

Inflation Inertia – The Role of Multiple, Interacting Pricing Rigidities

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Summary

Monetary models with nominal rigidities are known to have difficulties in matching some important features of the empirical impulse responses of monetary policy shocks, especially inertia of the inflation rate and the hump-shaped responses of consumption, investment and output. To remedy this, the literature has mostly employed a combination of backward-looking price-setting and of not always uncontroversial real rigidities.

This paper addresses the problem without a need to depart from the assumption of rational forward-looking price-setting in a fully specified optimizing model. This is accomplished by specifying a more comprehensive model of the economy that stresses interactions between rigidities in the pricing behavior of multiple sectors. Specifically, there is a long chain of intermediate input supply relationships, with nominal rigidities cascading from upstream to downstream. In addition, while price- and wage-setters are subject to nominal rigidities, their pricing behavior itself differs in one important way from conventional models: they can choose a more general price path. This has powerful effects on inertia when combined with highly persistent monetary policy shocks (as found in the data). Finally, a small number of simple and intuitively appealing real rigidities goes a long way in matching empirical impulse responses for real variables. These are habit persistence in consumption and time-to-build investment with an initial quadratic capital stock adjustment cost.

The paper is at this stage mostly a theoretical and qualitative exercise. The detailed matching of empirical and model impulse responses is the subject of ongoing work.