PRELIMINARY

Simple Pricing Rules, the Phillips Curve and the Microfoundations of Inflation Persistence

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Abstract

Models in which pricing decisions depend on indexing or rule of thumb behaviour have become prominent in the monetary policy literature and tend to match macroeconomic data well given their prediction of inflation persistence. The extent to which firms index their prices to past inflation has been assumed constant. We explore the consequences of endogenising the degree of indexing such that firms move closer to constrained optimal prices and find that the degree of indexing depends sensitively on firms' perceptions of the degree of persistence in the economy. This has striking implications. Firstly models in which the degree of indexing is fixed are vulnerable to the Lucas critique since that parameter will change in different regimes. Secondly we study the interactions between perceived persistence, which governs indexing and thus the quantitative significance of lagged inflation in the Phillips curve, and actual persistence which depends on the latter. We find that if firms adjust their indexing behaviour to actual persistence, lagged inflation disappears from the Phillips curve and the models no longer predict persistence.

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Key Words: Indexing, Monetary Policy, Phillips curve, Inflation persistence, Microfoundations

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