Monopolistic Competition, Overlapping Generations,

and the Role of Monetary Policy

Abstract

This paper studies a simple overlapping generations model (OGM) with monopolistic competition in goods markets. I show that the set of rational expectations equilibria of the model can be characterized by a simple difference equation in the real quantity of money, in the same way as the standard, competitive OGM. The monopolistic competition case results, however, in less output, less consumption, and lower welfare relative to the competitive case.

The model is then used to reexamine some issues of monetary policy. Previous studies have stressed that the existence of imperfect competition in goods markets may justify activist monetary policy. I show that this rationale for policy intervention remains true in dynamic models, although transmissions mechanisms and policy prescriptions turn out to be very different. This is shown by discussing the effectiveness of monetary policy, the optimal quantity of money, and the welfare cost of inflationary finance.

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