

State-dependent Nominal Rigidities and Disinflation Programs in Small Open Economies

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Overview of the paper

- Seeks to rationalize output dynamics during temporary disinflation programs
 - ERB: initial boom followed by recession
 - MB: initial recession followed by recovery
- Allow firms to respond to disinflation
 - Increase speed of optimal price revisions

Key elements

- Calvo probability of being able to revise prices
 - $1-\lambda_H, 1-\lambda_L$: constant hazard of being able to revise
 - Adjusting firm sets p_t and ω_t : $p_{t+s}=\omega_t^s p_t$
 - Also, choose $\{\lambda_H, \lambda_L\}$: pay fixed cost if choose higher

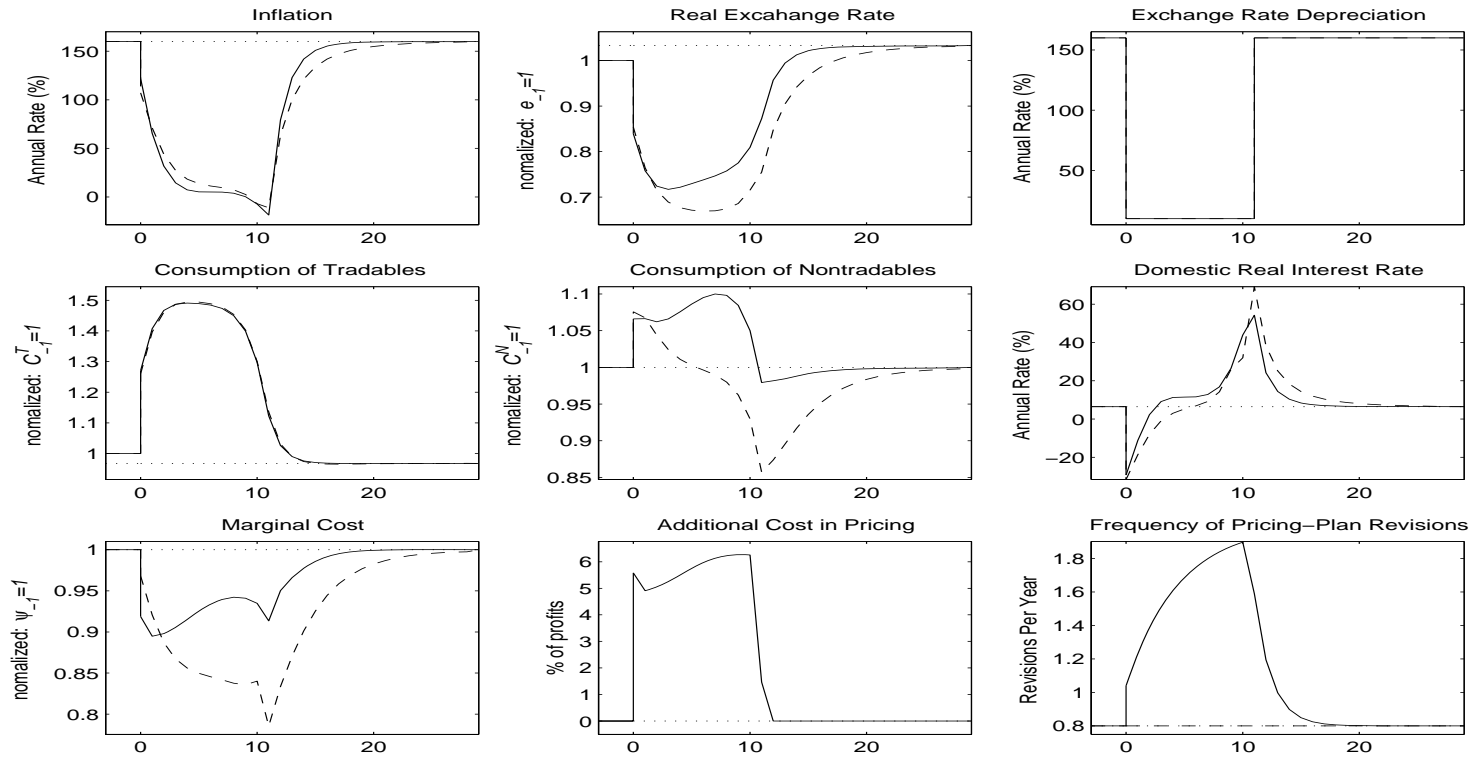
Prices during temporary disinflation

- Standard model:
 - Adjusters keep ω_t high
 - Expect inflation to increase in future periods
 - Prices too high: output drops a lot (lower real balances)
 - Even if MC falls as less distortion in labor market

Prices during disinflation

- This model:
 - Adjusters choose low ω_t
 - Choose higher frequency of revisions
 - Prices fall more than in standard model
 - Output drops less than in standard model

(a) Temporary Exchange Rate-Based Disinflation Program



(b) Temporary Money-Based Disinflation Program

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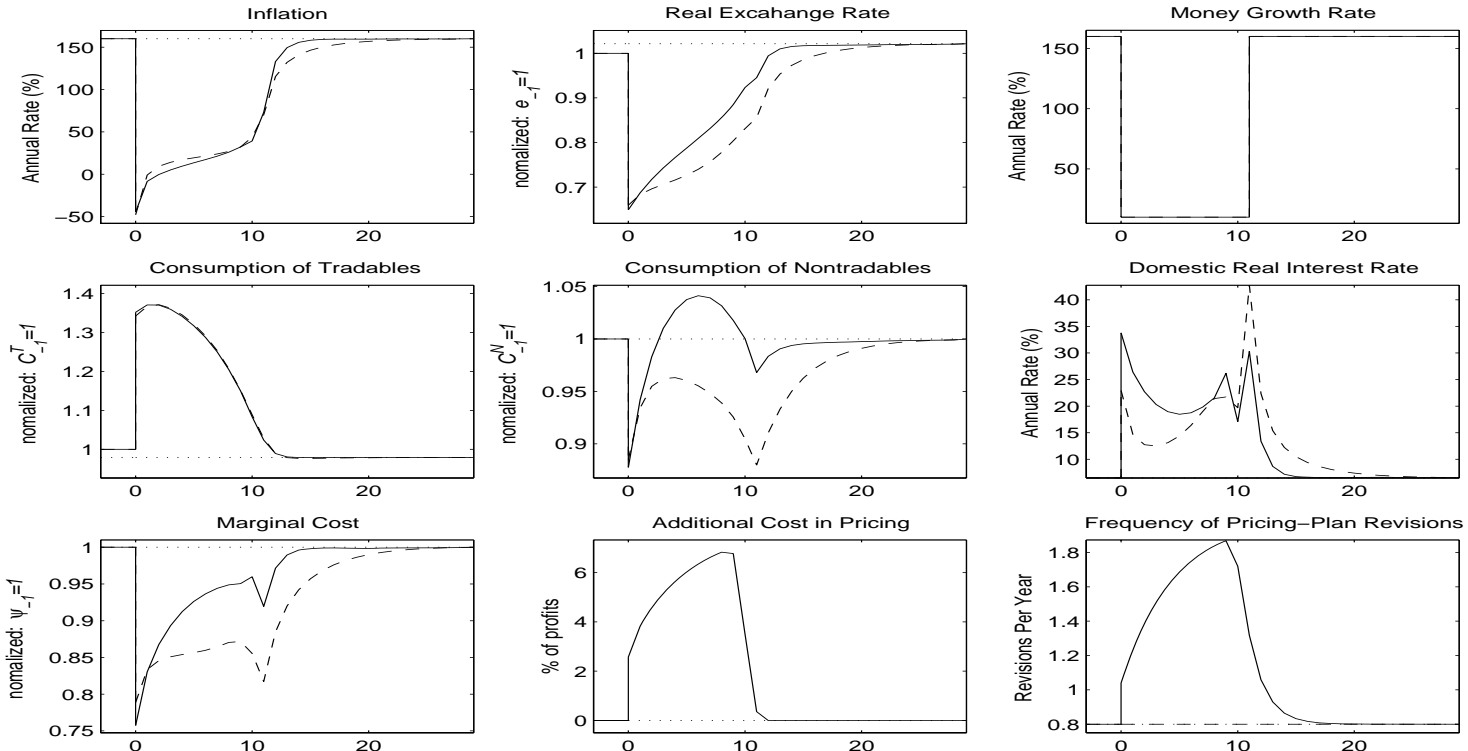


Figure 3: Temporary Disinflation Programs

Semantics

- Not exactly model of “state-dependent pricing”
 - Rather: “endogenous time-dependent pricing”
 - Ball, Mankiw, Romer ('88) , Devereux & Yetman ('02)
 - Bonomo-Carvalho ('04): similar exercise as this paper
 - No indexation
 - Choose date of next adjustment, not probability
 - Recession is longer with endogenous rules

State vs. Time-Dependent Pricing

- Time-dependent pricing
 - Information/decision-making costs
 - Date of price changes exogenous (or set in advance)
- State-dependent pricing
 - Physical adjustment (menu costs)
 - Date of price changes depends on state of world
 - Larger shocks: more likely adjustment

Comments I

- Frictions imposed on firms implausibly large
 - Can't revise ω : informational/decision-making costs?
 - How much are they willing to pay to change plan?
 - What happens to cross-sectional price dispersion during crisis?
- ERB generates boom because less inflation distortions: e.g. labor-leisure choice
 - Why only allow price indexation?
 - Why not wage indexation?

Comments II

- Why not allow firms to choose λ
 - Paper allows to choose between 2 values, high and low
 - Or even better: date of future price change
- Why not allow flexible pricing plan: set ω_{t+s}
 - Or just index to exchange rate?
- Why not calibrate λ to micro-evidence
 - Gagnon ('06): 50% of prices change monthly in Mexico in 1995

Conclusions

- Impressive computational exercise
 - Rich model
 - numerous predictions
- Addresses Lucas' critique: firm behavior not independent of policy
- Micro-frictions need to be addressed more rigorously