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The (Q,S,s) Pricing Rule: A Quantitative Analysis*

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Abstract

Are nominal prices sticky because menu costs prevent sellers from continuously adjusting their prices to keep up with inflation or because search frictions make sellers indifferent to any real price over some non-degenerate interval? The paper answers the question by developing and calibrating a model in which both search frictions and menu costs may generate price stickiness and sellers are subject to idiosyncratic shocks. The equilibrium of the calibrated model is such that sellers follow a (Q,S,s) pricing rule: each seller lets inflation erode the effective real value of the nominal prices until it reaches some point s and then pays the menu cost and sets a new nominal price with an effective real value drawn from a distribution with support $[S, Q]$, with $s < S < Q$. Idiosyncratic shocks short-circuit the repricing cycle and may lead to negative price changes. The calibrated model reproduces closely the properties of the empirical price and price-change distributions. The calibrated model implies that search frictions are the main source of nominal price stickiness.

JEL Codes: D11, D21, D43, E32.

Keywords: Search frictions, Menu costs, Sticky prices.

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