Research Working Papers

Variable Elasticity Demand and Inflation Persistence

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This paper proposes a model of monetary policy that relies on price dispersion to explain empirical evidence on inflation persistence.

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We propose a novel explanation for the well-known persistent inflation response to monetary policy shocks by introducing variable elasticity demand curves in a staggered price model with trend inflation. The demand curves induce strategic complementarity in price setting and thus generate inflation persistence under positive trend inflation through the effect on inflation dynamics of a measure of price dispersion, which differs from relative price distortion. We also show that credible disinflation leads to a gradual decline in inflation and a fall in output and that lower trend inflation reduces inflation persistence, as observed around the time of the Volcker disinflation.

JEL Classification: E31, E52

Article Citations

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Related Research

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