CCK107.tex

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 δ, 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 ≈ 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.