Calvo, Celasun and Kumhof  
A Theory of Rational Inflationary Inertia  
Discussion by Lars E.O. Svensson

- Model of inflation inertia, with better microfoundations  
  - Small open economy, tradeable and nontradeable goods  
    - Tradeables: Law of one price  
    - Nontradeables: Sticky inflation  
    - Exchange rate stabilization experiments  
      * Unanticipated reduction of currency depreciation/tradeables inflation implies recession  
- Empirical estimation of derived Phillips curve on Mexican data

Model of inflation inertia

- Calvo 83  
  - Firms set optimal constant prices, exogenous Poisson process, arrival rate $\delta$, expected time between changes $1/\delta$  
  - Inflation jump variable, no inertia  
  - Credible disinflation implies boom (Ball)  
- Yun 96  
  - Firms set optimal initial price, indexed to steady-state inflation  
- Calvo, Celasun and Kumhof 01  
  - Firms set optimal initial price and optimal constant firm-specific inflation  
  - Inflation inertia: Distributed lag of previous firm-specific inflations

Comments

- Improvement: Inflation inertia with better microfoundations  
- Incentive-compatible, higher profit  
- Why stop at constant firm-specific inflation?  
- Why not firm-specific price path?  
- (Why not index to price level?)  
- Why exogenous price change instead of state-dependent?

Stabilization experiments

- Unanticipated permanent and temporary reduction of currency depreciation/tradeables inflation from 40%/yr to 10%/yr  
- Initial nontradeables recession: Nontradeables inflation inertia, relative price of nontradeables too high  
- Dynamics of consumption and inflation depends on anticipated future depreciation/inflation  

Comments

- Drastic stabilization, normal price changes, incentives?  
- Perfect foresight after initial surprise?  
- Reason for stabilization?  
- Optimal stabilization?  
  * Announce well in advance  
  * Credible gradual disinflation optimal?

Empirical evidence (preliminary)

- Discrete-time version  
- Mexican data 98.1–99.1  
- “Errors in variables”, RE, GMM  
- Constant parameters, dummy for Tequila crisis  
- $\delta = 0.8 (0.04)$, expected time between price changes $\approx 5$ qtrs

Additional comments

- Discrete vs. continuous time  
- Compare with literature  
- Stochastic difference equations  
- LQ-model, optimization (discretion and commitment) and estimation, Söderlind EEA 99  
- Optimal policy, inflation targeting, etc.