Inflation Dynamics with Bounded Rationality

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Summary

There is an unbalanced specification in the standard new Keynesian model. In the model, stickiness is assumed in the price setting and then individual firm has a fixed probability to change its price in any given period, which means that market is imperfect. On the other hand, individual firm is assumed as one who can conduct profit maximization and calculate the degree of nominal rigidity in the future completely. In order to avoid the unbalanced specification, we suppose that firms choose the price with the bounded rationality. Concretely, we assume that firms refer to the lagged inflation in the price setting, which is one of the simplest forms to express the bounded rationality, and then we obtain the hybrid new Keynesian Phillips curve to express inflation dynamics, named the sticky price with bounded rationality Phillips curve (SPBR).

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