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Testing an alternative price-setting behavior in the new Keynesian Phillips curve: Extrapolative price-setting mechanism^{*}

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Abstract

In this paper, we propose an expanded version of the hybrid NKPC by incorporating the extrapolative price-setting mechanism in the backward-looking part. We assume that when firms set the price at time t , they use information on the price in period $t-1$ plus a portion of change in prices between $t-1$ to $t-2$ (a partial error correction). Under this expanded setting, we explicitly derive both structural and reduced-form NKPCs. The empirical results show that the extrapolative component is strongly significant in explaining inflation dynamics. In addition, the expanded version of the hybrid NKPC exhibits a better empirical performance than the original hybrid NKPC proposed by Galí and Gertler (1999) in terms of various statistical criteria.

JEL classification: E31; E52

Keywords: extrapolative price-setting; inflation dynamics; new Keynesian Phillips curve; forward-looking; backward-looking

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