

The Cyclical Effects of Trend Inflation in an Estimated Medium-Scale New Keynesian Model.

Preliminary

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Abstract

A major neoclassical criticism regarding medium-scale New Keynesian Models is their recent use of dubiously structural shocks. This paper estimates an enriched version of a modern DSGE model featuring i) non-zero trend inflation, ii) economic growth stemming from distinct sources, iii) a roundabout production structure and iv) a parsimonious selection of shocks. The model estimated from a bayesian procedure delivers highly sensible estimates, including estimates of the frequency of prices nominal wage adjustments broadly consistent with recent micro-level evidence. The model is also consistent with a highly persistent inflation process despite the absence of ad hoc wage and price indexation mechanisms to past inflation. Trend inflation has strong business-cycle implications, mainly through its interaction with shocks to the marginal efficiency of investment. Seen through the lens of our new framework, medium-scale New Keynesian models are not necessarily prone to the neoclassical criticism of the proliferation of shocks and use of arbitrary wage- and price-setting mechanisms.

JEL classification: E31, E32, E37.

Keywords: Wage and price contracting; trend inflation; trend growth in technology; roundabout production; investment shocks; inflation costs; business cycles; Bayesian Estimation.