

Consumers' Price Beliefs, Central Bank Communication, and Inflation Dynamics*

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Abstract

Many developed economies in recent years have been characterized by a tight labor market and a low inflation environment, a phenomenon referred to as “missing inflation.” To explain this phenomenon, we develop a dispersed information model in which consumers’ search for cheaper prices affects firms’ pricing behavior. The model shows that firms are reluctant to pass through cost increases because they fear a disproportionate decline in their sales. A history of low and stable inflation amplifies this effect by decreasing consumers’ inflation beliefs. In this case, enhancement of the central bank’s communication regarding its inflation target more firmly anchors consumers’ inflation beliefs and makes the Phillips curve flatter, while enhancement of the central bank’s communication about the current aggregate price level has the opposite effect.

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