only factor of production.

The utility function of a representative household i is

$$U^i = \log(C^i - \alpha C^A) + \chi \log\left(\frac{M^i}{P}\right) - \frac{\kappa}{2} y(i)^2. \tag{1}$$

The variable C^i is a CES basket of all varieties consumed by household i

$$C^i = \left[\int_0^1 c^i(z)^{(\theta-1/\theta)} \,\mathrm{d}z\right]^{(\theta/\theta-1)},$$

where $c^i\, z$ is consumption of commodity z by household i and $\theta(> 1)$ is the elasticity of substitution between varieties. In the utility function, C^A is the average consumption of goods across all households. The parameter α captures the importance of average consumption, as I will explain below. χ is a positive parameter, M^i money holdings and P

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