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How does the Phillips curve slope vary with repricing rates?

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Price-setting Microdata Analysis Network (PRISMA)

This paper contains research conducted within the Price-setting Microdata Analysis Network (PRISMA). PRISMA consists of economists from the ECB and the national central banks (NCBs) of the European System of Central Banks (ESCB).

PRISMA is coordinated by a team chaired by Luca Dedola (ECB), and consisting of Chiara Osbat (ECB), Peter Karadi (ECB) and Georg Strasser (ECB). Fernando Alvarez (University of Chicago), Yuriy Gorodnichenko (University of California Berkeley), Raphael Schoenle (Federal Reserve Bank of Cleveland and Brandeis University) and Michael Weber (University of Chicago) act as external consultants.

PRISMA collects and studies various kinds of price microdata, including data underlying official price indices such as the Consumer Price Index (CPI) and the Producer Price Index (PPI), scanner data and online prices to deepen the understanding of price-setting behaviour and inflation dynamics in the euro area and EU, with a view to gaining new insights into a key aspect of monetary policy transmission (for further information see https://www.ecb.europa.eu/pub/economic-research/research-networks/html/researcher_prisma.en.html)

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This paper is released in order to make the results of PRISMA research generally available, in preliminary form, to encourage comments and suggestions prior to final publication. The views expressed in the paper are the author's own and do not necessarily reflect those of the ESCB.

In sticky price models, the slope of the Phillips curve depends positively on the probability of price adjustment. I use a series for the empirical frequency of price adjustment to test this implication. I find some evidence that the Phillips curve slope depends positively on the repricing rate. My results support the implication from New Keynesian theory with Calvo pricing that the Phillips curve slope is a convex function of the frequency of price adjustment. However, at all observed values of the frequency of price adjustment, the empirical Phillips curve relation is much flatter than the New Keynesian Phillips Curve at standard parameter values would imply.

Keywords: Inflation, Phillips curve, price setting

JEL codes: C22, E31

Non-Technical Summary

The relationship between inflation in the price level and demand (i.e. the quantity of goods and services that households desire to purchase) is important for central banks. This is because monetary policy seeks to stabilize inflation and production by influencing demand. When inflation is more sensitive to changes in demand, monetary policy will tend to have a larger effect on inflation and a smaller effect on production.

In models that are commonly used for monetary policy analysis, inflation is more sensitive to changes in demand when firms adjust their prices more often. To see why, consider the case where households wish to buy more of all types of goods and services, while firms' capacity to produce these goods and services stays the same. Standard theory implies that if all firms were changing their prices all the time, then this increase in demand would cause all firms to immediately increase their prices until the point where demand would be back down to the amount of goods and service that firms are able to produce. In that case, monetary policy actions would immediately have their full effect on inflation but would have no effect on how much is actually sold.

In reality, firms do not change their prices all the time, presumably because changing prices is costly. In that case, when demand for all goods and services increases, prices won't immediately increase for all goods and services. Theory implies that for goods or services with prices that have not yet been adjusted, firms would actually produce more to meet the increase in demand, until the moment that they do adjust their price. Eventually, all prices will adjust and demand will be back down to its original level. In the models, the larger the fraction of prices that is adjusted in every period, the shorter the economy-wide process of price adjustment takes, and therefore the shorter the period in which production is above the level that firms could sustain for a longer time. Therefore, when firms adjust their prices more frequently, changes in demand reach their full effect on the economy-wide price level more quickly and have smaller effects on production.

In this paper, I examine whether data for the United States for 1979Q1-2016Q4 are in line with this implication from standard models. I find that there is some evidence that there is indeed a positive relationship between the sensitivity of inflation to demand fluctuations and the frequency with which firms change their prices. The result holds when I use a measure for inflation that arguably performs best at removing temporary price changes. With other inflation measures, the results are not clear-cut. This could be because those measures still contain a substantial amount of temporary price changes that make it more difficult to observe a relationship even if there is one.

US firms tend to change their prices less often now than say forty years ago. My results suggest that this caused inflation to become less sensitive to demand fluctuations. In theory, this tends to cause the effect of monetary policy on inflation to become smaller and its effect on production to become larger.

Furthermore, I find that the sensitivity of inflation to demand is particularly unstable at times when firms update their prices relatively frequently. This occurred in the late 1970s and early 1980s.

In addition, I show that at all times of analysis, inflation is much less sensitive to demand fluctuations than standard models imply. This suggests that monetary policy has smaller effects on inflation, and larger effects on production, than standard models imply.

1 Introduction

A cornerstone implication of sticky price models is that when firms change their prices more frequently, aggregate demand fluctuations have a larger effect on inflation in the short run, i.e. the short-run Phillips curve is steeper. In particular, the New Keynesian Phillips Curve (NKPC), which is derived from a New Keynesian model with pricing as in Calvo (1983), implies that the slope is a positive and convex function of the probability of price adjustment.

In this paper, I examine empirically how the Phillips curve slope depends on the frequency of price adjustment, using the series for the adjustment frequency that Nakamura, Steinsson, Sun and Villar (2018) computed from price-level data.

To my knowledge, the present paper is the first to examine the relation between the Phillips curve slope and the frequency of price adjustment empirically. Earlier papers that test implications of sticky price models for the Phillips curve slope, such as Ball, Mankiw and Romer (1988), DeFina (1991), De Veirman (2009) and Ball and Mazumder (2011), examine the role of variables such as trend inflation or aggregate volatility, which in theory affect the Phillips curve slope through the frequency of price adjustment. Against the background that a long time series for the frequency of price adjustment was not yet available at that time, these papers did not explicitly examine the influence of the adjustment frequency on the Phillips curve slope.[1]

When I model the Phillips curve slope as a linear function of the adjustment frequency, I detect a statistically significant positive relation between the slope and the frequency when I use an inflation measure that arguably has the least amount of noise. My findings suggest

[1] Bils and Klenow (2004) and Nakamura and Steinsson (2008) were among the first to provide comprehensive evidence on the frequency of price adjustment in the United States.

that the Phillips curve slope was essentially zero at most times since the late 1990s due to relatively infrequent price adjustment at that time. For the period from the Great Recession onwards, this is consistent with the fact that inflation remained stable notwithstanding a long sequence of negative output gaps.

These results relate to an empirical literature that finds that the Phillips curve has flattened in the United States. See, for instance, Ball and Mazumder (2011), Blanchard (2016) and Del Negro, Lenza, Primiceri and Tambalotti (2020).[2] My results suggest that the Phillips curve may have flattened endogenously, as a result of declining repricing rates.

Next, I estimate Phillips curves with a slope that depends on the frequency of price adjustment according to the same non-linear functional form as that of the NKPC. In line with the New Keynesian model with Calvo pricing, I find that the sensitivity of inflation to aggregate demand fluctuations is a convex function of the adjustment frequency.

I also characterize the degree of sensitivity of inflation to demand which the NKPC implies given the empirically observed frequencies of price adjustment, with other structural parameters set at standard values. Given the same empirical adjustment frequencies, the degree of sensitivity of inflation to output implied by the structural parameters is much higher than that implied by my estimates at all times in the sample period. On average, the implied theoretical Phillips curve slope is about ten times steeper than the implied empirical slope specified as a non-linear function of the frequency. This finding implies that the Calvo model overstates the short-run response of inflation to aggregate demand fluctuations and understates the real effects.

[2]See Costain, Nakov and Petit (2021) for an explanation of this flattening based on a state-dependent pricing model. See De Veirman (2009), Blanchard, Cerutti and Summers (2015) and Okuda, Tsuruga and Zanetti (2021) for evidence of such flattening in other economies.

The NKPC assumes that firms set prices as in Calvo (1983), which is a prominent type of time-dependent pricing. With Calvo pricing, firms have to wait until they are given the opportunity to adjust their price so as to react to a change in aggregate demand. In time-dependent pricing models such as those with Calvo price setting, firms that adjust their price cannot self-select into being those that desire the largest price changes. On the contrary, such a selection effect is present in state-dependent pricing models. For the same frequency of price adjustment, this implies that inflation responds more strongly to shocks in state-dependent pricing models than in time-dependent pricing models. Combined with my finding that the Calvo model overstates the speed of adjustment of prices relative to the empirical macro relations, this suggests that state-dependent pricing models would overstate the empirical response by even more.

The remainder of the paper is organized as follows. Section 2 shows that empirically, the Phillips curve slope depends positively on the frequency of price adjustment. Section 3 documents that the relation between the slope and the frequency is convex both in the NKPC and in the data, but that the theoretical slope implied by standard values for the structural parameters is much steeper than the slope of the empirical Phillips curve. Section 4 concludes.

2 Does the Phillips curve slope depend on the frequency of price adjustment?

In this section, I show that empirically, there is evidence for a positive relationship between the Phillips curve slope and the frequency of price adjustment, but this relationship is significant only with trimmed mean PCE inflation.

Figure 1 plots the data. The top panel shows the median quarterly frequency of consumer price adjustment in the United States from Nakamura, Steinsson, Sun and Villar (2018), with the blue line representing an unsmoothed quarterly series and the black line representing a backward-looking four-quarter moving average. Aiming to reduce the impact of any measurement error, I perform analysis with the smoothed series throughout this paper. Note that Nakamura e.a. (2018) focus on an annual series, plausibly for the same reason.

While Nakamura e.a. (2018) report the frequency as the fraction of prices that change per month, I express it as the fraction of price changes per quarter so as to allow for a comparison with the quarterly probability of price adjustment from sticky price models in Section 3.[3]

The middle panel of Figure 1 plots the output gap, which I computed as the percentage difference between real Gross Domestic Product (GDP) and Congressional Budget Office estimates of real potential output.

The bottom panel plots inflation in the deflator for Personal Consumption Expenditures (PCE) excluding food and energy (in blue), as well as trimmed mean PCE inflation from the Federal Reserve Bank of Dallas (the thick black line). Trimmed mean PCE inflation is less volatile than PCE inflation ex food and energy. In particular, the former measure has smaller short-run fluctuations than the latter. Plausibly due to this feature, it turns out that my Phillips curve regressions for trimmed mean PCE inflation provide a better fit and tighter

[3] Figure XIV in Nakamura, Steinsson, Sun and Villar (2018) plots an annual series for the frequency of price adjustment. I thank Jón Steinsson for sending me the underlying unsmoothed quarterly series $\widetilde{freq}_t^m$ expressed as the fraction of price changes per month. From this series, I first compute the frequency expressed as the fraction of price changes per quarter $\widetilde{freq}_t^q$ through the formula $(1 - \widetilde{freq}_t^m)^3 = 1 - \widetilde{freq}_t^q$. I then compute the four-quarter moving average as $freq_t = (1/4) \sum_{i=0}^{3} \widetilde{freq}_{t-i}^q$.

estimates than those with core PCE inflation. As I discuss later in this section, this is why I use trimmed mean PCE inflation as the baseline.

Beyond these two measures for core PCE inflation, I also report results using inflation in the constant methodology Bureau of Labor Statistics research series for the Consumer Price Index (CPI) excluding food and energy, and for inflation in the GDP deflator. Throughout,

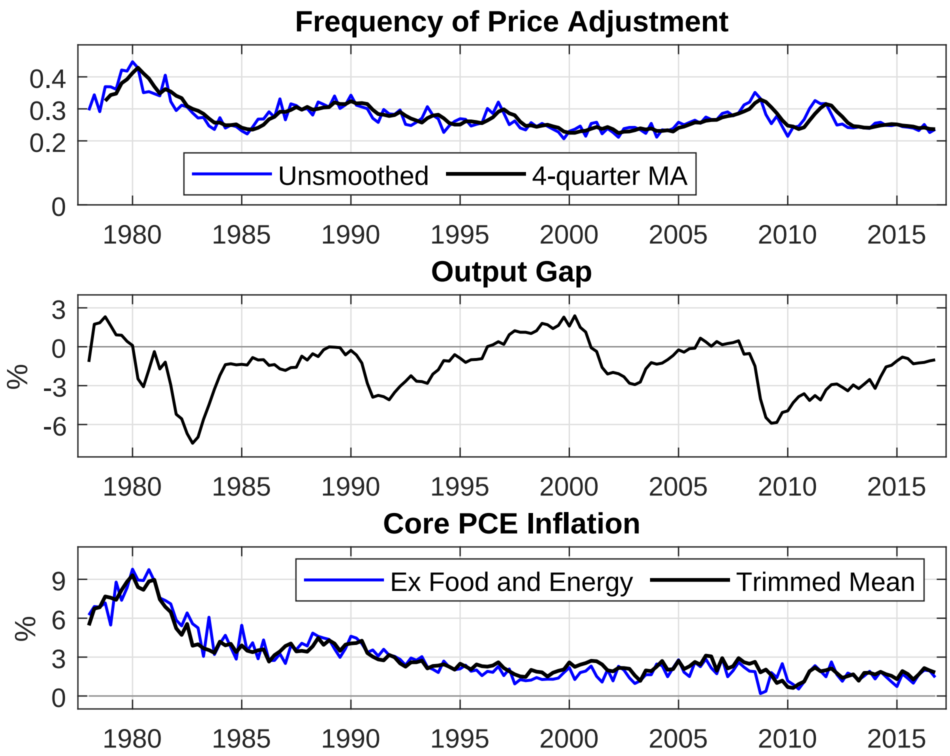

Figure 1. Data

Note: This figure plots quarterly time series for the United States. The top panel plots the median frequency of consumer price adjustment excluding sales, expressed as the share of prices that change per quarter. These data underly Nakamura, Steinsson, Sun and Villar (2018). From the unsmoothed frequency (in blue), I computed the four-quarter backward-looking moving average (the thick black line). The middle panel plots the output gap, defined as the percent deviation of real Gross Domestic Product from the Congressional Budget Office estimate of real potential output. The bottom panel plots inflation in the deflator for Personal Consumption Expenditures ex food and energy (in blue) and trimmed mean PCE inflation from the Federal Reserve Bank of Dallas (the thick black line). Both cases pertain to annualized quarter-on-quarter inflation.

I use quarter-on-quarter annualized inflation.

In this section, I specify the Phillips curve slope as a linear relationship of the frequency of price adjustment. With trimmed mean PCE inflation, I estimate the following regression:

$$\pi_t = \beta(L)\pi_t + (a + b\ freq_t)(ygap_t + \sum_{i=1}^{5} p_i\ ygap_{t-i}) + \varepsilon_t \tag{1}$$

where π_t is inflation, $freq_t$ is the frequency of price adjustment, $ygap_t$ is the output gap and ε_t is the residual. Equation (1) assumes adaptive inflation expectations. In particular, $\beta(L)\pi_t = \sum_{i=1}^{7} \beta_i \pi_{t-i}$. I impose $\beta_7 = (1 - \sum_{i=1}^{6} \beta_i)$, i.e., the inflation lag coefficients sum to one. This is equivalent to specifying the equation in terms of changes in inflation. I omit the intercept to avoid the possibility of a long-run trend in inflation. At the 5% level, neither of these two restrictions is rejected. In combination, these two assumptions yield a standard accelerationist Phillips curve.

The sample is 1979Q1-2016Q4, with earlier quarters used for lags. Lag selection is based on the Akaike Information Criterion (AIC).

I measure the Phillips curve slope by the sum of the output gap coefficients. In equation (1), the sum of the output gap coefficients is $(a+b\ freq_t)(1+\sum_{i=1}^{5} p_i)$. This specification allows the Phillips curve slope to vary over time due to changes in the frequency of price adjustment. Since the p's are time-invariant, it assumes that the coefficients on individual output gap terms remain proportional to one another.

First, I estimate a Phillips curve where I set $b = 0$, such that equation (1) reduces to a standard Phillips curve with a time-invariant slope. (I discuss the case with unrestricted b below.)

The adjusted R-squared of the regression with trimmed mean PCE inflation is 0.95. A Breusch-Godfrey LM test for serial correlation up to eight lags reveals no serial correlation in the residuals.

The leftmost numerical part of Table 1 reports results from Wald tests for the null hypothesis that $a(1+\sum_{i=1}^{5} p_i) = 0$, which is the sum of the output gap coefficients after setting $b = 0$.

Throughout this paper, I use Newey-West heteroskedasticity and autocorrelation robust standard errors.

As the first numerical row shows, the Phillips curve slope is 0.03 but statistically insignificant. This is also quite small in economic terms. In combination with the inflation lag coefficients, the Phillips curve slope implies that if the output gap is 1% for one year and 0 at all other times, annualized quarterly inflation increases by 0.11 percentage points in the long run.

Next, I allow the slope to depend on the frequency of price adjustment by estimating b along with the other coefficients. I perform Wald tests for the null hypothesis that $b(1 + \sum_{i=1}^{5} p_i) = 0$, i.e. that the frequency of price adjustment has no effect on the sum of the output gap coefficients.

As the first numerical row of the right part of Table 1 shows, I find that $b(1+\sum_{i=1}^{5} p_i) = 1.92$, which is statistically significant at the 1% level.

The remainder of the upper left numerical part of Table 1 documents that with other inflation measures, the slope of the accelerationist Phillips curve is also positive. It is statistically significant at the 5% level with inflation in the PCE deflator ex food and energy and in the constant methodology core CPI. It is insignificant with inflation in the GDP deflator.

Since the GDP deflator is the only one among the four inflation measures that captures headline inflation, it is also the only one for which I enter relative oil price inflation as a regressor. For every inflation measure, I use the lag specification that the AIC selects for that particular inflation measure.

TABLE 1 WALD TESTS: PHILLIPS CURVE SLOPE AND RELATION TO FREQUENCY OF PRICE ADJUSTMENT

		Significant Phillips curve slope?			*Significant relation to frequency?*		
		H_0: $a(1+\sum_{i=1}^{5} p_i)=0$			H_0: $b(1+\sum_{i=1}^{5} p_i)=0$		
infexp	inflation	slope	stderr	pval	rel freq	stderr	pval
$\beta(L)\pi_t$	PCE_TM	0.03	0.02	0.11	1.92**	0.62	0.00
$\beta(L)\pi_t$	PCEX	0.06*	0.03	0.04	2.04	1.18	0.09
$\beta(L)\pi_t$	GDPDEF	0.04	0.03	0.24	-0.05	0.22	0.84
$\beta(L)\pi_t$	CPIX	0.07*	0.03	0.03	0.81	0.62	0.19
$\pi^e_{t\|t-1}$	GDPDEF	0.02	0.04	0.56	0.86	0.73	0.24
$\pi^e_{t+1\|t}$	GDPDEF	0.05	0.04	0.22	0.85	0.87	0.33
$\pi^e_{t+1\|t-1}$	GDPDEF	0.06	0.04	0.16	1.00	0.88	0.26

Notes: "Significant Phillips curve slope?" pertains to Wald tests for the null hypothesis that the sum of the output gap coefficients is zero after imposing $b = 0$. "Significant relation to frequency?" tests whether the sum of the output gap coefficients depends on a four-quarter moving average of the frequency of price adjustment. In each case, I report the value for the function of the coefficients that is indicated above the table, its standard error and the p-value of the F-statistic. $\beta(L)\pi_t$ stands for adaptive expectations as in equation (1). For any quarters τ_1 and τ_2, $\pi^e_{\tau_2|\tau_1}$ stands for Survey of Professional Forecasters forecasts formed in τ_1 for inflation in the GDP deflator at time τ_2. PCE_TM is trimmed mean PCE inflation from the Dallas Fed; PCEX is PCE inflation ex food and energy; GDPDEF is GDP deflator inflation; CPIX is inflation in the constant methodology research series for the CPI ex food and energy. Throughout, lag selection is based on the AIC. The sample is 1979Q1-2016Q4, with earlier quarters used for lags. I use Newey-West standard errors. * marks significance at the 5% level; ** at the 1% level.

The corresponding rows in the right part of the table show that with inflation measures other than trimmed mean PCE inflation, there is no statistically significant relation between the slope of the accelerationist Phillips curve and the frequency of price adjustment.

Taken together, the evidence in favor of the hypothesis that the slope depends on the price adjustment frequency is not overwhelming. One interpretation is that the specification with trimmed mean PCE inflation is better able to pinpoint the relation. Arguably, this inflation measure is better at cleaning out transitory relative price shocks than ex food and energy measures of core inflation are, such that variation in this inflation measure can be more easily explained by the regressors in the Phillips curve. In the accelerationist Phillips curve where the slope depends linearly on the frequency of price adjustment, the adjusted R-squared is 0.95 with trimmed mean inflation, as opposed to 0.88 for PCE inflation ex food and energy and somewhat lower still for the other inflation measures. The higher R-squared goes along with a smaller standard error of the regression, which tends to imply tighter confidence bands around the regression point estimates.[4]

Adopting the above interpretation, in much of the paper I focus on results with trimmed mean PCE inflation.

For the case with trimmed mean PCE inflation, the blue line in Section 3's Figure 3 plots the time variation in the Phillips curve slope implied by the coefficient estimates for equation (1) and the empirical frequencies of price adjustment. I find that the Phillips curve slope varied between -0.06 in 2002Q2 and 0.33 in 1980Q2. Relative to the constant-coefficients slope of 0.03, that variation is substantial. (The interpretation of the other lines in this figure

[4]This interpretation is akin to that of Ball and Mazumder (2019a) on the measurement of the Phillips curve slope with median inflation.

will become clear in Section 3.)

The implied changes in the Phillips curve slope are at times swift, a type of instability in the output-inflation trade-off which can greatly alter the effects of aggregate demand fluctuations.

A first example of this is the Volcker disinflation. The Phillips curve in which the slope depends linearly on the frequency implies that the slope was 0.33 in 1980Q2. Together with the inflation lag coefficients, this implies that if repricing rates would have stayed as high as in 1980Q2 and in the scenario that the output gap was -1% for a year and zero at all other times, that would have implied a long-run reduction in inflation by 1.16 percentage points. However, the frequency of price adjustment quickly declined from its 1980Q2 peak, such that on average in 1982, the implied Phillips curve slope was 0.13. With this slope, an output gap of -1% for one year implies a long-run reduction in inflation by 0.44 percentage points. This suggests that the output gap, which reached its trough at an average of -6.23 percent in 1982, had an effect on inflation that was less than half of what it would have been if the slope had stayed at its 1980Q2 level.

The Great Recession provides a second example of swift implied changes in the Phillips curve slope. The implied Phillips curve slope was 0.14 in 2008Q4. However, the slope declined swiftly after that, to essentially zero on average in 2010, where it stayed for most of the remainder of the sample period. This suggests that the output gap, which was -4.18% on average in 2010, had virtually no downward effect on inflation, as opposed to what would have occurred if the slope had stayed at 0.14. In the latter case, a -1% output gap for one year would have implied a long-run decline in inflation by 0.50 percentage points. This suggests that the negative output gaps in 2010 would have tended to imply a long-run decline in inflation by $4.18 * 0.50 = 2.09$ percentage points. Against the background that trimmed mean PCE inflation was 1.68% on average in 2008Q1-2016Q4, the implied differences in the effects of the output gap on inflation are substantial.

To further check robustness, I estimate Phillips curves where I relax the assumption of adaptive expectations. In particular, I regress over 1978Q4-2016Q4:

$$\pi_t = \beta \pi^e_{t+1|t} + (a + b\ freq_t)\ ygap_t + \sum_{i=0}^{6} \gamma_i\ (\pi_{o,t-i} - \pi_{t-i}) + \varepsilon_t \tag{2}$$

where $\pi^e_{t+1|t}$ is the forecast from the Survey of Professional Forecasters (SPF) of GDP deflator inflation in quarter t+1, formed in quarter t. $\pi_{o,t} - \pi_t$ is relative inflation in the West Texas Intermediate spot crude oil price. As before, lag selection is based on the AIC.

An advantage of using survey expectations is that this flexibly deals with any structural break in the process by which inflation expectations are formed.[5]

Since the one-quarter ahead forecast is only available over the required time span for GDP deflator inflation, in this context I use inflation in the GDP deflator as the dependent variable. With $\pi^e_{t+1|t}$, the timing of inflation expectations is the same as that of the New Keynesian Phillips curve, which features in Section 3.

The timing of the deadlines by which SPF forecasters need to submit their forecasts and those of the Bureau of Economic Analysis publications of the GDP deflator are such that when SPF forecasters make their forecast in quarter t, they know the preliminary estimate of

[5]The results from Ball and Mazumder (2019b) suggest that US inflation expectations became anchored from 1998 onwards.

the GDP deflator in t-1, but do not know the GDP deflator in t. In this context, equation(2) treats $\pi^e_{t+1|t}$ as exogenous.

The row marked $\pi^e_{t+1|t}$ in Table 1 summarizes the results. When I set $b = 0$ in equation (2), the point estimate for the Phillips curve slope is 0.05, but insignificant.

When I estimate b along with the other coefficients in equation (2), I do not find a significant relation between the Phillips curve slope and the frequency of price adjustment.

The rows $\pi^e_{t|t-1}$ and $\pi^e_{t+1|t-1}$ show that the results are similar when I instead use, respectively, SPF forecasts for quarter t formed in quarter t-1 and SPF forecasts for quarter t+1 formed in t-1.[6]

As a final robustness check, I estimate Phillips curves where I allow the coefficients in the inflation expectations terms to depend on the frequency of price adjustment. In the case of trimmed mean PCE inflation and with adaptive inflation expectations, I estimate the following equation:

$$\pi_t = (c + d\ freq_t)(\pi_{t-1} + \sum_{i=2}^{7} q_i\ \pi_{t-i}) + (a + b\ freq_t)(ygap_t + \sum_{i=1}^{5} p_i\ ygap_{t-i}) + \varepsilon_t \qquad (3)$$

which differs from equation (1) in two ways. First, it does not impose the restriction that the inflation lag coefficients sum to one. Second, it accounts for the possibility that the sum of the inflation lag coefficients depends on the frequency of price adjustment. Since the q's are time-invariant, it assumes that the coefficients on individual inflation lag terms remain proportional to one another.

[6]For each of the three types of survey expectations, I choose the lag specification based on the AICs that apply for that particular type of expectations.

With forward-looking survey expectations, I estimate the following equation:

$$\pi_t = (c + d\ freq_t)\ \pi^e_{t+1|t} + (a + b\ freq_t)\ ygap_t + \sum_{i=0}^{6} \gamma_i\ (\pi_{o,t-i} - \pi_{t-i}) + \varepsilon_t \tag{4}$$

which differs from equation (2) in that it allows the coefficient on inflation expectations to depend on the frequency of price adjustment. I estimate analogous equations with the two other variants of survey expectations, i.e. $\pi^e_{t|t-1}$ and $\pi^e_{t+1|t-1}$.

In equations (3) and (4), I freely estimate b and d. Therefore, the price adjustment frequency can affect both the Phillips curve slope and the relation between inflation and inflation expectations.

The interpretation of the effect of the frequency on the relation between inflation and inflation expectations is different for each of the two equations.

In equation (3), the entire term $(c + d\ freq_t)(\pi_{t-1} + \sum_{i=2}^{7} q_i\ \pi_{t-i})$ stands for inflation expectations. Therefore, if d is different from zero, this means that the frequency of price adjustment affects the way in which inflation expectations depend on lagged inflation.

In equation (4), $\pi^e_{t+1|t}$ represents inflation expectations. Therefore, if d is different from zero, this means that the price adjustment frequency affects the way in which inflation depends on inflation expectations.

The upper left numerical block of Table 2 shows the results of Wald tests for the null hypothesis H_0: $d(1 + \sum_{i=2}^{7} q_i) = 0$ in equation (3), i.e. that the sum of the inflation lag coefficients does not depend on the repricing rate. The lower left numerical block tests H_0: $d = 0$ in equation (4), i.e. that the coefficient on inflation expectations does not depend on the frequency.

In the specifications with adaptive expectations in trimmed mean PCE inflation, PCE inflation ex food and energy and the GDP deflator, the frequency of price adjustment does not significantly affect the inflation lag coefficients. With core CPI inflation, there is a significant and positive relation between the sum of the inflation lag coefficients and the frequency.

If there is indeed such a positive relation, that means that inflation expectations react

Table 2 Wald Tests: Relation of Inflation Expectations Coefficients and of Phillips Curve Slope to Frequency of Price Adjustment

		Significant relation expectations coefficients to frequency?			*Significant relation Phillips curve slope to frequency?*		
		H_0: $d(1+\sum_{i=2}^{7} q_i)=0$			H_0: $b(1+\sum_{i=1}^{5} p_i)=0$		
infexp	inflation	relat exp-freq	stderr	pval	relat slope-freq	stderr	pval
adaptive	PCE_TM	0.07	0.20	0.74	1.91**	0.64	0.00
adaptive	PCEX	0.45	0.39	0.24	1.97	1.20	0.10
adaptive	GDPDEF	0.42	0.34	0.23	0.02	0.12	0.88
adaptive	CPIX	0.96*	0.37	0.01	0.76	0.92	0.41
$\pi^e_{t\|t-1}$	GDPDEF	1.06*	0.41	0.01	-0.17	0.32	0.59
$\pi^e_{t+1\|t}$	GDPDEF	0.86*	0.40	0.03	1.71	0.95	0.07
$\pi^e_{t+1\|t-1}$	GDPDEF	1.41**	0.48	0.00	2.48**	0.90	0.00

Notes: This table pertains to Phillips curves where both the inflation expectations coefficients and the slope are allowed to depend on the frequency of price adjustment. The upper left numerical block pertains to Wald tests for the null hypothesis that the sum of the coefficients on lagged inflation in equation (3) does not depend on the frequency. The lower left block tests whether the coefficient on survey expectations in equation (4) depends on the frequency. The right blocks test whether the Phillips curve slope depends on the frequency. In each case, I report the value for the function of the coefficients that is indicated above the table, its standard error and the p-value of the F-statistic. Other notes are as under Table 1.

more strongly to inflation fluctuations in the recent past when prices are adjusted more often.

The lower left numerical block shows that with all three variants for survey expectations, the frequency significantly affects the expectations coefficient.

This suggests that inflation reacts more strongly to changes in inflation expectations when prices are adjusted more often.

The right numerical blocks in Table 2 reveal that Wald test results regarding the relation between the Phillips curve slope and the frequency of price adjustment are quite similar to the baseline results in Table 1. In particular, with trimmed mean PCE inflation, the point estimate as well as the standard error is essentially the same as in the baseline. The most noteworthy difference is that with survey expectations $\pi^e_{t+1|t-1}$, the positive relation between the slope and the frequency is now significant at the one percent level.

Therefore, while there is some evidence that repricing rates affect the relation between inflation and inflation expectations, my findings suggest that this does not matter much for the relation between the Phillips curve slope and repricing rates. If anything, this robustness check provides slightly stronger evidence for a positive relation between the slope and the frequency.

3 How does the Phillips curve slope depend on the frequency of price adjustment? Theory vs. empirics

In this section, I document that both in the New Keynesian model and in the data, the sensitivity of inflation to aggregate demand fluctuations is a convex, increasing function of the repricing rate. I also show that at all frequencies of adjustment that occurred in the United States, the data imply that inflation is much less sensitive to aggregate demand fluctuations than the New Keynesian model implies.

I first turn to theory, so as to set up the stage for a comparison with the empirical estimates that I present later in this section. In sticky price models, the short-run Phillips curve is steeper when firms reprice more frequently. This intuition is formalized in the New Keynesian Phillips Curve (NKPC). In the canonical NKPC, inflation π_t depends on the contemporaneous output gap $ygap_t$ and on current expectations of future inflation $E_t\pi_{t+1}$:

$$\pi_t = \beta E_t \pi_{t+1} + \kappa \; ygap_t \tag{5}$$

where β is the household time discount factor, and where expectations are rational. As Galí (2008) shows, equation (5) follows from a New Keynesian model with Calvo pricing. The coefficient on the output gap is:

$$\kappa \equiv \left(\frac{(1-\theta)(1-\theta\beta)}{\theta}\right)\left(\frac{1-\alpha}{1-\alpha+\alpha\epsilon}\right)\left(\frac{\phi+\alpha}{1-\alpha}+\sigma\right) \tag{6}$$

where θ is the probability that a firm cannot reset its price, $1-\alpha$ governs the marginal product of labor, ϵ governs the price elasticity of demand, ϕ governs the elasticity of labor supply and σ is the inverse of the household's intertemporal elasticity of substitution.

To examine what this implies for the level of the Phillips curve slope and for its relation to the adjustment probability, I now calibrate the structural parameters in (6). I calibrate most of the structural parameters to the full information estimates of Smets and Wouters

(2007). In particular, I set $\beta = 0.9984$, $\alpha = 0.19$, $\phi = 1.83$ and $\sigma = 1.38$. Furthermore, I set $\epsilon = 6$.

In Smets and Wouters (2007), all firms adjust prices every quarter, with a fraction of firms setting their prices optimally and a fraction indexing partially to inflation. Therefore, the Smets-Wouters model does not feature a parameter that could directly be compared to the empirical frequency of price adjustment.

In Galí and Gertler (1999), a fraction of firms hold prices fixed every period, with some of the firms that do adjust doing so optimally and the remainder indexing fully to lagged inflation. I calibrate $\theta = 0.834$, which is Galí and Gertler's estimate for the probability of non-adjustment.

I now plug the above values for the structural parameters into equation (6) to obtain the implied Phillips curve slope. Given that Smets and Wouters (2007) estimated their model on non-annualized quarterly data, I multiply the implied slope by four so as to allow for a comparison with the slopes from the empirical Phillips curves that I estimated with annualized quarterly inflation. I obtain $4\kappa = 0.21$. This is substantially steeper than any of the estimated Phillips curve slopes from Table 1 in Section 2.

Moreover, with Galí and Gertler's (1999) estimated $\theta = 0.834$, price adjustment is less frequent than in the data from Nakamura, Steinsson, Sun and Villar (2018). On average in my sample, the empirical frequency of non-adjustment, expressed as a rate per quarter, is 0.7239. This illustrates the fact that typically, model-based estimates of the probability of price adjustment differ from empirical evidence on the adjustment frequency. When I instead set $\theta = 0.7239$, I obtain $4\kappa = 0.68$, which is not in the ballpark of my empirical estimates of the Phillips curve slope.

Therefore, with an empirically realistic value for the average frequency of non-adjustment and other structural parameters at standard values, the slope of the New Keynesian Phillips curve is much steeper than what I find in the data.

Note that even in the case with forward-looking survey expectations $\pi^e_{t+1|t}$, the specification required by the data is not entirely the same as that of the New Keynesian Phillips curve. This is because empirical survey expectations typically do not conform to the assumption of rational expectations and because equation (2) controls for relative oil price inflation.

We are about to see that both the theoretical and empirical Phillips curve slopes are convex functions of the adjustment frequency. With convexity, Jensen's inequality implies in both the theoretical and the empirical case that the time average of the slopes implied by the empirical series of adjustment frequencies exceeds the slope evaluated at the average adjustment frequency. It is therefore important to evaluate the Phillips curve slope at a broader range of values for the frequency.

I do so now. From here on, I focus on the overall inflation response to output gap fluctuations. These take into account the way inflation expectations respond as well as the slope of the Phillips curve. My conclusions are the same whether I focus on the overall inflation response or on the Phillips curve slope.[7]

In particular, I plot the inflation responses to the output gap being one percent for four consecutive quarters and zero at all other times. I track the cumulative change in inflation from before this transitory change in the output gap to twenty quarters after the last quarter

[7]See De Veirman (2022) for results analogous to those in Figures 2 and 3 below, but pertaining to the Phillips curve slope rather than to the overall inflation response.

with a positive output gap.

The black curve in Figure 2 tracks this five-year inflation response for the New Keynesian Phillips Curve as a function of the probability of price adjustment $1 - \theta$, keeping other structural parameters at the above-mentioned values. (For the purpose of this scenario analysis, I assume that $E_t\pi_{t+1} = \pi_{t-1}$.) The function is upward sloping, such that an increase in the adjustment probability implies a stronger inflation response. The function is convex, such that the inflation response varies more strongly with changes in repricing rates at times when many firms change their prices.

These reflect general features of the slope of the NKPC. By inspecting the first derivative of the slope of the NKPC from equation (6) with respect to the non-adjustment probability, we can see that the slope of the NKPC is decreasing in the probability of non-adjustment:

$$\frac{\delta\kappa}{\delta\theta} = \left(\frac{\beta\theta^2 - 1}{\theta^2}\right)\left(\frac{1-\alpha}{1-\alpha+\alpha\epsilon}\right)\left(\frac{\phi+\alpha}{1-\alpha} + \sigma\right) \tag{7}$$

If $0 < \beta < 1$ and $0 < \theta < 1$, then $\beta\theta^2 - 1 < 0$ and $\theta^2 > 0$. If $0 \leq \alpha < 1$ and $\epsilon \geq 0$, then $1-\alpha > 0$ and $1-\alpha+\alpha\epsilon > 0$. If, in addition, $\phi \geq 0$ and $\sigma \geq 0$, then $[(\phi+\alpha)/(1-\alpha)] + \sigma \geq 0$. As a result, $\delta\kappa/\delta\theta \leq 0$.

Since the slope of the NKPC is decreasing in the probability of non-adjustment θ, it is increasing in the probability of adjustment $1 - \theta$.

Second, from the second derivative we can see that the slope of the NKPC is a convex function of the probability of non-adjustment:

$$\frac{\delta^2\kappa}{\delta\theta^2} = \left(\frac{2}{\theta^3}\right)\left(\frac{1-\alpha}{1-\alpha+\alpha\epsilon}\right)\left(\frac{\phi+\alpha}{1-\alpha}+\sigma\right) \tag{8}$$

If $\theta > 0$, then $\theta^3 > 0$ and $\delta^2\kappa/\delta\theta^2 \geq 0$.

The blue line in Figure 2 charts the relationship between the five-year inflation response implied by the empirical Phillips curve slope from Section 2 and the frequency of price adjustment. Like in Section 2, this relation is upward sloping. Recall that in that section, I imposed a linear relationship between the slope and the frequency.

In the United States in 1978Q1-2016Q4, the frequency of price adjustment ranged from 0.22 to 0.43 per quarter. Over this range, the inflation response implied by the empirical Phillips curve slope specified as a linear function of the adjustment frequency is always well below that implied by the New Keynesian model with Calvo pricing. In addition, at most observed values for the frequency, the inflation response varies much more strongly with changes in repricing rates in the case of the New Keynesian Phillips curve than in the case of the empirical Phillips curve.

To see whether the assumption of a linear relation between the slope and the frequency in Section 2 accounts for these differences, I now estimate empirical Phillips curves in which the slope depends on the frequency of price adjustment in a non-linear fashion akin to that of the NKPC. As before, I use trimmed mean PCE inflation.

Defining the probability of price adjustment $\zeta \equiv 1-\theta$, one can rewrite equation (6) as follows:

$$\kappa \equiv \left[(1-\beta)\left(\frac{\zeta}{1-\zeta}\right)+\beta\left(\frac{\zeta^2}{1-\zeta}\right)\right]\left(\frac{1-\alpha}{1-\alpha+\alpha\epsilon}\right)\left(\frac{\phi+\alpha}{1-\alpha}+\sigma\right) \tag{9}$$

such that the Phillips curve depends on two non-linear terms in the probability of price adjustment: $[\zeta/(1-\zeta)]$ and $[\zeta^2/(1-\zeta)]$.

In a first specification, I write the Phillips curve slope as an unrestricted function of these two non-linear terms, after replacing the probability of price adjustment ζ by the empirical frequency of price adjustment $freq_t$:

$$\pi_t = \beta(L)\pi_t + \left[c + d\ \left(\frac{freq_t}{1-freq_t}\right) + e\ \left(\frac{freq_t^2}{1-freq_t}\right)\right](ygap_t + \sum_{i=1}^{5} p_i\ ygap_{t-i}) + \varepsilon_t \tag{10}$$

where $\beta(L)$ is as defined under equation (1). I call this the unrestricted non-linear specification.

In a second specification, I estimate:

$$\pi_t = \beta(L)\pi_t + f\ \left[(1-g)\ \left(\frac{freq_t}{1-freq_t}\right) + g\ \left(\frac{freq_t^2}{1-freq_t}\right)\right](ygap_t + \sum_{i=1}^{5} p_i\ ygap_{t-i}) + \varepsilon_t \tag{11}$$

I call this the restricted non-linear specification due to the fact that I restrict the coefficients on the two non-linear terms to sum to one like in equation (9). The parameter f stands for $[(1-\alpha)/(1-\alpha+\alpha\epsilon)][(\phi+\alpha)/(1-\alpha)+\sigma]$ from that equation.

In Figure 2, the red and green lines chart how the five-year inflation response to aggregate demand fluctuations depends on the adjustment frequency in, respectively, the unrestricted and restricted non-linear case. In both cases, the function is upward-sloping and convex. Recall that the empirical quarterly adjustment frequency ranges from 0.22 to 0.43 in my

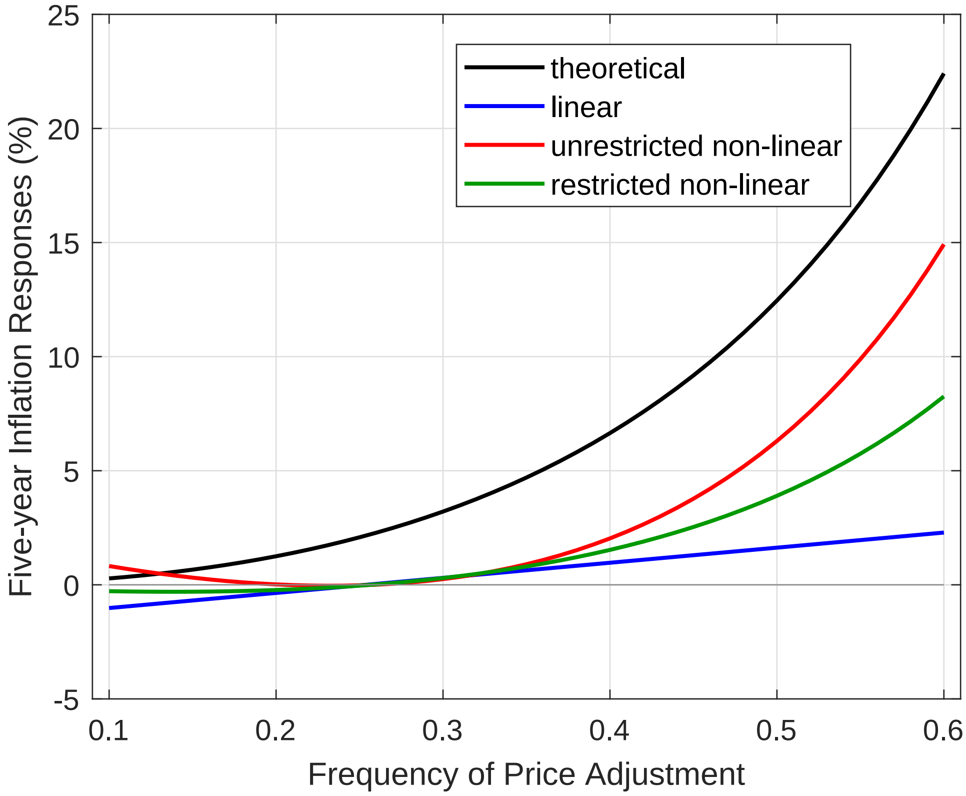

Figure 2. Five-year Inflation Responses to Output as a Function of the Frequency of Price Adjustment

Note: This figure considers the scenario where the output gap is one percent for four quarters in a row and is zero at all other times. It reports the change in inflation from before the spell with positive output gaps to twenty quarters after the last quarter with a positive output gap. The black line charts the inflation response for the New Keynesian Phillips Curve of equation (5) as a function of the quarterly probability of price adjustment, with other structural parameters at standard values. For the purpose of this analysis, I assume $E_t\pi_{t+1} = \pi_{t-1}$. The other lines indicate the relation between the inflation response and the frequency of price adjustment for three types of empirical Phillips curves. The blue, red and green lines pertain to the cases where the slope is, respectively, a linear, unrestricted non-linear, and restricted non-linear function of the frequency. The relevant equations are, respectively, (1), (10) and (11). In all cases, I use annualized quarter-on-quarter trimmed mean PCE inflation. In the US in 1978Q4-2016Q4, the adjustment frequency ranged from 0.22 to 0.43. In that range, all empirical slopes are well below the model-implied Phillips curve slope.

sample. For the higher adjustment frequencies within that range, the inflation responses from the non-linear specifications are closer to the theoretical inflation response than when I specify the slope as a linear function of the frequency. Among the three empirical specifications, the unrestricted non-linear specification is closest to theory.

Still, the inflation responses implied by the empirical Phillips curves remain clearly below those implied by the New Keynesian Phillips curve at all observed values for the frequency of price adjustment. To see this from another angle, Figure 3 shows the time path of the five-year inflation responses implied by the empirical values for the frequency of price adjustment. The solid black line shows the slope of the NKPC when setting the other structural parameters to their values estimated by Smets and Wouters (2007) and setting $\epsilon = 6$. Because price adjustment was very frequent around 1980, the NKPC implies that inflation reacted very strongly to output gap fluctuations at that time. In 1980Q2, the NKPC implies that an output gap of one percent for one year tended to cause inflation to be 8 percentage points higher five years later. However, the convexity of the relationship between the slope and the frequency implies that the inflation response was particularly unstable at that time. Around 1985, the same scenario implied a five-year change in inflation by 2 percentage points.

For the unrestricted and restricted non-linear case, respectively, the red and green lines in Figure 3 show that relaxing the assumption of a linear relation bridges a non-trivial part of the gap between theory and empirics around 1980, especially so for the unrestricted non-linear case. At all other times, the differences between the linear and non-linear specifications are minor. In all cases in Figure 3, the inflation responses implied by the empirical Phillips curves are always well below those implied by the New Keynesian Phillips Curve.

With the empirical Phillips curves, the largest inflation response occurs in 1980, and in the case where the Phillips curve slope is an unrestricted non-linear function of the frequency of price adjustment. In that case and at that time, an output gap of one percent for one

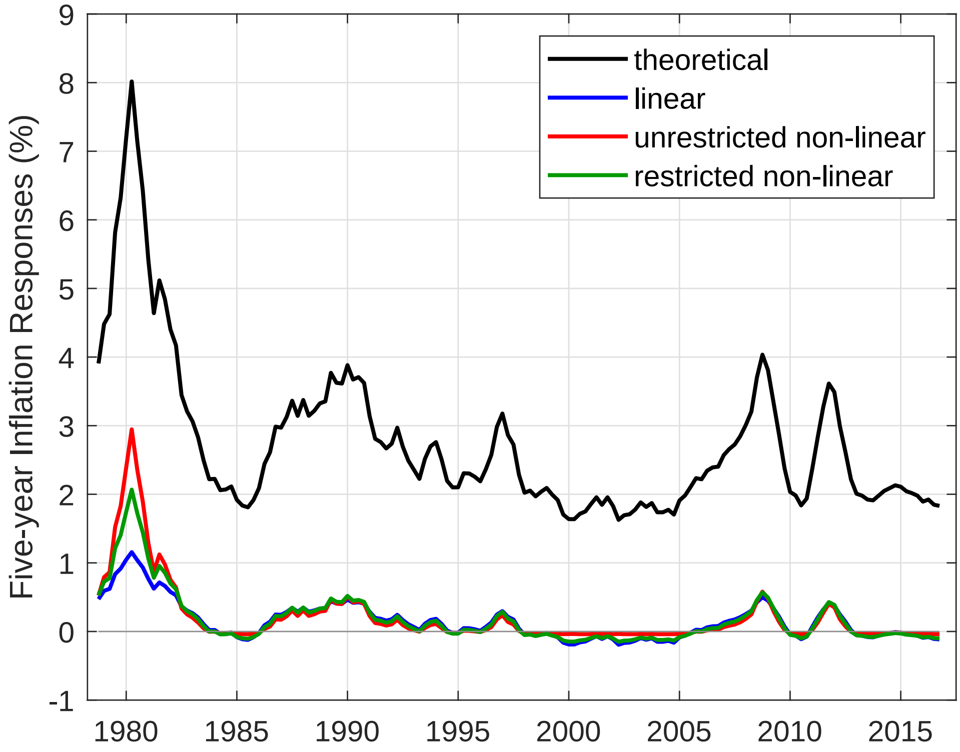

Figure 3. Five-year Inflation Responses to Output Implied by the Empirical Repricing Rate

Note: This figure considers the scenario where the output gap is one percent for four quarters in a row and is zero at all other times. It reports the change in inflation from before the spell with positive output gaps to five years after the last quarter with a positive output gap. The solid black line charts the five-year inflation responses implied by the New Keynesian Phillips Curve and the empirical series for the frequency of price adjustment, with other structural parameters at standard values. For the purpose of this analysis, I assume $E_t\pi_{t+1} = \pi_{t-1}$. The other lines show inflation responses implied by empirical Phillips curves. The blue, red and green lines represent the case where the slope is, respectively, a linear, unrestricted non-linear, and restricted non-linear function of the frequency. The relevant equations are, respectively, (1), (10), and (11). I use annualized quarter-on-quarter trimmed mean PCE inflation. At all times, the inflation responses for all three empirical Phillips curves are well below those implied by the New Keynesian Phillips Curve.

year tends to cause inflation to be 3 percentage points higher after five years. From the mid-1980s onwards, all five-year inflation responses implied by the empirical Phillips curves hover between about 0 to about 0.5 percentage points.

This difference in the inflation responses between the theoretical and empirical cases reflects the fact that the Phillips curves slopes are very different. On average over the sample, the model-based Phillips curve slope is 0.71. Among the empirical specifications, the time average of the slope is steepest in the unrestricted non-linear case, at 0.07. In this sense, the theoretical slope is typically about ten times steeper than the unrestricted non-linear slope.

Looking at particular episodes, the empirical Phillips curve slopes imply that reducing inflation during the Volcker disinflation was much costlier than the model-based Phillips curve implies.

At the end of the sample, the empirical slopes imply that to the extent that expansionary monetary policy is able to shift the aggregate demand curve to the right, this would stimulate real output to a substantial extent while it would have small short-run effects on prices. To be sure, the Phillips curve is only one part of the picture. The effect of monetary policy stimulus on aggregate demand depends on other factors, such as whether monetary policy is at the effective lower bound on nominal interest rates and on the extent to which monetary policy transmission through the banking system is operative.

The evidence in this section suggests that when one matches the empirical frequency of price adjustment in a model where nominal rigidities follow from Calvo price setting, the model implies an inflation response to aggregate demand fluctuations that is much larger than what one actually observes in the data. However, with Calvo pricing, the probability of non-adjustment is a structural parameter. In such a context, agents expect that the probability of price adjustment remains constant. This does not match the observation from Figure 1 that in the data, the frequency of price adjustment varies substantially over time.

It is therefore instructive to gauge what state dependent pricing models would mean for the inflation response to aggregate demand fluctuations. State-dependent pricing models stand a much better chance at explaining the observed short-run fluctuations in the adjustment frequency in that they imply that the frequency of price adjustment varies endogenously. Auclert, Rigato, Rognlie and Straub (2021) show that the implications of state-dependent pricing models such as those by Golosov and Lucas (2007) and Nakamura and Steinsson (2010) are observationally equivalent to those of canonical New Keynesian Phillips Curves with a higher probability of price adjustment. Therefore, to generate the implications from a state-dependent pricing model calibrated at the empirical frequency of price adjustment, one can use a New Keynesian Phillips Curve with higher-than-empirical adjustment frequencies. As I documented under equation (7), the inflation response to aggregate demand fluctuations implied by the New Keynesian Phillips Curve is increasing in the frequency of price adjustment. Therefore, one can infer that in state-dependent pricing models, the empirical series for the frequency of price adjustment would imply an even steeper output-inflation trade-off than the one implied by Calvo price setting.

Therefore, I infer that for a large class of models with nominal rigidities, inflation is more sensitive to aggregate demand fluctuations than with Calvo pricing, and therefore more sensitive than with empirical Phillips curves.

4 Conclusion

I find some evidence that the slope of the Phillips curve depends positively on the frequency of price adjustment, although the evidence requires focus on a particular inflation measure for which the relation can arguably be better identified as it yields a better-fitting regression. Consistent with the New Keynesian model, the sensitivity of inflation to aggregate demand fluctuations is a convex function of the adjustment frequency. My results suggest that at all times since the late 1970s, inflation was much less responsive to aggregate demand fluctuations than the model-based Phillips curve calibrated at standard values for the structural parameters would imply.

I can only partially explain the discrepancy by specifying the Phillips curve slope as a non-linear function of the frequency of price adjustment akin to that of the New Keynesian Phillips Curve.

Given that the New Keynesian Phillips curve is derived from Calvo pricing, and state-dependent pricing models imply that inflation is even more sensitive to aggregate demand fluctuations, I infer that, when calibrated to micro evidence on the frequency of price adjustment, a broad class of models with nominal rigidities imply steeper output-inflation trade-offs than what is the case in the data. Models with real rigidities[8] constitute a promising line of research aiming to reduce this gap between theory and empirics.

[8] For instance, see Höynck (2020) and Rubbo (2021).

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