

New Keynesian AS: Introduction

Can we develop a microeconomic model that implies $\pi_t = \pi^e + \beta(\gamma - \bar{\gamma})_t$?

Note this means

- no jumps in price level, π never ∞
- p moves toward, but can be persistently away from, level that makes $\gamma = \bar{\gamma}$.

Some approaches:

1) Imperfect information

"Lucas supply function" "Sticky information"

Pricesetters have outdated information, can't/choose not to/get information about current state of markets

2) "Menu cost"

Assume a cost of adjusting wage or price,

If benefit of adjusting is small enough, you'll leave p_i fixed.

3) Time dependent price adjustment

You can adjust p_i only at certain points in time
At other times, impossible (or costly) to adjust p_i

For most models in 1), 2) or 3), must

Abandon perfect competition

In perfectly competitive markets (stocks, commodities, foreign exchange) prices do jump!

In a perf. comp. market, a producer loses a lot if he fails to adjust $p_i = mc$

- if $p_i < mc$, loses lots of money

- if $p_i > mc$, cut p_i a little & greatly increase sales

So, we need a general-equilibrium model with non-competitive markets.

Simplest: monopoly (or monopolistic competition)