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Inflation Persistence and Optimal Positive Long-run Inflation*

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Abstract

Within New Keynesian economics, the optimality of a monetary policy that aims at zero inflation is surprisingly robust. Full price stability is optimal despite the inefficiency of the nonstochastic steady state and the existence of a positively sloped long-run Phillips-curve trade-off. Even under inflation persistence due to backward-looking price indexation by price setters, zero inflation remains optimal. We show how backward-looking rule-of-thumb behaviour by price setters results in optimal positive long-run inflation. The features that seem capable of delivering an endogenously optimal positive inflation target are costly disinflation, long-run Phillips-curve trade-off, and steady-state distortions.

JEL classification: E31, E52.

Keywords: Optimal monetary policy, inflation persistence.

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