New Pricing Models, Same Old Phillips Curves?

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July 2022

Abstract

We show that, in a broad class of menu cost models, the dynamics of aggregate inflation in response to arbitrary shocks to aggregate costs are nearly the same as in Calvo models with suitably chosen Calvo adjustment frequencies. We first prove that the canonical menu cost model is first-order equivalent to a mixture of two time-dependent models, which reflect the extensive and intensive margins of price adjustment. We then show numerically that, in any plausible parameterization, this mixture is well-approximated by a single Calvo model. This close numerical fit carries over to other standard specifications of menu cost models. Thus, the Phillips curve for a menu cost model looks like the New Keynesian Phillips curve, but with a higher slope.

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This paper benefited from very useful comments by Mark Aguiar, Fernando Alvarez, Marios Angeletos, Luigi Bocola, Marco Bonomo, Ricardo Caballero, Luca Dedola, Yoon Jo, Pete Klenow, Oleksiy Kryvtsov, John Leahy, Francesco Lippi, Virgiliu Midrigan, Raphael Schoenle, Joe Vavra, Gianluca Violante, Iván Werning, and Jesse Wursten. This research is supported by the National Science Foundation grant numbers SES-1851717 and SES-2042691 and the Domenic and Molly Ferrante award.

1 Introduction

The nature of nominal rigidities is a central question in monetary economics. In sticky-price models, monetary policy has aggregate effects because producers' prices do not immediately respond to changes in their costs. Motivated by the complex patterns of price changes observed in the micro data, macroeconomists have been building models with increasing degrees of realism, with the aim of improving our quantitative understanding of the behavior of aggregate inflation and the response of economic activity to changes in monetary policy.

Broadly speaking, existing price-setting models fall into two categories. The first category consists of tractable models in which firms have random opportunities to adjust their prices. In these "old" *time-dependent* (TD) models, the probability that a price can adjust is an exogenous function of the time elapsed since it last adjusted. The leading TD model is the Calvo model, where this probability is constant (Calvo 1983, Yun 1996).[1] In this model, the first-order dynamic relationship between inflation π_t and aggregate real marginal costs $\widehat{mc}_t$ is given by the well-known New Keynesian Phillips curve:

$$\pi_t = \kappa \cdot \widehat{mc}_t + \beta \mathbb{E}_t \left[\pi_{t+1} \right] \tag{NK-PC}$$

where $0 < \beta < 1$ is a discount factor and $\kappa > 0$ is the slope coefficient, with a higher slope indicating more flexible prices (see e.g. Woodford 2003b, Galí 2008). This single equation summarizes the first-order aggregate implications of the Calvo price-setting model. Its simplicity and tractability have made it ubiquitous in the New Keynesian DSGE literature.

In the past two decades, the increasing availability of administrative micro data underlying national price indices—as first documented in Bils and Klenow (2004) and Nakamura and Steinsson (2008)—has laid bare the deficiencies of TD models vis-à-vis the data, and spurred the development of a second category of price-setting models.[2] These models assume the presence of heterogeneous producers that are subject to idiosyncratic productivity shocks and adjust their prices in a lumpy fashion because of fixed "menu" costs and other features (e.g. Golosov and Lucas 2007, Klenow and Kryvtsov 2008, Nakamura and Steinsson 2010, and Midrigan 2011).[3] In these "new" *state-dependent* (SD) models, price changes are endogenous and depend both on the state of the economy and the state of the firm. Except in certain special cases, SD models must be solved numerically, and their computational complexity makes them difficult to incorporate into broader DSGE models. In particular, macroeconomists' understanding of their aggregate implications has been limited by the lack of an available equivalent to the New Keynesian Phillips curve.[4]

[1] Another widely used example of a time-dependent model is Taylor (1979). Sheedy (2010) and Carvalho and Schwartzman (2015) study these models in more generality.

[2] In the data, there is little connection between the size of price changes and the duration of price spells, and the frequency of price changes tends to move with the aggregate inflation rate. Both of these facts are inconsistent with a Calvo model but consistent with menu cost models; see for instance Klenow and Malin (2010).

[3] In addition to menu costs, these models consider random free adjustments, infrequent and leptokurtic shocks, multiple sectors, and/or multi-product firms. In turn, they build on an earlier theoretical literature that studied menu costs in partial equilibrium, including Barro (1972) and Sheshinski and Weiss (1977).

[4] Instead, to study aggregate implications of menu cost models, the literature has had to resort to stark general equilibrium assumptions, such as the combination of one-time permanent money shocks and a utility function for the

In this paper, we fill this gap. We extend the notion of an aggregate Phillips curve to menu cost models and establish two major new results. First, the Phillips curve of the canonical menu cost model is the same as that of a mixture of two TD models—an *exact equivalence* between SD and TD. Second, for a wide range of common parameterizations, this Phillips curve is numerically almost identical to the Calvo Phillips curve (NK-PC), for some κ. This *numerical equivalence* between SD and Calvo extends to broader menu cost models beyond the canonical model.

Our starting point is a formalization of the concept of a Phillips curve for a general price-setting model. Given an $MA(\infty)$ process $\sum_s \widehat{mc}_s \epsilon_{t-s}$ for aggregate real marginal costs, the model produces an certain $MA(\infty)$ process for aggregate inflation $\sum_s \pi_s \epsilon_{t-s}$. We call *generalized Phillips curve* the first-order mapping between these two sets of MA coefficients, and we represent this mapping as an infinite-dimensional matrix $\mathbf{K}$, so that $(\pi_0, \pi_1, \ldots)' = \mathbf{K} \cdot (\widehat{mc}_0, \widehat{mc}_1, \ldots)'$. Just like the NKPC, this mapping—or "sequence-space Jacobian" (Auclert, Bardóczy, Rognlie and Straub 2021)—characterizes the first-order aggregate implications of the price-setting model. We also define a similar object, the *pass-through matrix* Ψ, mapping MA coefficients on aggregate nominal marginal costs to MA coefficients on the aggregate price level. $\mathbf{K}$ and Ψ are related via a simple one-to-one mapping. We characterize both of these matrices explicitly for TD models, and then proceed to analyze them for menu cost models.

Our first main result characterizes $\mathbf{K}$ and Ψ for the canonical menu cost model. Following Alvarez, Le Bihan and Lippi (2016), we define this model to feature a quadratic loss function for producers, a Cobb-Douglas price index, permanent idiosyncratic productivity shocks, and random opportunities for free adjustments (as in Nakamura and Steinsson 2010). We prove that the pass-through matrix Ψ of the canonical model is a convex combination of the pass-through matrices of two TD models. Hence, the first-order aggregate implications of the canonical model are exactly the same as those of a mixture model in which a fraction of price-setters follow one TD rule and the remainder follow a different rule. In particular, the canonical model and the mixture TD model have the same generalized Phillips curve $\mathbf{K}$.

The two TD models in the mixture reflect the two margins of aggregate price adjustment in the menu cost model: first, adjustment along the *extensive* margin (movements in *Ss* adjustment bands) and second, adjustment along the *intensive* margin (movements in reset prices). Caballero and Engel (2007) previously decomposed the impact effect on the price level from a permanent shock to nominal marginal cost as the sum of an extensive and intensive margin component. Our result shows how their structural decomposition extends to the entire impulse response of prices, and to arbitrary shocks to costs. We show that both TD models are characterized by steady-state moments of the menu cost model and therefore theoretically recoverable from panel data on prices, and that they are easily obtained numerically, facilitating efficient computation. We also show that the adjustment hazards of these models, which we call *virtual* hazards, both eventually converge to the same constant, but generally do so from different directions: from above for the extensive margin, and from below for the intensive margin.

representative agent that features linear disutility of labor, and log utilities over consumption and money.

An antecedent to our exact equivalence result is Gertler and Leahy (2008), which we nest as a special case. In the menu cost model studied by Gertler and Leahy (2008), firms have either no shock to their ideal price, or a shock drawn from a uniform distribution with wide support. This assumption implies that in each period, before the realization of the shock, each firm has the same probability of adjusting its price. We find that in the equivalent mixture, the extensive and intensive margin virtual hazards are constant and equal to each other. The model is therefore exactly equivalent to Calvo.

For menu cost models with a more general distribution of shocks, the Gertler and Leahy (2008) result no longer applies exactly. Our second main result, however, shows that there is still *numerical equivalence* between menu cost and Calvo models. This occurs because the virtual hazards for the two TD models, while individually not constant, move in different directions and roughly offset each other in practice. This numerical equivalence is highly robust and extends beyond the canonical menu cost model. In particular, it applies to more complex pricing models, such as two-product models as in Midrigan (2011), for which our exact equivalence result no longer directly holds.

Our numerical equivalence result can therefore be viewed as a broad generalization of Gertler and Leahy (2008): menu cost models in a very large class, and under most reasonable parameterizations, have a generalized Phillips curve that is almost identical to the standard NKPC for some slope parameter κ. Crucially, as in Gertler and Leahy (2008), the slope κ is distinct from—and generally higher than—that implied by a Calvo model with the same adjustment frequency.[5]

Our result is distinct from a previous connection between menu cost and Calvo models uncovered by Alvarez, Le Bihan and Lippi (2016) and further developed in Alvarez, Lippi and Passadore (2017). These papers derive an elegant sufficient statistic for the cumulative impulse response (CIR) of the price level (relative to its long-run response) to a permanent shock to aggregate nominal costs in a broad class of pricing models, including menu cost and Calvo models. By contrast, our result shows equivalence between menu cost and Calvo for the entire impulse response of prices to any shock to costs.[6] The two results are highly complementary: the Alvarez, Le Bihan and Lippi (2016) sufficient statistic gives the Calvo frequency that equalizes the *size* of monetary non-neutrality across menu cost and Calvo models; our results then establish that, for this Calvo frequency, all impulse responses are numerically close between the two models.

A limitation of the Alvarez, Le Bihan and Lippi (2016) result is that it requires special general equilibrium assumptions to draw conclusions about the output effects of monetary policy.[7] By contrast, the generalized Phillips curves of menu cost models allow us to solve for the effects of monetary policy or any other aggregate shock, in any DSGE model, under the assumption of

[5] Bakhshi, Khan and Rudolf (2007) numerically compare the first-generation menu cost model by Dotsey, King and Wolman (1999), which does not have idiosyncratic shocks, to a Calvo model.

[6] See Baley and Blanco (2021) for a different extension of Alvarez, Le Bihan and Lippi (2016), characterizing the CIR of higher order moments. Our focus on the entire impulse response is shared by Alvarez and Lippi (2022), who analytically characterize the impulse response to a permanent nominal marginal cost shock in a menu cost model.

[7] Under these assumptions, listed in footnote 4, the CIR of the price level to a permanent shock to nominal costs relative to its long run value is directly related to the CIR of output to permanent money shocks.

menu cost pricing rather than Calvo pricing. We demonstrate this result in the context of two models: a textbook three-equation New Keynesian model, and the more sophisticated Smets and Wouters (2007) model. We show that correctly solving these models to first order in aggregate shocks with small idiosyncratic risk simply amounts to replacing the NKPC with the generalized Phillips curve of the menu cost model. Implementing this in a standard calibration, we find that the changes in inflation and output by switching from Calvo to menu cost pricing are negligible. We conclude that there is no loss of generality, even in the context of DSGE models, in considering the NKPC as a model of the Phillips curve, provided κ is appropriately chosen.

While it is an extremely useful benchmark, the canonical menu cost model with free adjustment is not capable of matching the rich distributions of price changes observed in micro data (Alvarez, Lippi and Oskolkov 2022a). To remedy this issue, we extend our exact equivalence result to the case in which menu costs are randomly distributed according to an arbitrary probability distribution. We then show how to use this extended result to directly compute the pass-through matrix and generalized Phillips curve from the empirical distribution of price changes alone, without any need for model simulation. Applying this technique to Israeli supermarket data from Bonomo, Carvalho, Kryvtsov, Ribon and Rigato (2022), we again find that the resulting generalized Phillips curve is very close to that of a Calvo model.

Our results are important for three separate literatures. First, for the literature developing partial equilibrium menu cost models that match rich aspects of the micro data, we show that solving for the generalized Phillips curve $\mathbf{K}$ allows one to embed these models into general equilibrium, and we provide three practical ways of solving for $\mathbf{K}$: an exact equivalence result, an approximate equivalence result, and a result that infers $\mathbf{K}$ directly from the price change distribution. Second, for the literature developing DSGE models, we provide a new rationalization of the Calvo Phillips curve based on menu costs, extending Gertler and Leahy (2008) to a much more general setting.

Finally, for the literature developing price-setting models that can match both micro and macro data, we provide both optimism and caution. Optimism, because we can now represent menu cost models using generalized Phillips curves, which can be taken to the macro data. Caution, because these Phillips curves are so close to the Calvo model that they suffer from the same deficiencies, such as a lack of internal inflation persistence (e.g. Fuhrer and Moore 1995) and extreme forward-looking behavior (e.g. Del Negro, Giannoni and Patterson). One has to look beyond menu cost models alone[8] to resolve these puzzles: for instance, to multi-sector models with complex input-output linkages (Rubbo 2020, La'O and Tahbaz-Salehi 2022), or to deviations from full-information rational expectations (Mankiw and Reis 2002, Woodford 2003a, Sims 2003, Nimark 2008, Maćkowiak and Wiederholt 2015, Gabaix 2020, Angeletos and Huo 2021, Afrouzi and Yang 2021).

Our results establish a first-order connection between menu cost and TD models,[9] and so

[8] In particular, our results show that although actual adjustment hazards are increasing in menu cost models, unlike in TD models (Sheedy 2010) this does not generate inflation persistence. This is because it is the virtual hazards, rather than the actual hazards, that matter for inflation persistence.

[9] This connection transcends price-setting applications. For instance, it also applies to investment with fixed costs.

should not be taken to imply equivalence between menu costs and Calvo beyond first order in aggregates. When we investigate aggregate non-linearity and aggregate state-dependence, however, we find a limited quantitative role for either, at least in the canonical menu cost model. Still, the welfare implications of menu cost and Calvo models may be quite different. We leave an exploration of this question to future research.

In parallel and independent work, Alvarez, Lippi and Souganidis (2022b) also study the pass-through matrix Ψ of the canonical menu cost model, focusing on the continuous-time case. Their paper uses Ψ to analytically characterize the impulse response to a permanent nominal cost shock under strategic complementarities. We study strategic complementarities in section 5.2, where we show that, remarkably, they simply scale down the generalized Phillips curve $\mathbf{K}$, just like they scale down the slope parameter κ in the Calvo NKPC. Together, our papers show the importance of the pass-through matrix for the general equilibrium analysis of menu cost models.

Layout. The rest of the paper is structured as follows. Section 2 sets up our benchmark time-dependent and state-dependent models, and introduces the concepts of pass-through matrix and generalized Phillips curve. Section 3 proves our exact equivalence result and explores its implications. Section 4 demonstrates our numerical equivalence result. Section 5 shows formally how our pricing models can be embedded into general equilibrium. Finally, section 6 shows how we can obtain the generalized Phillips curve from micro data in a richer model with generalized hazard functions.

2 Old and New Pricing Models

We begin by setting up "old" (time-dependent, TD) and "new" (state-dependent, SD) pricing models. We write the model assuming perfect foresight with respect to aggregate shocks. We then solve for first-order impulse responses to these shocks, starting from the steady state without aggregate shocks. By first-order certainty equivalence, this delivers the impulse responses to the same shocks in a fully stochastic model.[10]

[10]For instance, suppose that in the first-order solution to the model where the primitive innovations to aggregates are $\{\epsilon_t\}$ and aggregate nominal marginal costs follow $\log MC_t = \sum_{j=0}^{\infty} \widehat{MC}_j \epsilon_{t-j}$, the aggregate price index follows $\log P_t = \sum_{j=0}^{\infty} \widehat{P}_j \epsilon_{t-j}$, as in a Wold decomposition. Then, the sequence $\{\widehat{P}_j\}_{j=0}^{\infty}$ is also the first-order impulse response to a perturbation $\{\widehat{MC}_j\}_{j=0}^{\infty}$ to the path of marginal costs, assuming perfect foresight and starting from the steady state with idiosyncratic risk but no aggregate risk. Formally, we solve for this latter concept, but thanks to this equivalence we can use the concepts interchangeably. (For instance, we simulate data from the stochastic model and run regressions from Galí and Gertler (1999) in section 4.2.) For more discussion of certainty equivalence, see e.g. Simon (1956) and Fernández-Villaverde, Rubio-Ramírez and Schorfheide (2016). Note that certainty equivalence in our case is only with respect to aggregate shocks (for which we obtain the first-order perturbation solution) and not with respect to idiosyncratic shocks (for which we obtain the full nonlinear solution).

2.1 State-dependent models (menu cost models)

Our benchmark state-dependent (SD) model is a discrete-time menu cost model with random free adjustments in the spirit of Nakamura and Steinsson (2010)'s "CalvoPlus" model. Like Alvarez, Le Bihan and Lippi (2016), we consider a quadratic loss function for producers, permanent idiosyncratic productivity shocks, and random opportunities for free adjustments. Unlike them, we work in discrete time and allow for arbitrary distributions for the idiosyncratic shocks. We call the resulting model the "canonical menu cost model". In section 5, we justify the quadratic approximation in the context of a fully-microfounded New Keynesian model with menu-cost pricing.

There is a continuum of firms $i \in [0,1]$, each of which sells a single product in each period $t = 0, 1, 2, \ldots$, at log price p_{it} in period t. We denote by $p_{it}^* + \log MC_t$ firm i's optimal log price in period t. MC_t is the economy-wide level of the nominal marginal cost (for instance, in simple models, this would be the aggregate nominal wage). p_{it}^* captures the influence of idiosyncratic shocks on the optimal price, which can stem from idiosyncratic productivity or demand shocks. We assume that p_{it}^* evolves as a random walk,

$$p_{it}^* = p_{it-1}^* + \epsilon_{it} \tag{1}$$

where ϵ_{it} is iid over time and across firms, drawn from a mean-zero distribution with a pdf f that is symmetric, single-peaked, and continuously differentiable, with $f'(x) < 0$ for $x > 0$ and vice versa. These assumptions nest the standard case of a normal distribution.

In each period, the firm faces a quadratic loss function proportional to $\frac{1}{2}\left(p_{it} - p_{it}^* - \log MC_t\right)^2$, and has to pay an extra fixed cost ξ_{it} to change its price. The fixed cost is random, $\xi_{it} \in \{0, \xi\}$, iid over time and across firms, with a free adjustment ($\xi_{it} = 0$) materializing with probability $\lambda \in [0,1]$.

A common and convenient way to express a firm's pricing problem in this setting is in terms of the "price gap". Here, we define the price gap x_{it} relative to the idiosyncratic optimal price, $x_{it} \equiv p_{it} - p_{it}^*$. With this definition, firm i solves the following price-setting problem:

$$\min_{\{x_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left[\frac{1}{2}\left(x_{it} - \log MC_t\right)^2 + \xi_{it} 1_{\{x_{it} \neq x_{it-1} - \epsilon_{it}\}}\right] \tag{2}$$

where the menu cost ξ_{it} has to be paid whenever $p_{it} \neq p_{it-1}$, that is, whenever the price gap x_{it} is chosen to differ from $p_{it-1} - p_{it}^* = x_{it-1} - \epsilon_{it}$.

We define the price level P_t using a Cobb-Douglas aggregator of prices p_{it}; given that p_{it}^* has a zero cross-sectional average, this is given by:

$$\log P_t = \int x_{it} di \tag{3}$$

Inflation is given by $\pi_t = \log P_t - \log P_{t-1}$. In section 5, we derive equations (2) and (3) explicitly as an approximation to a microfounded price-setting model with menu costs.

As we show formally in appendix B, the solution to problem (2) has a well-known "*Ss*" pattern, with the optimal policy taking the form

$$x_{it} = \begin{cases} x_{it-1} - \epsilon_{it} & \text{with prob } 1-\lambda \text{ if } x_{it-1} - \epsilon_{it} \in [\underline{x}_t, \overline{x}_t] \\ x_t^* & \text{otherwise} \end{cases}$$

Following the literature, we refer to $\underline{x}_t$ and $\overline{x}_t$ as the *lower* and *upper adjustment bands*, and x_t^* as the *reset point*. The triplet $(\underline{x}_t, \overline{x}_t, x_t^*)$ constitutes the *policies* of the menu cost model. In general, these policies vary over time when the sequence of nominal marginal cost $\log MC_t$ does. In a steady state $\log MC_t$ is constant, and we can normalize it to $\log MC = 0$. Then, the three policies $(\underline{x}, \overline{x}, x^*)$ are constant, with a reset price of zero, $x^* = 0$, and symmetric *Ss* bands, $\overline{x} = -\underline{x} > 0$. Price gaps converge to a stationary distribution. We denote by $g(x)$ the stationary distribution of gaps $x_{it-1} - \epsilon_{it}$ *before* adjustment; this convention will be convenient in what follows.

We assume that the economy is in such a steady state at the beginning of $t = 0$, with a price gap distribution given by $g(x)$, consistent with $\log MC = 0$. We denote the probability (frequency) of price adjustment in the steady state by freq. Price resets come both from prices leaving the adjustment bands and from free resets inside the adjustment bands, so $\text{freq} = \int_{-\infty}^{\underline{x}} g(x)dx + \int_{\overline{x}}^{\infty} g(x)dx + \lambda \int_{\underline{x}}^{\overline{x}} g(x)dx$.

2.2 Time-dependent models

For state-dependent models, price setting depends only on the firm's state; for instance, in the canonical model, this state is the price gap x_{it}. For time-dependent (TD) models, by contrast, price setting depends only on the time since last adjustment (e.g. see Whelan, 2007, Sheedy, 2010, and Carvalho and Schwartzman, 2015). In particular, price setting is governed by an exogenous "survival function" Φ_s for $s = 0, 1, 2, \ldots$, which counts the fraction of firms that have not yet adjusted their price after s periods among a cohort of firms that last adjusted their price at date 0. Mechanically, $\Phi_0 = 1$, and $\Phi_s \in [0, 1]$ is weakly decreasing in s.[11]

Each period t, firms are randomly given opportunities to reset, based on the survival function Φ_s and the time since they last adjusted. The optimal reset price gap is then given by

$$x_t^* \equiv \arg\min_x \mathbb{E}_0 \sum_{s=0}^{\infty} \beta^s \Phi_s \frac{1}{2} \left(x - \sum_{r=1}^{s} \epsilon_{it+r} - \log MC_{t+s} \right)^2 \tag{4}$$

where $x - \sum_{r=1}^{s} \epsilon_{it+r}$ is the price gap of firm i at date $t+s$ if it starts with a price gap of x at date t and does not adjust between t and $t+s$. Observe that the argmin in (4) is common across all firms, which is why we write the reset price gap as x_t^*, independent of i. Denote by $\lambda_s \equiv (\Phi_{s-1} - \Phi_s) / \Phi_{s-1} \in [0, 1]$ the adjustment hazard (or adjustment probability) at horizon $s > 0$. When $\Phi_{s-1} = 0$, we set $\lambda_s = 1$. The law of motion of individual price gaps x_{it} can then be

[11] For proposition 3 we will impose the regularity condition that survival eventually declines exponentially, i.e. that $\Phi_s < C/v^s$ for some constant C and $v > 1$.

expressed as

$$x_{it} = \begin{cases} x_t^* & \text{with probability } \lambda_s \\ x_{it} - \epsilon_{it} & \text{otherwise} \end{cases} \qquad \text{where } s = \text{time since last adjustment.}$$

The hazards λ_s can in principle have any shape. When they are constant, $\lambda_s = \lambda \in [0,1]$, we obtain the standard Calvo model. Accordingly, the survival function of a Calvo model is given by $\Phi_s = (1-\lambda)^s$. Another standard TD model is the T-period Taylor (1979) model, which has a stark form of increasing hazard, with $\lambda_s = 0$ for $s < T$ and $\lambda_T = 1$.

Given x_{it}, the price index and inflation are then constructed as in section 2.1. One object that will be useful below is the "age" distribution of prices in the steady state. Denote by a_s the share of prices that last adjusted s periods ago, that is, the share of prices with age s. This distribution satisfies $a_s = (1-\lambda_s)\, a_{s-1}$, which combined with the definition of λ_s delivers $a_s \propto \Phi_s$. Since $\sum_{s=0}^{\infty} a_s = 1$, we find the share of prices with age s to be

$$a_s = \frac{\Phi_s}{\sum_{r=0}^{\infty} \Phi_r}$$

2.3 Aggregate dynamics: pass-through matrix

The SD and TD models defined so far have in common that, at the aggregate level, starting from the steady state distribution of price gaps, they translate a (perfect-foresight) sequence of nominal marginal costs $\{MC_t\}$ to a sequence of price levels $\{P_t\}$, through the aggregation of optimal price-setting responses of heterogeneous firms to $\{MC_t\}$. In other words, both types of models describe a mapping

$$P_t = \mathcal{P}_t\left(\{MC_s\}\right) \tag{5}$$

Implicit in the function $\mathcal{P}_t$ is a time-varying distribution of price gaps induced by the $\{MC_t\}$ sequence. We are interested in the effects of small (first-order) shocks to this sequence. Log-linearizing (5), and denoting log deviations with a hat, we have

$$\hat{P}_t = \sum_{s=0}^{\infty} \frac{\partial \log \mathcal{P}_t}{\partial \log MC_s} \widehat{MC}_s \tag{6}$$

Here, the partial derivative $\frac{\partial \log \mathcal{P}_t}{\partial \log MC_s}$ describes the response of the price level at date t with respect to an anticipated one-time unit-size shock to marginal cost at some potentially different date s. We collect all the partial derivatives in a single matrix, which we call the *pass-through matrix* $\Psi = (\Psi_{t,s})$, with $\Psi_{t,s} \equiv \frac{\partial \log \mathcal{P}_t}{\partial \log MC_s}$. Stacking (6) across t into a vector-valued equation, we obtain

$$\hat{\mathbf{P}} = \Psi \cdot \widehat{\mathbf{MC}} \tag{7}$$

where $\hat{\mathbf{P}} \equiv \left(\hat{P}_0, \hat{P}_1, \hat{P}_2, \ldots\right)'$ and $\widehat{\mathbf{MC}} \equiv \left(\widehat{MC}_0, \widehat{MC}_1, \ldots\right)'$.

The pass-through matrix Ψ is the first-order representation of any SD or TD pricing model. Once Ψ is computed, (7) can be used to evaluate the impulse response of the price level $\hat{\mathbf{P}}$ with respect to an arbitrary (first-order) nominal marginal cost shock $\widehat{\mathbf{MC}}$, or alternatively, to map the coefficients in an MA for marginal costs to those of an MA for prices. For instance, the s-th column of Ψ corresponds to the dynamic price level response to an anticipated one-time shock to marginal cost at date s. By linearity, the sum across all columns of Ψ, i.e. $\sum_{s=0}^{\infty} \Psi_{t,s}$, is the price level response to a permanent shock to nominal marginal cost, as commonly analyzed in the literature (e.g. Golosov and Lucas 2007, Alvarez et al. 2016). Long-run neutrality of money implies that this response limits to 1, $\lim_{t\to\infty} \sum_{s=0}^{\infty} \Psi_{t,s} = 1$. Flexible prices correspond to the case where Ψ equals the identity matrix, so that the price level moves one for one with the marginal cost shock, irrespective of the shape of the shock.

Pass-through matrix for a TD model. For a TD model, Ψ can be evaluated analytically as follows. The reset price gap x_t^* satisfies the first-order condition of the problem in (4),

$$x_t^* = \frac{\sum_{s\geq 0} \beta^s \Phi_s \widehat{MC}_{t+s}}{\sum_{s\geq 0} \beta^s \Phi_s} \tag{8}$$

Equation (8) shows that, as in the standard Calvo model (e.g. Galí 2008), the optimal reset price gap is a weighted average of future nominal marginal cost shocks. The weights are given by a beta-discounted version of the survival function Φ_s. We refer to (8) as the *policy equation*.

From equation (3) and the TD assumption we see that the price level, in turn, is a weighted average of past reset price gaps, with the age distribution as weights,

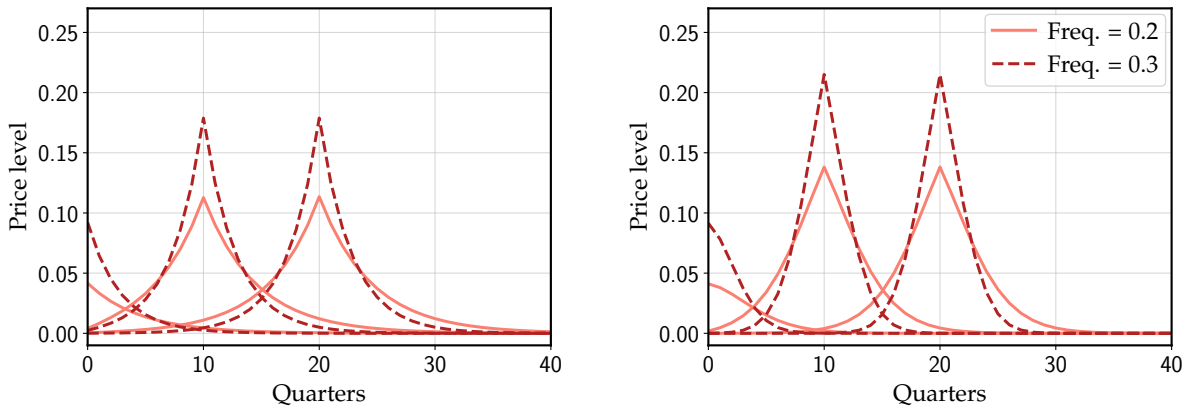
$$\hat{P}_t = \sum_{s\geq 0} a_s x_{t-s}^* = \frac{\sum_{s\geq 0} \Phi_s x_{t-s}^*}{\sum_{s\geq 0} \Phi_s} \tag{9}$$

We refer to (9) as the *law of motion* of the price level. Notice that the weights in the policy equation (8) are exactly the beta-discounted versions of the weights that appear in the law of motion (9). This is a key property of TD models to which we will return.

Combining the policy equation (8) and the law of motion (9), we obtain the pass-through matrix for a TD model with survival function Φ_s as:

$$\Psi^{\Phi} \equiv \frac{1}{\left(\sum_{s\geq 0} \Phi_s\right)\left(\sum_{s\geq 0} \beta^s \Phi_s\right)} \begin{pmatrix} \Phi_0 & 0 & 0 & \cdots \\ \Phi_1 & \Phi_0 & 0 & \cdots \\ \Phi_2 & \Phi_1 & \Phi_0 & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix} \begin{pmatrix} \Phi_0 & \beta\Phi_1 & \beta^2\Phi_2 & \cdots \\ 0 & \Phi_0 & \beta\Phi_1 & \cdots \\ 0 & 0 & \Phi_0 & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix} \tag{10}$$

The matrix on the right in (10) captures the dynamic response of the reset price gap to a change in marginal costs; the matrix on the left captures the dynamic response of the price level to a change in the reset price gap.



(a) Calvo

(b) Increasing adjustment hazards

Figure 1: Columns $s \in \{0, 10, 20\}$ of TD pass-through matrices.

Note: on the left panel, the Calvo adjustment frequencies are $\lambda \in \{0.2, 0.3\}$. On the right panel, the sequence of adjustment hazards is proportional to $1 - e^{-0.2(t+1)}$, linearly scaled in order to generate the same total adjustment frequencies $\{0.2, 0.3\}$.

Figure 1 displays example columns of Ψ^{Φ}. The left panel shows the case of a Calvo model, where $\Phi_s = (1-\lambda)^s$ for two values of λ. The right panel shows a case of increasing adjustment hazards. The columns of Ψ^{Φ} are tent shaped: pass-through to prices is always highest in the period of the shock itself, even if the shock is anticipated to happen at a later date $s > 0$. When the frequency of adjustment is higher, the tent is more spiked, reflecting the fact that firms adjust less in advance and more in the period of the shock itself.

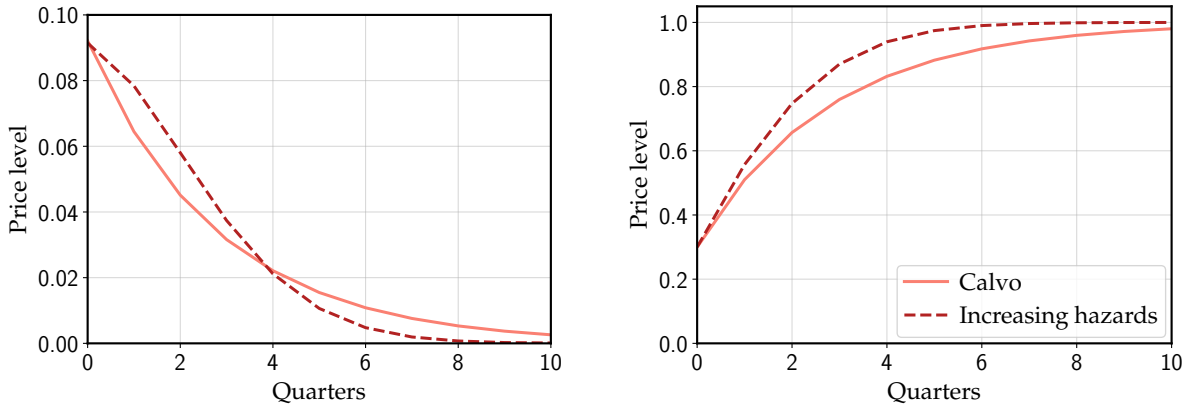
Using the expression for Ψ^{Φ} in (10), we can evaluate the impulse responses of a TD model to arbitrary marginal cost shocks. Two important special cases are that of a one-time, perfectly transitory, shock to marginal cost at date $t = 0$; and that of a permanent shock to marginal cost. For the one-time shock, we find that the response of the price level $\hat{P}_t$ is proportional to Φ_t; for the permanent shock $\hat{P}_t$, it is proportional to the cumulative sum of Φ_t,

$$\text{one-time shock: } \hat{P}_t = \frac{\Phi_t}{\left(\sum_{s\geq 0}\Phi_s\right)\left(\sum_{s\geq 0}\beta^s\Phi_s\right)} \qquad \text{permanent shock: } \hat{P}_t = \frac{\sum_{s=0}^{t}\Phi_s}{\sum_{s\geq 0}\Phi_s} \tag{11}$$

Figure 2 displays these two impulse responses for the Calvo model and a model with increasing hazards. The formulas in (11) allow the survival function Φ_t of any TD model to be read off from either impulse response. In particular, the impulse response to a permanent shock delivers exactly the weights that enter the law of motion (9). We will use this property below.

2.4 Aggregate dynamics: generalized Phillips curve

The pass-through matrix characterizes the response of the price level to nominal marginal cost shocks. However, a large empirical literature (e.g. Galí and Gertler 1999, Galí, Gertler and López-Salido 2001, Sbordone 2002) studies the empirical response of inflation to shocks to *real* marginal cost, commonly known as the "Phillips curve" relationship. This distinction is also important



(a) One-time shock (b) Permanent shock

Figure 2: Responses to nominal marginal cost shocks.

Note: impulse responses to one-time (left) and permanent (right) increases in nominal marginal costs. Parameter values are the same as in figure 1 for the 0.3 frequency case.

for general equilibrium models. In simple GE models, such as that in Golosov and Lucas (2007), the pass-through matrix is sufficient to analyze the price level response to a shock to the money growth rate. But in richer models, with less restrictive assumptions on preferences and monetary shocks, a Phillips curve relationship as in (NK-PC) between inflation and real marginal cost is more useful—since, for instance, real marginal cost is closely tied to the output gap (see section 5).

We generalize this concept of a Phillips curve to a general TD or SD model as follows. Define real marginal cost as $mc_t \equiv \frac{MC_t}{P_t}$. In log-deviations, this corresponds to $\widehat{mc}_t \equiv \widehat{MC}_t - \hat{P}_t$, and in our stacked vector notation to $\widehat{\mathbf{mc}} \equiv \widehat{\mathbf{MC}} - \hat{\mathbf{P}}$. Substituting this equation into (7), we can derive the price level response to a real marginal cost shock as[12]

$$\hat{\mathbf{P}} = \Psi\left(\widehat{\mathbf{mc}} + \hat{\mathbf{P}}\right) = \sum_{k\geq 1} \Psi^k \cdot \widehat{\mathbf{mc}} = \Psi\left(\mathbf{I} - \Psi\right)^{-1} \widehat{\mathbf{mc}} \tag{12}$$

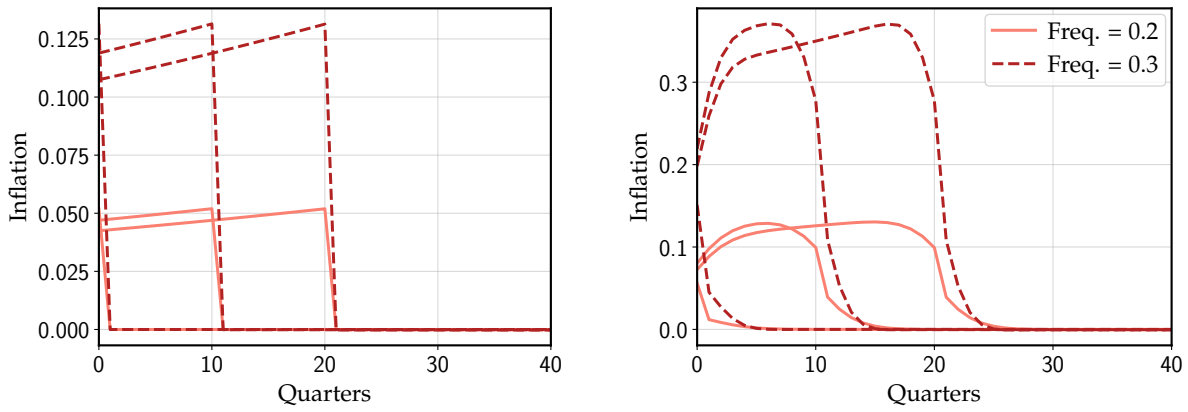
Taking first differences of (12) corresponds to left-multiplying both sides with $\mathbf{I} - \mathbf{L}$, where $\mathbf{L}$ is the lag matrix with entries of 1 one below the diagonal. We thus find the stacked inflation response

$$\boldsymbol{\pi} = (\mathbf{I} - \mathbf{L})\,\hat{\mathbf{P}} = \underbrace{(\mathbf{I} - \mathbf{L})\,\Psi\,(\mathbf{I} - \Psi)^{-1}}_{\equiv \mathbf{K}}\,\widehat{\mathbf{mc}} \tag{13}$$

Equation (13) defines the *generalized Phillips curve* $\mathbf{K}$, or GPC for short.[13] This matrix is the linear map from an arbitrary shock to *real* marginal cost $\widehat{\mathbf{mc}}$ to inflation. In that sense, $\mathbf{K}$ generalizes the

[12] Although it is not immediate from (12) that the sum $\sum_{k\geq 1} \Psi^k$ converges to some bounded, finite $\Psi(I-\Psi)^{-1}$, we prove in appendix D.3 that it does so (and indeed characterize its asymptotic shape) for any arbitrary mixture of SD and TD models. Using a different, eigenvalue-based approach, Alvarez et al. (2022b) study the convergence properties of $\sum_{k\geq 1} (\theta\Psi)^k$ for various θ's, where θ indexes strategic complementarity in a model with nominal cost shocks. The case $\theta = 1$ is relevant for the generalized Phillips curve, since for a fixed shock to real cost, there is strategic complementarity in nominal price-setting.

[13] We pick letter $\mathbf{K}$ in order to mirror the slope parameter κ in the NKPC.



(a) Calvo

(b) Increasing adjustment hazards

Figure 3: Columns $s \in \{0, 10, 20\}$ of time-dependent Phillips curve matrices.

Note: Generalized Phillips curves for the same time-dependent models as in figure 1.

NKPC to pricing models with a general pass-through matrix Ψ. In fact, (13) describes a one-to-one mapping between the pass-through matrix Ψ and the generalized Phillips curve $\mathbf{K}$.[14]

Generalized Phillips curve for a TD model. For a general TD model, $\mathbf{K}$ can be evaluated numerically using the formula in (13), combined with the TD pass-through matrix (10). In the case of a Calvo model with $\Phi_s = (1-\lambda)^s$, there is a particularly convenient analytical expression:

$$\mathbf{K} = \begin{pmatrix} \kappa & \beta\kappa & \beta^2\kappa & \cdots \\ 0 & \kappa & \beta\kappa & \cdots \\ 0 & 0 & \kappa & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix}$$

where $\kappa = \frac{\lambda(1-\beta(1-\lambda))}{1-\lambda}$. This is the matrix version of the NKPC, which can also be written as $\pi_t = \kappa \sum_{s\geq 0} \beta^s \widehat{mc}_{t+s}$. Figure 3 plots the columns of $\mathbf{K}$ for a Calvo model (left) and for a model with increasing adjustment hazards (right). The interpretation is analogous to before. Column s represents the inflation response to a one-time, anticipated, unit-size real marginal cost shock at date s. For a Calvo model, the inflation response is zero after date s, exactly equal to κ at date s, and discounted by β in the periods before s. With increasing hazards, there is inertia, with inflation responding less on impact, and remaining positive after date s. This inertia is due to a "catch-up" effect for prices that do not adjust when the shock hits, as discussed by Sheedy (2010).

[14] To obtain Ψ from $\mathbf{K}$, we write $\Psi = \mathbf{TK}\left(\mathbf{I} + \mathbf{TK}\right)^{-1}$ where $\mathbf{T} = (T_{ts})$ with $T_{ts} = 1$ for $t \geq s$ and 0 elsewhere.

	Golosov-Lucas (GL)	**Nakamura-Steinsson** (NS)
Menu cost (ξ)	0.0060	0.0513
Prob. of free adj. (λ)	0	0.179
Shock std. (σ_ϵ)	0.046	0.060
Discount factor (β)	0.99	0.99

Table 1: Calibrated parameter values.

2.5 Calibration

To illustrate our theoretical results, and provide a benchmark for our numerical results, we will simulate two SD models whose parameterizations are inspired by Golosov and Lucas (2007) (henceforth GL) and Nakamura and Steinsson (2010) (henceforth NS). For these two models, we pick the following standard calibration.

We assume that the shock distribution f is normal with variance σ_ϵ^2. For GL, we assume no free adjustments, $\lambda = 0$, and choose ξ and σ_ϵ to match a quarterly average frequency of price changes of 23.9% and a median size of price adjustments of 8.5%. This corresponds to the frequency and adjustment size for the median sector in the US CPI (see Nakamura and Steinsson 2010). For NS, we keep the same targets, but also choose λ in order to match a share of free adjustments of 75%. We set the discount factor to $\beta = 0.99$. These calibrated parameters are summarized in table 1.[15]

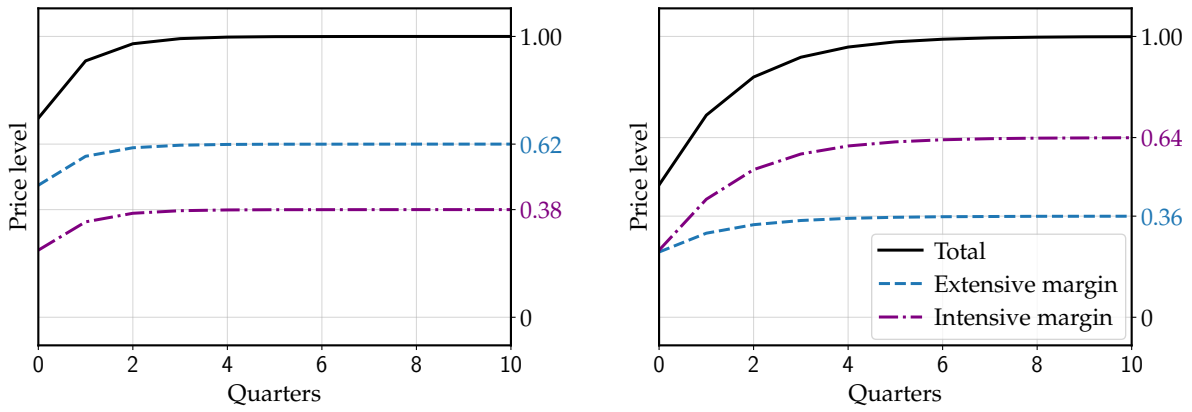
3 Exact Equivalence between SD and TD Pricing Models

We are now ready to compare the aggregate implications of state- and time-dependent models for the dynamics of prices and inflation. Since the pass-through matrix encapsulates all the first-order implications of the pricing models introduced so far, a simple place to start is as follows. Consider an SD model with a given pass-through matrix Ψ. Can we find a survival function Φ_s such that the pass-through matrix Ψ^Φ of the TD model with survival function Φ_s is equal to Ψ?

If such a Φ_s exists, one should be able to recover it from a single impulse response in the SD model—in particular, the impulse response to a permanent shock to nominal marginal cost. The black lines in figure 4 show the impulse responses of the price level to such a shock in the GL and NS models. As expected given its stronger "selection effect", the GL model shows a faster convergence of the price level to 1 than the NS model.

The equation for the impulse response to a permanent shock in (11) implies that, if this SD impulse response is generated by a TD model with survival function Φ_s, then it should be equal to $\sum_{s=0}^{t} \Phi_s / \sum_{s\geq 0} \Phi_s$ at each t. This gives us a way to read off a candidate Φ_s from figure 4. Unfortunately, while this procedure will by construction generate the correct impulse response to permanent shocks, it generally does not produce the correct impulse responses to any other shock in the SD

[15] Note that the scaling properties of our model imply that there are only two independent degrees of freedom that matter for aggregate dynamics. Given λ and ξ/σ_ϵ^2, σ_ϵ (which we use to target the median price change size) only scales the *Ss* bands and shock size, with no first-order effect on aggregate prices (see also Alvarez et al. 2016).



(a) Golosov-Lucas (b) Nakamura-Steinsson

Figure 4: Price level responses to permanent nominal marginal cost shocks.

Note: impulse responses of prices to a permanent nominal marginal cost shocks decomposed into changes in reset points (intensive margin) and adjustment bounds (extensive margin). Parameter values as in table 1.

model. In other words, no single TD model can match the entire pass-through matrix of an SD model: in this sense, TD and SD models are truly different.

3.1 Exact equivalence result

To make progress, we now consider the underlying drivers of the SD impulse responses in figure 4. As in the analysis in Caballero and Engel (2007), the permanent shock shifts up both the adjustment bands $\underline{x}_t, \overline{x}_t$, and the reset price gap x_t^*. We can thus separate each total impulse response into an *extensive margin* component, driven by the shift in the adjustment bands, and an *intensive margin* component, driven by the shift in the reset price gap. Since the shock is evaluated to first order, this decomposition is additive.

The blue and purple lines in figure 4 show those extensive and intensive margin contributions for the GL and NS models. On impact, as Caballero and Engel (2007) showed, the contribution of the intensive margin is the same across the two models, and equal to the calibrated frequency of price changes (freq). As they also pointed out, the impact contribution of the extensive margin is large in the GL model, contributing to faster aggregate adjustment than in the NS model. The figure shows that the extensive margin continues to make a large contribution through the impulse response of the GL model and ultimately accounts for 62% of its eventual price level response. For NS, the long-run share of the extensive margin is only 36%.

Consider repeating the TD-matching strategy discussed above, separately for the extensive and intensive margin impulse responses. For each, we read off a survival function, which we denote by Φ^e and Φ^i for the extensive and intensive margins. We call these *virtual survival functions*, since they are different from the actual survival function of the SD model, as we discuss further in section 3.3 below. We can also read off the share α of the eventual price level response that is accounted for by the extensive margin.

Our main result in this section is that these survival functions are *structural*: the implied mixture TD model has the same impulse responses to all shocks as the underlying SD model.

Proposition 1. *The pass-through matrix Ψ of the canonical menu cost model is a mixture of two time-dependent (TD) pass-through matrices,*

$$\Psi = \alpha \Psi^{\Phi^e} + (1-\alpha)\, \Psi^{\Phi^i} \tag{14}$$

The "virtual" survival functions Φ^e and Φ^i and the share α are such that:

- $\alpha \Sigma_{s=0}^{t} \Phi_s^e / \sum_{s\geq 0} \Phi_s^e$ *is the impulse response of the price level to a permanent nominal marginal cost shock when only the* Ss *band shifts;*
- $(1-\alpha)\, \Sigma_{s=0}^{t} \Phi_s^i / \sum_{s\geq 0} \Phi_s^i$ *is the impulse response of the price level to a permanent nominal marginal cost shock when only the reset price gap shifts.*

Proposition 1 formalizes this TD-matching approach and proves that it works. The pass-through matrix of an SD model is exactly equal to the linear combination of the pass-through matrix of the extensive margin (with share α) and the pass-through matrix of the intensive margin (with share $1-\alpha$). This implies that the SD impulse response to *any* shock, $\Psi \cdot \widehat{\mathbf{MC}}$, can be exactly decomposed into an extensive margin contribution $\alpha \Psi^{\Phi^e} \cdot \widehat{\mathbf{MC}}$ and an intensive margin contribution $(1-\alpha)\, \Psi^{\Phi^i} \cdot \widehat{\mathbf{MC}}$, and that both contributions come from TD models. For example, given equation (11), the impulse response of the SD model to a one-time shock is simply given by

$$\alpha \frac{\Phi_0^e}{\left(\sum_{s\geq 0} \Phi_s^e\right)\left(\sum_{s\geq 0} \beta^s \Phi_s^e\right)} \Phi_t^e + (1-\alpha)\, \frac{\Phi_0^i}{\left(\sum_{s\geq 0} \Phi_s^i\right)\left(\sum_{s\geq 0} \beta^s \Phi_s^i\right)} \Phi_t^i \tag{15}$$

Our result thus naturally generalizes the Caballero and Engel (2007) decomposition to arbitrary shocks and to the entire impulse response.[16] Since the pass-through matrix characterizes the entire behavior of a pricing model, proposition 1 implies more broadly that the SD model is identical to a mixture TD model, in which a fixed share of firms α follows the TD rule Φ^e and the remaining firms follow the TD rule Φ^i.

Corollary 1. *To first order, the aggregate pricing behavior of the canonical menu cost model is identical to that of a mixture of a time-dependent model with survival function Φ^e and weight α, and a time-dependent model with survival function Φ^i and weight $1-\alpha$. In particular, these two models share the same generalized Phillips curve.*

A useful way to interpret our equivalence result is as one of dimensionality reduction. To see this, truncate the matrices in (14) to be of size $T \times T$. From (10), we see that, up to a constant, a

[16] In empirical work it is also common to decompose inflation into an intensive and an extensive margin, e.g. Klenow and Kryvtsov (2008) and Dedola, Kristøffersen and Züllig (2021). Typical decompositions in this literature relate the extensive margin to movements in the frequency of price changes. In our model, the overall frequency of price changes is constant to first order, with the extensive margin term reflecting opposite-sign movements in the frequencies of price increases and declines.

$T \times T$ truncated TD pass-through matrix Ψ^{Φ} only depends on $\Phi_0, \ldots, \Phi_{T-1}$. Thus, (14) effectively is a reduction from T^2 dimensions down to $2T-1$ dimensions.[17]

Computational benefits of proposition 1. The dimensionality reduction idea highlights the computational benefits of proposition 1. It is typically relatively straightforward to compute the impulse response of the price level to permanent nominal marginal cost shocks in menu cost models—making this a popular exercise for papers in the literature (e.g., Golosov and Lucas 2007, Alvarez et al. 2016). It is typically much harder to compute the impulse responses to non-permanent, e.g. AR(1), shocks, and even harder to embed menu cost models in fully specified general-equilibrium models without making restrictive assumptions on preferences and monetary shocks.

Proposition 1 suggests a simple way to solve these computational issues, as follows. First, compute the impulse response to a permanent shock assuming that only the *Ss* bands adjust, and then assuming that only the reset price gap adjusts, obtaining Φ^e, Φ^i, α as outlined above. Then compute the right hand side of (14) using the formula in (10) to obtain the pass-through matrix Ψ. This makes it possible to simulate arbitrary shocks to nominal costs by taking the matrix product of Ψ and the shock vector. In addition, using (13), we can construct the generalized Phillips curve $\mathbf{K}$ and simulate arbitrary shocks to real marginal cost shocks as well.

Continuous time version of our result. While our result is set in discrete time, a similar result holds in continuous time. We present it in appendix A.

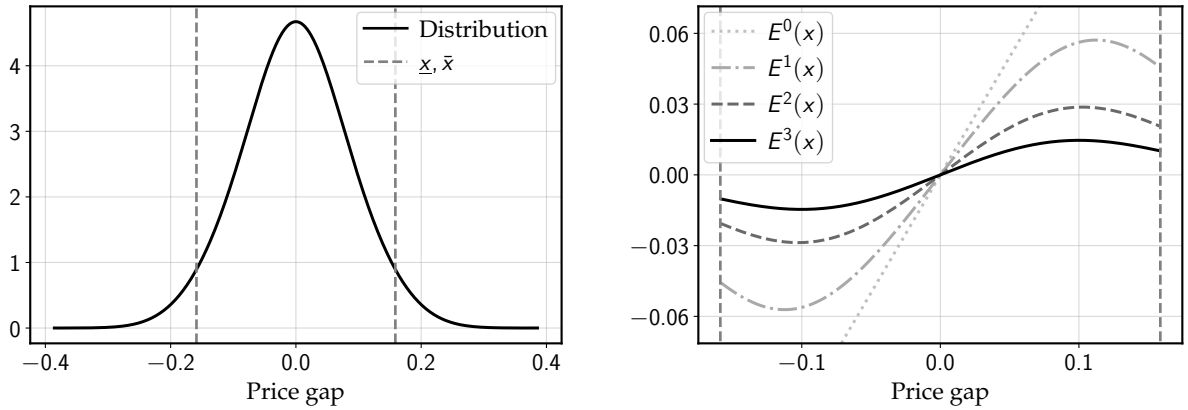
3.2 Proof of proposition 1

The proof of proposition 1 has several steps. First, we introduce a new object: the expected price gap $E^t(x)$, t periods in the future, for a firm with a price gap of x today. We then study how, to first order, the aggregate price index is affected by past policy changes (the law of motion), and these policy changes are determined in response to future marginal cost shocks (the policy equation). In both cases, we find a central role for $E^t(x)$. When we combine the law of motion and policy equation to obtain the pass-through matrix, we see that this matrix is a weighted sum of two terms—representing the extensive and intensive margins—each of which has exactly the same form as in the time-dependent case (10), with survival functions derived from $E^t(x)$. We conclude by identifying these terms with the decomposition (14) in proposition 1.

Expected price gaps. Consider a menu cost model in steady state, with $\log MC_t = 0$. Let x be the price gap of firm i at the end of period 0, after it has had a chance to adjust. For each $t \geq 0$, we define $E^t(x) \equiv \mathbb{E}_0 [x_{it} | x_{i0} = x]$ as the firm's expected price gap at the end of period t.[18] Clearly,

[17] $2T-2$ for $\Phi^e_1, \ldots, \Phi^e_{T-1}$ and $\Phi^i_1, \ldots, \Phi^i_{T-1}$ given that $\Phi^e_0 = \Phi^i_0 \equiv 1$; 1 for the constants multiplying the truncated matrices in (14).

[18] These objects also feature in Alvarez et al. (2016) and Alvarez and Lippi (2022), who derive an analytical expression for them in continuous time (see appendix A).



(a) Stationary distribution $g(x)$

(b) Expected price gaps $E^t(x)$

Figure 5: Stationary distribution $g(x)$ and expected price gaps $E^t(x)$.

Note: stationary distribution of price gaps before adjustments (left) and expected future price gaps given initial position x (right) for the Nakamura-Steinsson model, calibrated as in table 1.

the identity of firm i is irrelevant for this object, so $E^t(x)$ only depends on the price gap x and the horizon t. Since the model is symmetric in steady state, E^t is an odd function for all t, i.e. $E^t(-x) = -E^t(x)$, and in particular $E^t(0) = 0$.

Starting with $E^0(x) = x$ and applying the law of iterated expectations, $E^t(x)$ is given recursively for $t > 0$ by

$$E^t(x) = (1-\lambda)\int_{-\bar{x}}^{\bar{x}} f(x'-x)E^{t-1}(x')dx', \tag{16}$$

taking expectations over $E^{t-1}(x')$ using the no-adjustment transition probability from x to x'. (The contribution from price adjustments to (16) is 0, since $E^{t-1}(0) = 0$.)

The right panel in figure 5 plots $E^t(x)$ as function of x for different horizons t. At longer horizons t, expected price gaps all converge towards zero. This happens for two reasons: first, prices are more likely to have adjusted at longer horizons, after which their expected price gaps are zero; second, the expected price gap conditional on not having adjusted also converges to zero, due to a selection effect that we explore in more detail in the next section.

The left panel in figure 5 plots the stationary distribution $g(x)$ of price gaps after shocks have realized, but before firms have adjusted their price. Prices that lie outside the steady state *Ss* band $[\underline{x}, \bar{x}]$, and a random share λ of prices inside the bands, adjust to 0.

Relationship between expected price gaps and the law of motion. In general, the log price level at any date t, after adjustment, is given by

$$\log P_t = (1-\lambda)\int_{\underline{x}_t}^{\bar{x}_t} x g_t(x)dx + \left(\lambda + (1-\lambda)\left(1 - \int_{\underline{x}_t}^{\bar{x}_t} g_t(x)dx\right)\right) x_t^* \tag{17}$$

where $g_t(x)$ is the density of price gaps at date t before adjustments in that period, and the first and second terms are the contributions from non-adjusters and adjusters, respectively.

Now suppose that at date $t-s$, starting from the stationary distribution $g(x)$, there is a one-time change in policies $\overline{x}_{t-s}$, $\underline{x}_{t-s}$, and x^*_{t-s}, after which policies all return to the steady state. We can then rewrite $\log P_t$ as

$$\log P_t = (1-\lambda)\int_{\underline{x}_{t-s}}^{\overline{x}_{t-s}} E^s(x)g(x)dx + \left(\lambda + (1-\lambda)\left(1 - \int_{\underline{x}_{t-s}}^{\overline{x}_{t-s}} g(x)dx\right)\right) E^s(x^*_{t-s}) \tag{18}$$

where we obtain the average value of price gaps x at date t by taking the average over the expected price gap $E^s(x)$ at date $t-s$.

Totally differentiating (18) around the steady state, we have

$$d\log P_t = (1-\lambda)E^s(\overline{x})g(\overline{x})(d\overline{x}_{t-s} + d\underline{x}_{t-s}) + \text{freq}\cdot(E^s)'(0)dx^*_{t-s} \tag{19}$$

where the first term simplifies due to symmetry, the second term simplifies since $E^s(0)=0$, and $\text{freq} = \lambda + (1-\lambda)\left(1 - \int_{-\overline{x}}^{\overline{x}} g(x)dx\right)$ is the steady-state price adjustment frequency.

Equation (19) gives the first-order response, around the steady state, of $\log P_t$ to changes in policy at any date $t-s$. We can then sum these contributions from each $t-s \geq 0$ to obtain the full first-order law of motion for prices

$$d\log P_t = (1-\lambda)g(\overline{x})\sum_{s=0}^{t} E^s(\overline{x})(d\overline{x}_{t-s} + d\underline{x}_{t-s}) + \text{freq}\cdot\sum_{s=0}^{t}(E^s)'(0)dx^*_{t-s} \tag{20}$$

Relationship between expected price gaps and the policy equation. Let $V_t(x)$ denote the post-adjustment value function for a firm at any date t. Given equation (2), this satisfies

$$V_t(x) \equiv \frac{1}{2}(x - \log MC_t)^2 + \beta(1-\lambda)\mathbb{E}_\epsilon\left[\min(V_{t+1}(x+\epsilon), \xi + \min_{x^*} V_{t+1}(x^*))\right] + \beta\lambda\min_{x^*} V_{t+1}(x^*) \tag{21}$$

To start, suppose that aggregate marginal cost remains at its steady-state level at every date except s, where there is a shock $d\log MC_s$. Differentiating equation (21) around the steady state, this implies $dV_s(x) = -x$. Further, we show in appendix C.1 that by an envelope argument, the implied perturbation to the value function $dV_t(x)$ for any $t < s$ is

$$dV_t(x) = \beta(1-\lambda)\int_{\underline{x}}^{\overline{x}} f(x'-x)dV_{t+1}(x')dx \tag{22}$$

i.e. that it is the discounted change to $dV_{t+1}(x')$, taking expectations over all x' where there is no adjustment under the steady-state policy.[19]

Given that $dV_s(x) = E^0(x) = -x$, and that (22) has exactly the same form as our earlier recursion (16), except with an additional discount factor β, It follows that

$$dV_t(x) = -\beta^{s-t}E^{s-t}(x). \tag{23}$$

[19] The contribution from resets turns out to be zero because all dV_t are odd and satisfy $dV_t(0)=0$.

Using similar arguments, we show in appendix C.1 that $V'(x) = \sum_{u=0}^{\infty} \beta^u E^u(x)$.

At each date t, the optimal adjustment thresholds are given by value-matching conditions $V_t(\bar{x}_t) = V_t(\underline{x}_t) = V_t(x_t^*) + \zeta$, and the optimal reset point is given by the first-order condition $V_t'(x_t^*) = 0$. Totally differentiating around the steady state, we have $d\bar{x}_t = -\left(dV_t(\bar{x}) - dV_t(0)\right)/V'(\bar{x})$, $d\underline{x}_t = -\left(dV_t(\underline{x}) - dV_t(0)\right)/V'(\underline{x})$, and $dx_t^* = -dV_t'(0)/V''(0)$, which combined with our results above become $d\bar{x}_t = d\underline{x}_t = \frac{\beta^{s-t}E^{s-t}(\bar{x})}{\sum_{u=0}^{\infty}\beta^u E^u(\bar{x})} d\log MC_s$ and $dx_t^* = \frac{\beta^{s-t}(E^{s-t})'(0)}{\sum_{u=0}^{\infty}\beta^u (E^u)'(0)} d\log MC_s$. Allowing for shocks at different dates s and summing to get the overall effect, we conclude

$$d\bar{x}_t = d\underline{x}_t = \frac{\sum_{s\geq t}\beta^{s-t}E^{s-t}(\bar{x})d\log MC_s}{\sum_{s\geq t}\beta^{s-t}E^{s-t}(\bar{x})} \tag{24}$$

$$dx_t^* = \frac{\sum_{s\geq t}\beta^{s-t}(E^{s-t})'(0)d\log MC_s}{\sum_{s\geq t}\beta^{s-t}(E^{s-t})'(0)} \tag{25}$$

i.e. that both the changes in thresholds $d\bar{x}_t, d\underline{x}_t$ and changes in reset point dx_t^* are given by weighted averages of shocks to future marginal cost.

Writing as mixture of time-dependent models. In vector form, we can write our law of motion for prices (20), given that $d\bar{\mathbf{x}} = d\underline{\mathbf{x}}$, as

$$\hat{\mathbf{P}} = 2(1-\lambda)g(\bar{x}) \begin{pmatrix} E^0(\bar{x}) & 0 & 0 & \cdots \\ E^1(\bar{x}) & E^0(\bar{x}) & 0 & \cdots \\ E^2(\bar{x}) & E^1(\bar{x}) & E^0(\bar{x}) & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix} d\bar{\mathbf{x}} + \text{freq} \cdot \begin{pmatrix} E^{0\prime}(0) & 0 & 0 & \cdots \\ E^{1\prime}(0) & E^{0\prime}(0) & 0 & \cdots \\ E^{2\prime}(0) & E^{1\prime}(0) & E^{0\prime}(0) & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix} d\mathbf{x}^*$$

where $\bar{\mathbf{x}} \equiv (\bar{x}_0, \bar{x}_1, \bar{x}_2, \ldots)'$, etc. Then, substituting in the vector form of (24)–(25) and rearranging, this becomes

$$\hat{\mathbf{P}} = \frac{2(1-\lambda)g(\bar{x})\sum_{s\geq 0}\frac{E^s(\bar{x})}{\bar{x}}}{\left(\sum_{s\geq 0}\frac{E^s(\bar{x})}{\bar{x}}\right)\left(\sum_{s\geq 0}\beta^s\frac{E^s(\bar{x})}{\bar{x}}\right)} \begin{pmatrix} \frac{E^0(\bar{x})}{\bar{x}} & 0 & 0 & \cdots \\ \frac{E^1(\bar{x})}{\bar{x}} & \frac{E^0(\bar{x})}{\bar{x}} & 0 & \cdots \\ \frac{E^2(\bar{x})}{\bar{x}} & \frac{E^1(\bar{x})}{\bar{x}} & \frac{E^0(\bar{x})}{\bar{x}} & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix} \begin{pmatrix} \frac{E^0(\bar{x})}{\bar{x}} & \beta\frac{E^1(\bar{x})}{\bar{x}} & \beta^2\frac{E^1(\bar{x})}{\bar{x}} & \cdots \\ 0 & \frac{E^0(\bar{x})}{\bar{x}} & \beta\frac{E^1(\bar{x})}{\bar{x}} & \cdots \\ 0 & 0 & \frac{E^0(\bar{x})}{\bar{x}} & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix} \widehat{\mathbf{MC}}$$

$$+ \frac{\text{freq}\cdot\sum_{s\geq 0}E^{s\prime}(0)}{\left(\sum_{s\geq 0}E^{s\prime}(0)\right)\left(\sum_{s\geq 0}\beta^s E^{s\prime}(0)\right)} \begin{pmatrix} E^{0\prime}(0) & 0 & 0 & \cdots \\ E^{1\prime}(0) & E^{0\prime}(0) & 0 & \cdots \\ E^{2\prime}(0) & E^{1\prime}(0) & E^{0\prime}(0) & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix} \begin{pmatrix} E^{0\prime}(0) & \beta E^{1\prime}(0) & \beta^2 E^{2\prime}(0) & \cdots \\ 0 & E^{0\prime}(0) & \beta E^{1\prime}(0) & \cdots \\ 0 & 0 & E^{0\prime}(0) & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix} \widehat{\mathbf{MC}} \tag{26}$$

We see that each term above, aside from the numerators, has *exactly* the form of the time-dependent pass-through matrix (10). In particular, just as in the time-dependent case, the rows of the upper triangular matrices (representing the policy equation that maps marginal cost shocks to policies)

are the same as the columns of the lower triangular matrices (representing the law of motion that maps policy shocks to aggregate prices), except with added discounting.[20] Hence, if we define the survival functions $\Phi^e_s \equiv \frac{E^s(\bar{x})}{\bar{x}}$ and $\Phi^i_s \equiv E^{s\prime}(0)$, this pass-through matrix simplifies to just

$$\Psi = 2(1-\lambda)g(\bar{x})\left(\sum_{s\geq 0}\frac{E^s(\bar{x})}{\bar{x}}\right)\Psi^{\Phi^e} + \text{freq}\left(\sum_{s\geq 0}E^{s\prime}(0)\right)\Psi^{\Phi^i}, \tag{27}$$

a weighted sum of the time-dependent pass-through matrices Ψ^{Φ^e} and Ψ^{Φ^i}. The first term gives the response from extensive-margin adjustments to $\bar{x}_t$ and $\underline{x}_t$, and the second term gives the response from intensive-margin adjustments to x^*_t.

In response to a permanent shock to marginal cost, it follows directly from (10) that the long-term response of prices must be one-for-one in time-dependent models, and we also know that it must be one-for-one in our state-dependent model.[21] For (27) be consistent with this, the sum of the coefficients on Ψ^{Φ^e} and Ψ^{Φ^i} must equal 1. Hence defining $\alpha \equiv 2(1-\lambda)g(\bar{x})\left(\sum_{s\geq 0}\frac{E^s(\bar{x})}{\bar{x}}\right)$, we can rewrite (27) as just

$$\Psi = \alpha\Psi^{\Phi^e} + (1-\alpha)\Psi^{\Phi^i} \tag{28}$$

which is identical to (14) in proposition 1.

Our expressions for Φ^e, Φ^i, and α have a sufficient statistic interpretation that may be of independent interest. In principle, given a law of motion of price gaps observed empirically, one can compute $E^t(x)$, recover Φ^e_t, Φ^i_t and α from our formulas, and therefore form the pass-through matrix from this information alone—without ever needing to solve the full model. We follow a related approach in section 6.

3.3 Properties of the equivalent time-dependent models

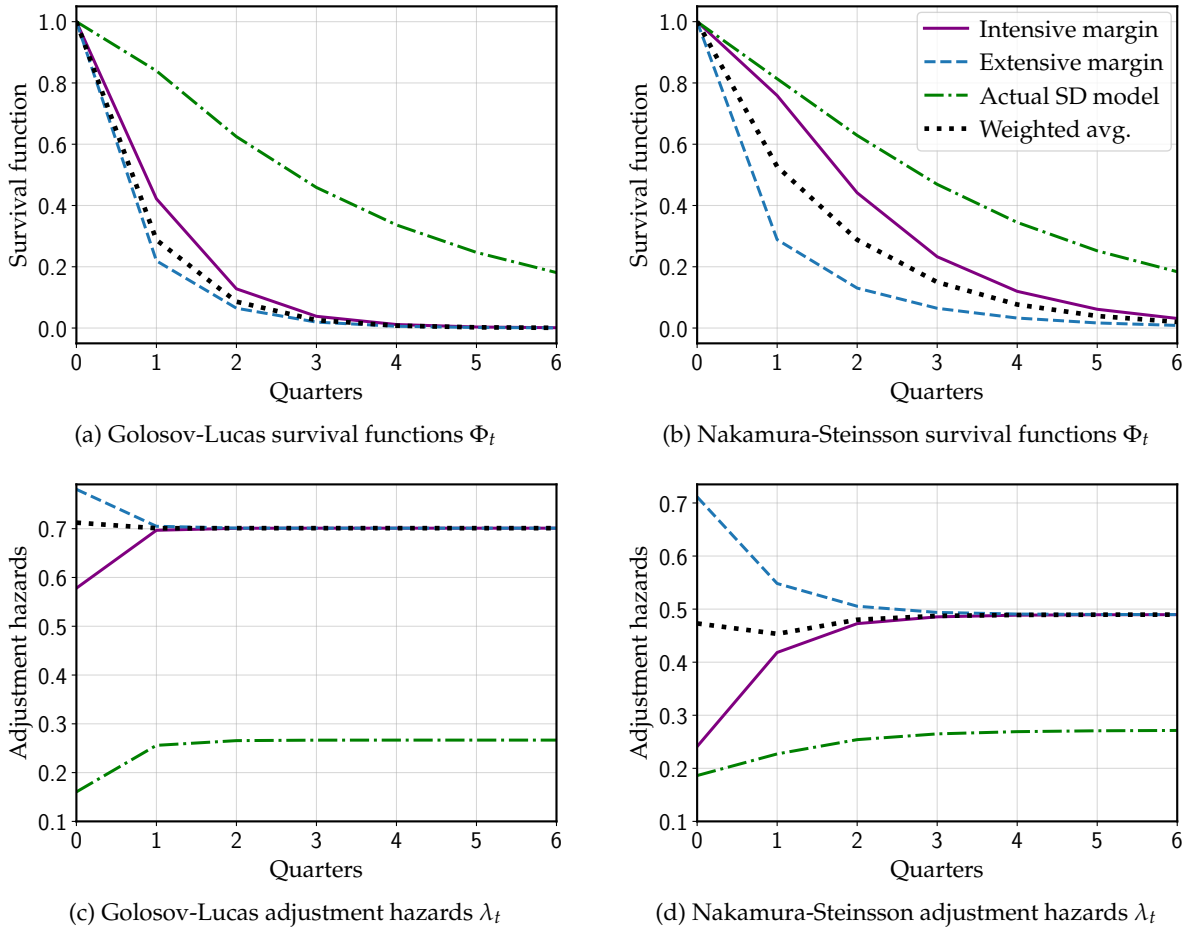
At the heart of the equivalence result in proposition 1 are the virtual survival functions Φ^e_t, Φ^i_t. Here, we study these functions in our calibrated examples and discuss their general properties.

Figure 6 plots Φ^e_t, Φ^i_t for the GL and NS models, as well as their associated hazards. Two facts stand out. First, within each model, the (virtual) extensive and intensive hazards converge to a common limit. Second, these hazards are noticeably greater in the GL model than in the NS model. This shows that the GL model is equivalent to a mixture of TD models with shorter-lived prices, reflecting its lower degree of monetary non-neutrality.

It is tempting to compare these virtual survival and hazard functions to the actual functions that we would obtain by counting how long prices survive in panel data simulated from the SD model. Figure 6 plots these actual survival functions and hazards, constructed as the probability

[20] Also, the first entries in these sequences, $\frac{E^0(\bar{x})}{\bar{x}}$ and $E^{0\prime}(0)$, equal 1, and appendix C.2 proves that they are positive and decreasing, as required for survival functions.

[21] It follows immediately from (24)–(25) that a unit permanent increase in marginal cost results in a unit permanent increase in both adjustment thresholds and the reset point. Just as in the original steady state, price gaps eventually converge to the new ergodic distribution, identical but translated to the right by these increases.



(a) Golosov-Lucas survival functions Φ_t

(b) Nakamura-Steinsson survival functions Φ_t

(c) Golosov-Lucas adjustment hazards λ_t

(d) Nakamura-Steinsson adjustment hazards λ_t

Figure 6: Survival functions and adjustment hazards.

Note: actual and virtual survival functions Φ_t^{actual}, Φ_t^e, Φ_t^i, as well as weighted average $\alpha\Phi_t^e + (1-\lambda)\,\Phi_t^i$, with corresponding adjustment hazards λ_t for the GL and NS models, calibrated as in table 1.

a price that adjusts at date 0 survives until date t without adjusting at any date $s \leq t$,

$$\Phi_t^{\text{actual}} \equiv \mathbb{P}\left(\text{no adj. until } t | x_0 = 0\right)$$

The actual SD hazards in both the GL and NS are increasing (see e.g. Alvarez and Lippi 2014) and at all times significantly below the hazards of the equivalent TD models. This implies that in both models, the aggregate price level is much more flexible than one would infer from using Φ_t^{actual} in a time-dependent model. We can prove this formally for the asymptotic hazards.

Proposition 2. *In the canonical menu cost model, the adjustment hazards λ_t^e, λ_t^i corresponding to Φ_t^e and Φ_t^i converge to the same limit $\lambda_\infty^{virtual}$. This limit is strictly above the limit of the actual adjustment hazard λ_∞^{actual}.*

This proposition extends an earlier result by Alvarez and Lippi (2022). Alvarez and Lippi (2022) showed that the asymptotic hazard of the aggregate price level in response to a permanent

nominal marginal cost shock is strictly below the asymptotic adjustment hazard of individual prices. Proposition 2 implies that their result holds in response to *any* shock, and that it holds separately for the responses of the extensive and intensive margins.[22]

Following Alvarez and Lippi (2022), we can attribute the gap between the asymptotic virtual and actual hazards to a selection effect. Our analytical expressions for the extensive and intensive margins shed light on selection effects for both margins. Recall that the extensive margin virtual survival curve is given by $\Phi_t^e = E^t(\bar{x})/\bar{x}$, and that the average price gap after adjustment is zero. Hence, one way to understand why Φ_t^e differs so much from the actual survival curve Φ_t^{actual} is through the following decomposition:

$$\Phi_t^e = \Phi_t^{\text{actual}} \times \frac{\mathbb{P}(\text{no adj. until } t | x_0 = \bar{x})}{\mathbb{P}(\text{no adj. until } t | x_0 = 0)} \times \frac{\mathbb{E}[x_t | \text{no adj. until } t, x_0 = \bar{x}]}{\bar{x}} \tag{29}$$

The two factors on the right of (29) give the two reasons why Φ_t^e declines faster than Φ_t^{actual}. First, prices at the boundary $\bar{x}$ are less likely to survive than prices at the reset point, so the middle term is strictly below 1. Second, price gaps that do not adjust for t periods are selected: on average, they have received idiosyncratic shocks that took them closer to the middle of the *Ss* band, rather than pushing them outside. Thus, the term on the right in (29) is also below 1.

This discussion highlights the importance of "selection effects" in the extensive margin of price adjustment, which are well understood in the literature (e.g. Golosov and Lucas 2007). However, a similar decomposition to (29) shows that there is also a selection effect in the intensive margin of price adjustment. Indeed, since $\Phi_t^i \equiv E^{t\prime}(0)$, we have:

$$\Phi_t^i = \Phi_t^{\text{actual}} \times \frac{\partial}{\partial x} \mathbb{E}[x_t | \text{no adj. until } t, x_0 = x] \Big|_{x=0} \tag{30}$$

The right factor in (30) measures the extent of this intensive margin selection effect. The logic behind this effect is the same as for the extensive margin: price gaps that do not adjust for t periods are selected, and tend to be closer to the middle of the *Ss* band. Hence the marginal effect of setting a higher price today on the future price gap is attenuated by selection, which compresses the surviving price gaps.

Indeed, as proposition 2 shows, asymptotically the extensive and intensive selection effects are equally powerful, leading to the same hazard $\lambda_\infty^{\text{virtual}} > \lambda_\infty^{\text{actual}}$. Initially, however, extensive margin selection is almost always stronger, because the probability of adjusting starting from $\bar{x}$ is much higher than starting from 0. This not only makes the middle factor of (29) below 1, but also makes the selection effect in the rightmost factor of (29) initially much stronger than in (30). In practice, this leads to the following general pattern.

Remark 1. The hazards corresponding to Φ_t^e generally increase over time; the hazards correspond-

[22] Like Alvarez and Lippi (2022), we establish this by characterizing the eigenvalues and eigenfunctions of the transition operator without reinjections. In our discrete-time setting with a more general assumption on the distribution of shocks, we no longer have analytical formulas for these, but we can still show $\lambda_\infty^{actual} < \lambda_\infty^{virtual}$ by relating them to the leading eigenvalues for even and odd eigenfunctions.

ing to Φ_t^i generally fall over time.

This property holds for all parameterizations of the canonical menu cost model with normal shocks we study in figure 9, as well as for the leptokurtic shocks discussed in appendix D.4. However, contrary to proposition 2, here we do not have an analytical result, and indeed we have found that the property fails for certain pathological distributions of idiosyncratic shocks.[23]

3.4 Relation to Gertler and Leahy (2008)

Gertler and Leahy (2008) is an important antecedent to our proposition 1. Gertler and Leahy (2008) gave an example of a menu cost model with a particular distribution of idiosyncratic shocks that is first-order equivalent to a Calvo model. Here, we re-derive their result in our context by showing that the two models have the same pass-through matrix, and we discuss the behavior of the extensive and intensive margin hazards in this case.

The Gertler and Leahy (2008) example is as follows. In the canonical menu cost model, set the probability of a free adjustment to zero, $\lambda = 0$, and assume the following distribution: idiosyncratic shocks are zero with probability $1-\eta$, and are otherwise uniformly distributed in an interval $[-M, M]$. Assume further that $\eta \in (0, 1]$ and that $M > 2\bar{x}$.[24]

In this model, the expected price gap function $E^t(x)$ has a very simple shape. To see why, consider $E^1(x)$. Any price gap x in the Ss interval remains at x with probability $1-\eta$. With probability η, the idiosyncratic shock is drawn from the uniform interval, sending x to $[x-M, x+M]$. By assumption, this interval includes $[\underline{x}, \bar{x}]$. So either the price gap lands outside the Ss band, in which case it adjusts to $x^* = 0$, or it remains inside the Ss band, in which case it is uniformly distributed within $[\underline{x}, \bar{x}]$, with expectation 0. Thus,

$$E^1(x) = \underbrace{(1-\eta)\, x}_{\text{zero shock}} + \underbrace{\eta \frac{2\bar{x}}{M} \cdot 0}_{\text{uniform shock, no adj.}} + \underbrace{\eta \left(1 - \frac{2\bar{x}}{M}\right) \cdot 0}_{\text{uniform shock, adj.}} = (1-\eta)\, x$$

Pursuing the same logic for $t \geq 1$ shows that $E^t(x) = (1-\eta)^t x$: expected price gaps exponentially converge to zero at rate η. Using the formulas for Φ_t^e and Φ_t^i, we therefore obtain:

$$\Phi_t^i = \Phi_t^e = (1-\eta)^t \qquad \text{and} \qquad \alpha = \frac{2\bar{x}}{M} \tag{31}$$

Hence, the virtual survival functions are identical, and with the same constant adjustment hazard η. Applying Proposition 1, we find that the pass-through matrix of the Gertler and Leahy (2008) model is identical to that of a Calvo model, with Calvo frequency η.

[23] A counterexample can be obtained by setting $\bar{x} = 1$ and having idiosyncratic shocks distributed according to $f(x) \propto e^{-(x/1.5)^8}$. The extensive and intensive margins of this model are then both non-monotonic.

[24] Note that this distribution of idiosyncratic shocks does not satisfy the regularity conditions in section 2.1. It has density $f(x) = (1-\eta)\delta(x) + \frac{\eta}{2M}\mathbf{1}_{x\in[-M,M]}$, which has a mass point at $x = 0$, and also does not satisfy strict single-peakedness, or differentiability at $-M$ and M. The proof of proposition 3 itself goes through, however, since it does not require conditions on f other than symmetry and continuity at the bands $-\bar{x}$ and $\bar{x}$, which are still satisfied here.

Gertler and Leahy (2008) pointed out that this virtual Calvo frequency is higher than the actual frequency of price adjustment, $\text{freq} = \eta\left(1 - \frac{2\bar{x}}{M}\right)$, delivering less monetary non-neutrality in the menu cost model than would be inferred from the frequency of price adjustment alone.[25] Equation (31) shows that the gap between the actual and the virtual frequency $\frac{2\bar{x}}{M}$, is equal to the weight on the extensive margin α. This is intuitive, since this weight is a measure of the importance of selection.[26]

The reader may wonder if there are other examples than Gertler and Leahy (2008) in which an SD model is exactly equivalent to Calvo or to a single TD model. It turns out that the answer is yes. We give such an example in appendix C.4.

4 Numerical Equivalence between SD and Calvo Pricing Models

The Gertler and Leahy (2008) model is an important but special example in which the extensive and intensive margin hazards are exactly constant and the menu cost model is exactly equivalent to a Calvo model. This is not true more generally: instead, in typical calibrations of the canonical menu cost model, extensive margin hazards are declining, and intensive margin hazards are increasing towards their common asymptotic value. Figure 6 illustrates this fact in the case of our benchmark GL and NS calibrations.

The figure also shows, however, that the hazard rate implied by the *average* virtual survival function $\alpha\Phi_t^e + (1-\alpha)\Phi_t^i$, plotted in the dotted black line, is, in fact, approximately constant in these examples. This suggests that these models may still effectively be close to a Calvo model.

In this section, we show that this is true across a wide range of parameterizations of the canonical menu cost model: the pass-through and Phillips curve matrices are numerically very close to those of a Calvo model. Moreover, this numerical equivalence result extends to broader menu cost models beyond the canonical model.

4.1 Distance between pricing models

We start by defining a notion of distance between pass-through or Phillips curve matrices, which will allow us to make quantitative statements about how "numerically close" two models are. For two Jacobian matrices $\mathbf{J}, \mathbf{J}'$, we define their relative distance as:

$$\text{dist}\left(\mathbf{J}, \mathbf{J}'\right) = \frac{\|\mathbf{J} - \mathbf{J}'\|}{\|\mathbf{J}\|} \tag{32}$$

[25] A special property of the Gertler-Leahy model is that, before the realization of the shock, all firms face the same probability of price adjustment, equal to freq. But because of the selection effect after the shock has hit, the equivalent Calvo model features a higher frequency of price change, equal to η.

[26] In this example, the weight on the extensive margin α is exactly equal to the gap between the virtual and the actual asymptotic hazard. In simulations of more general models we have found the two metrics to still be correlated. In these cases, the latter provides a more useful measure of selection that the former, since it directly relates to the difference between actual and measured adjustment probability.

where $\|\cdot\|$ is the operator norm induced by the standard L_2 norm in $\mathbb{R}^{\mathbb{N}}$.

To see why this notion of distance is natural and useful, consider first the comparison between the generalized Phillips curves of two Calvo models with slope parameters κ, κ', that is, $\mathbf{J} = \mathbf{K}^{\text{Calvo}}(\kappa)$, $\mathbf{J}' = \mathbf{K}^{\text{Calvo}}(\kappa')$. The denominator in (32) captures the average slope of the Phillips curve: how much of an inflation response a unit-standard-deviation real marginal cost shock can generate. For a Calvo model, we have[27]

$$\|\mathbf{K}^{\text{Calvo}}(\kappa)\| = \sup_{\widehat{\mathbf{mc}}:\, \|\widehat{\mathbf{mc}}\|=1} \|\mathbf{K}^{\text{Calvo}}(\kappa) \cdot \widehat{\mathbf{mc}}\| = \frac{\kappa}{1-\beta} \tag{33}$$

The numerator in (32) captures the worst-case standard deviation of the differential inflation response across the two models,

$$\|\mathbf{K}^{\text{Calvo}}(\kappa) - \mathbf{K}^{\text{Calvo}}(\kappa')\| = \sup_{\widehat{\mathbf{mc}}:\, \|\widehat{\mathbf{mc}}\|=1} \|\mathbf{K}^{\text{Calvo}}(\kappa) \cdot \widehat{\mathbf{mc}} - \mathbf{K}^{\text{Calvo}}(\kappa') \cdot \widehat{\mathbf{mc}}\|$$

One can evaluate this norm similarly to (33), finding $\|\mathbf{K}^{\text{Calvo}}(\kappa) - \mathbf{K}^{\text{Calvo}}(\kappa')\| = \frac{|\kappa-\kappa'|}{1-\beta}$. This then gives us the distance of the two Calvo models

$$\text{dist}\left(\mathbf{K}^{\text{Calvo}}(\kappa), \mathbf{K}^{\text{Calvo}}(\kappa')\right) = \frac{|\kappa - \kappa'|}{\kappa}$$

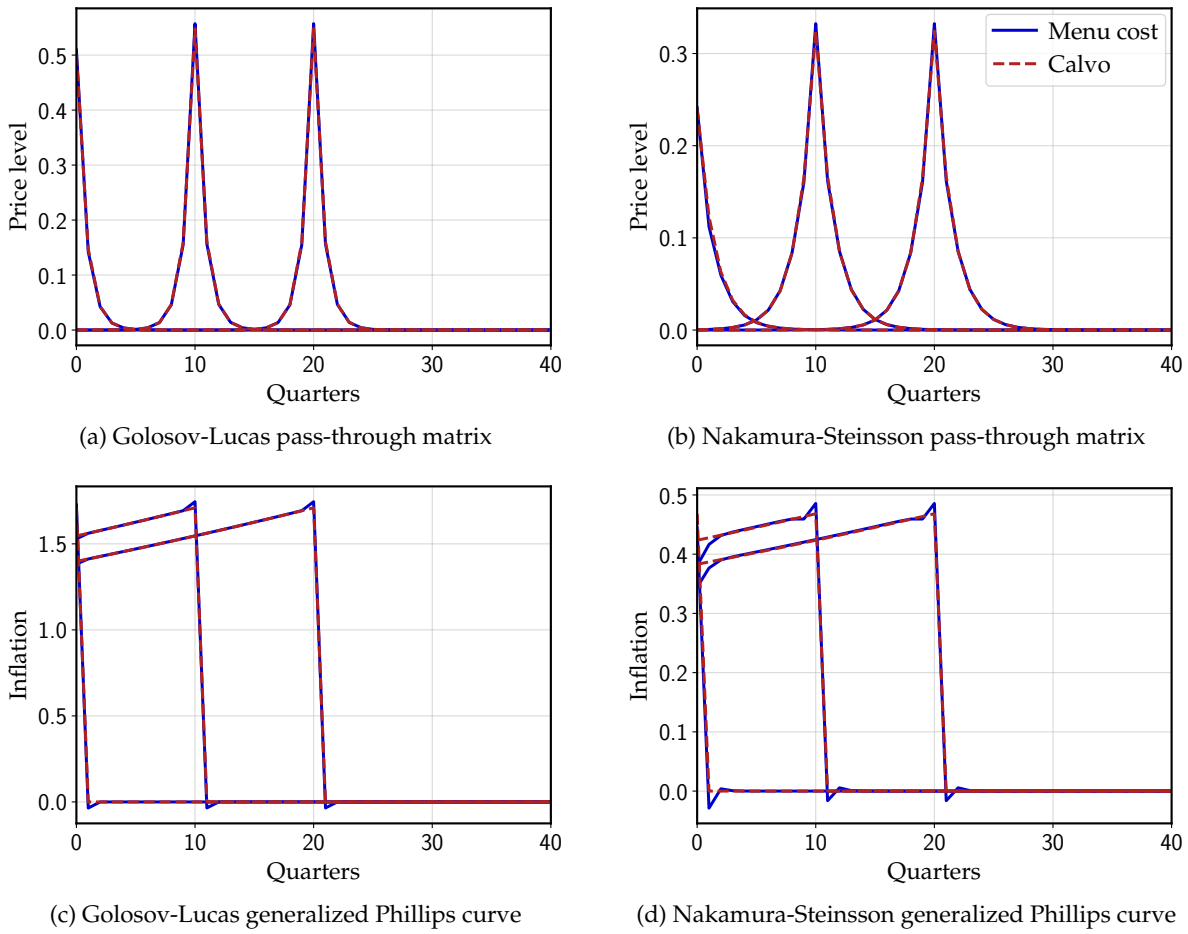
Intuitively, our measure of distance in (32) captures the relative difference in Phillips curve slopes. In the following, we apply (32) to compute the distance between the generalized Phillips curve $\mathbf{J} = \mathbf{K}$ of a menu cost model and the generalized Phillips curve of a Calvo model, $\mathbf{J}' = \mathbf{K}^{\text{Calvo}}(\kappa)$.

In principle, the distance measure (32) can also be used to compare pass-through matrices. Since pass-through matrices and generalized Phillips curves are related by the one-to-one mapping in (13), the distance measures end up being very similar. However, the distance between Phillips curve matrices has a more intuitive natural interpretation in terms of relative slopes, so we take it as our benchmark measure. We consider alternative distance measures in robustness checks.

4.2 Numerical equivalence result

The blue lines in figure 7 show the columns of the pass-through and Phillips curve matrices of the GL and NS models. As expected, the GL pass-through matrix is more spiked around the date of the anticipated nominal marginal cost shock than the NS pass-through matrix, indicating that the GL model is closer to flexible prices (see our discussion in section 2.3). Accordingly, the GL generalized Phillips curve has much larger columns than the NS generalized Phillips curve: the

[27] To get this result, consider an AR(1) shock to real marginal cost with persistence $\rho \in (0,1)$. Then, we have that $(1-\beta\rho)\,\text{sd}(\pi) = \kappa\text{sd}(\widehat{mc})$. Thus, $\|\boldsymbol{\pi}\|/\|\widehat{\mathbf{mc}}\| = \frac{\kappa}{1-\beta\rho}$ which is maximized for $\rho \to 1$, giving $\frac{\kappa}{1-\beta}$. To see that this is indeed the supremum, notice that by applying the triangle inequality to the NKPC, we have $\|\boldsymbol{\pi}\| \leq \kappa\|\widehat{\mathbf{mc}}\| + \beta\|\boldsymbol{\pi}\|$ and thus $\|\boldsymbol{\pi}\|/\|\widehat{\mathbf{mc}}\| \leq \frac{\kappa}{1-\beta}$.



(a) Golosov-Lucas pass-through matrix

(b) Nakamura-Steinsson pass-through matrix

(c) Golosov-Lucas generalized Phillips curve

(d) Nakamura-Steinsson generalized Phillips curve

Figure 7: Approximating menu cost Phillips curves with Calvo models.

Note: columns $s \in \{0, 10, 20\}$ of the pass-through and Phillips curve matrices for the GL and NS models, calibrated as in table 1, as well as the best-fitting Calvo approximations, obtained using the distance measure (32) applied to Phillips curve matrices.

same sized real marginal cost shock increases inflation by more than three times as much in GL relative to NS.

The red dashed lines in figure 7 show the best Calvo approximations obtained by minimizing the distance measure (32) for each of the two models. The fit is very close. The only visible deviations arise in early periods for the NS model, and in both models in periods around the date of the real marginal cost shock. The best fitting Calvo models for GL and NS have hazards λ of 0.707 and 0.487. Given $\beta = 0.99$, this implies Calvo slopes κ of 1.709 and 0.468.

Remark 2. The GL and NS models are numerically equivalent to Calvo.

The fact that a Calvo model can fit the aggregate pricing behavior of SD models so well is surprising. For instance, it is well known that menu cost models have upward sloping adjustment hazards (see for instance Alvarez and Lippi 2014, and the green line in figure 6). It is also well known that, in a time dependent model, upward sloping adjustment hazards imply an inertial Phillips curve (see Sheedy, 2010, and figures 1-3, panel b). Combining these results, it would be

natural to expect SD models to also feature inflation inertia. Yet they do not: a real marginal cost shock in the SD models in figure 7 neither causes a slow build-up in inflation initially, nor causes a slow reduction in inflation after the time of the shock.

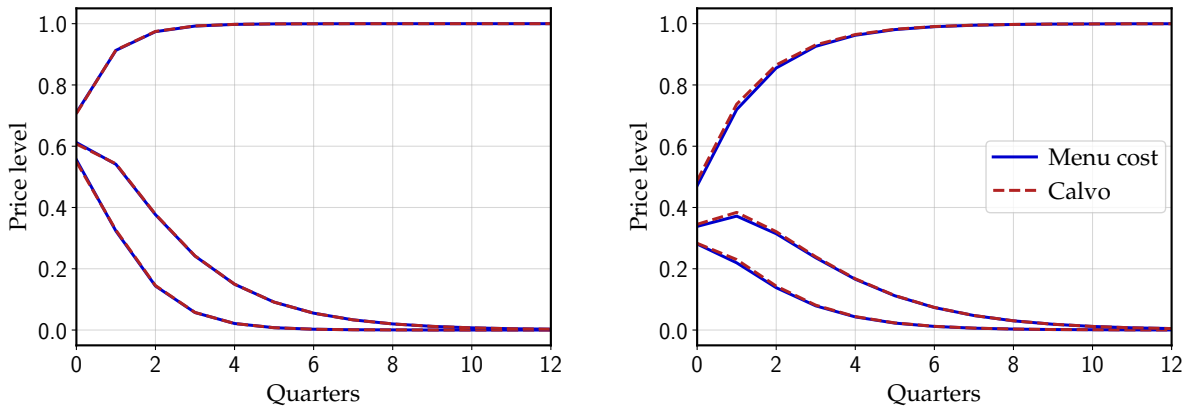
The reason for this lack of inertia is the difference between virtual and actual hazards. As figure 6 shows, in both the GL and the NS models, actual hazards increase, but average virtual hazards do not. In other words, the selection effect undoes the inertia in the Phillips curve that one would expect from actual hazards.

Relationship to earlier equivalence results. Several papers have previously explored the difference between SD and Calvo models. Our numerical equivalence result significantly extends these earlier findings. Alvarez et al. (2016) and Alvarez et al. (2017) characterize the cumulative impulse response (CIR) of one minus the price level (which is output in their model) to a unit-sized permanent shock to nominal costs in menu cost vs Calvo models, expressing those in terms of the kurtosis of the stationary distribution of price changes. Alvarez and Lippi (2022) characterize the entire impulse response of the price level to permanent shocks to nominal costs by finding the eigenvalues and eigenfunctions of the relevant dynamical system.

By contrast, our numerical equivalence result establishes that the entire impulse response to *arbitrary nominal* or *real* marginal cost shocks is well approximated by a Calvo model. This extension to all shocks is important, since it shows that the two price-setting models are effectively the same without restrictive assumptions on preferences or on the nature of aggregate shocks. We illustrate this result in figure 8 for various processes for nominal and real marginal cost shocks. The close match across responses follows directly from the fact that both the pass-through and Phillips curve matrices are sufficient statistics for the aggregate pricing behavior of a state-dependent model. If a Calvo matches these matrices well, it matches the entire aggregate behavior of the SD model, including impulse responses to all shocks.

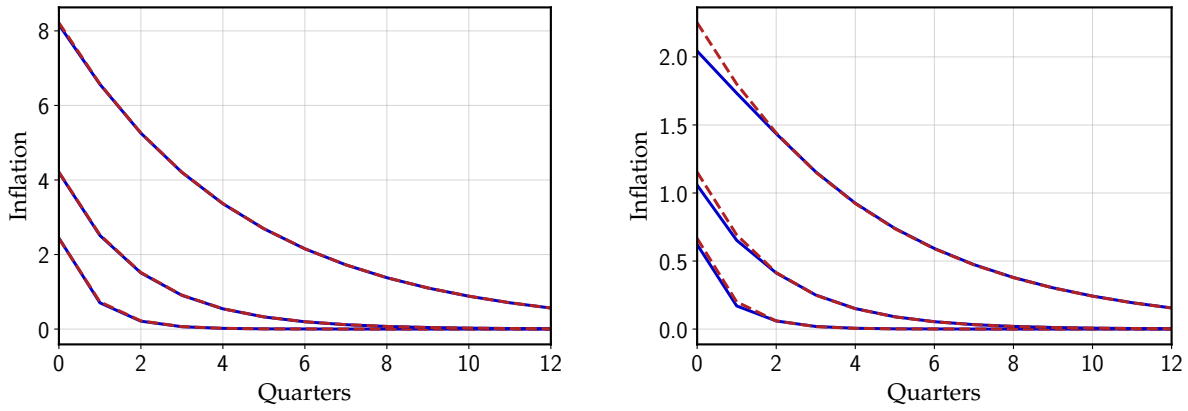
An interesting observation from figure 8 is that the Calvo approximation works somewhat less well for the NS model than for the GL model, in spite of the higher prevalence of free adjustments. The reason is as follows. While both models are calibrated to have the same frequency of price changes, in the GL model these adjustments are entirely triggered by price gaps leaving the inaction region. This leads to faster mixing of price gaps, and hence faster convergence of the intensive and extensive margin hazards relative to the NS model, as is clear from figure 6. In turn, this faster convergence makes GL more and NS less "Calvo-like".

Estimating the NKPC on data from the menu cost model. The numerical equivalence between SD and Calvo models has a simple implication: menu cost models are well described by the NKPC, for a model-specific slope parameter κ. This suggests an alternative distance metric: one can simulate data from an SD model, estimate (NK-PC) on the simulated data, and use the R^2 from the regression as a measure of fit. Implementing this procedure in the GL and NS models using an AR(1) process for real marginal cost with quarterly persistence 0.8 delivers $R^2 = 1.000$



(a) Golosov-Lucas nominal shocks.

(b) Nakamura-Steinsson nominal shocks.



(c) Golosov-Lucas real shocks

(d) Nakamura-Steinsson real shocks

Figure 8: Price level responses to AR(1) marginal cost shocks.

Note: impulse responses to AR(1) marginal cost shocks for GL and NS models, calibrated as in table 1, as well as the best-fitting Calvo approximations, obtained using the distance measure (32). Shock persistence values are $\{0.3, 0.6, 1\}$ for nominal shocks (top) and $\{0.3, 0.6, 0.8\}$ for real shocks (bottom).

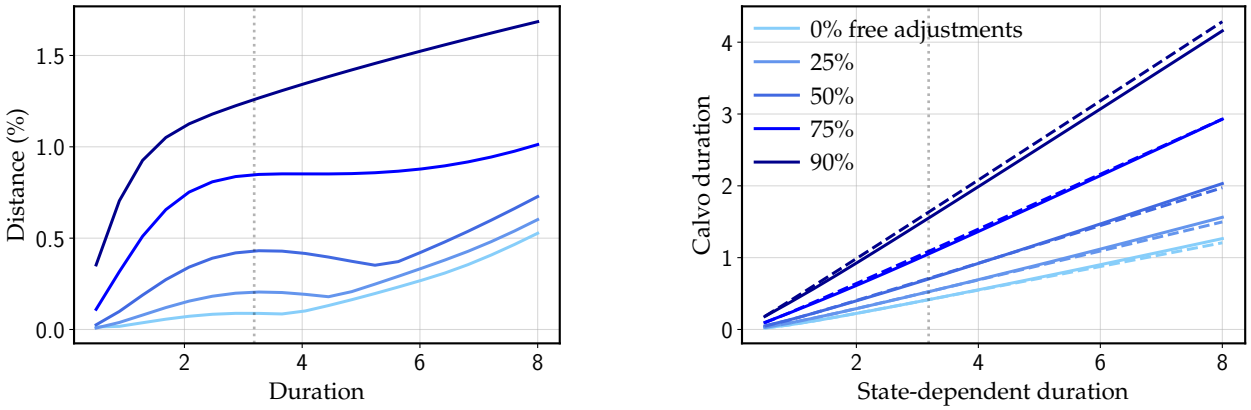
(GL) and $R^2 = 0.998$ (NS), also suggesting a tight match overall. Going beyond this procedure, we also estimate a hybrid Phillips curve, as in Galí and Gertler (1999). This delivers an estimated term on lagged inflation that is very close to 0, confirming the fact that menu cost models cannot generate inflation inertia. Details are provided in appendix D.1.

4.3 Robustness to parameterization of the canonical menu cost model

The GL and NS models are only two parametrizations of the canonical menu cost model. Here, we systematically explore the two-dimensional parameter space of this model within the class of normal idiosyncratic shocks.[28]

Figure 9(a) plots the relative distance (32) between the generalized Phillips curve and its best Calvo fit, as we vary both the duration (defined as $\frac{1}{\text{freq}} - 1$) and the share of free price adjustments.

[28] In appendix D.4 we consider an extension with leptokurtic shocks.



(a) Distance for various duration and share of free adjustments values.

(b) Distance-minimizing (solid) and ALL-implied (dashed) Calvo duration.

Figure 9: General parameter values.

Note: the left panel shows the distance between the state-dependent Phillips curve and the best-fitting Calvo approximation, measured with distance (32). The right panel shows the duration of the Calvo minimizer, as well as the one implied by the ALL result, that is, $d^{Calvo} = \frac{1}{6}\text{Kur}^{\text{MC}}\left(1+d^{MC}\right) - \frac{1}{2}$ for the value of Kur^{MC} in the simulation of the menu cost model under the duration d^{MC} and share of free adjustment under consideration. . The vertical dotted lines show the empirical duration that we target in our baseline calibration.

The dotted vertical line indicates the empirical duration in our baseline GL and NS calibration; recall that our GL calibration has no free adjustments and our NS calibration has a share of free adjustments of 75%.

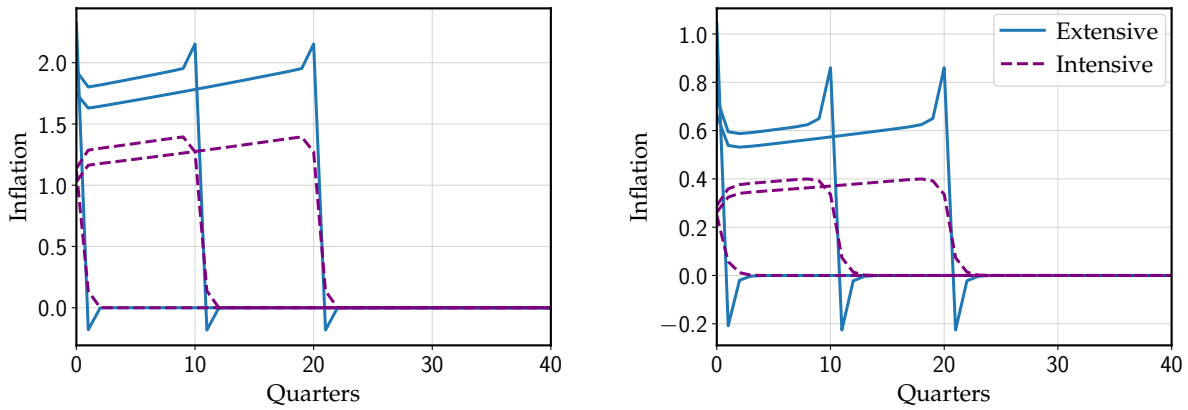
At smaller durations, we find a smaller distance, indicating a closer match between the SD and Calvo models. This is intuitive as tighter *Ss* bands not only increase frequency, but also increase the speed of mixing of price gaps, leading the intensive and extensive margin hazards to converge more quickly. This brings the model closer to Calvo. Less intuitively, but in line with our discussion of the worse Calvo fit of the NS model relative to GL, a greater share of free adjustments can increase the distance to Calvo. The distance only falls to zero for adjustment shares very close to 100% (not shown).[29]

4.4 Why do Calvo and menu cost models have such close aggregate predictions?

In the beginning of section 4, we observed that the average virtual survival function $\alpha\Phi_t^e + (1-\alpha)\,\Phi_t^i$ was close to a Calvo survival function $\Phi_t^{\text{Calvo}} = (1-\lambda)^t$, and conjectured that as a result, aggregate behavior might be close to Calvo as well. We then verified this conjecture numerically. In this section, we elaborate on the reasons for this close numerical fit.

In particular, we show in appendix D.2 that if we write the virtual survival functions as $\Phi_t^e = \Phi_t^{\text{Calvo}} + \eta_t^e$ and $\Phi_t^i = \Phi_t^{\text{Calvo}} + \eta_t^i$, then to a first-order approximation in the ηs, the gap between

[29] The general pattern in figure 9(a) is similar to that of appendix figure C.1, which shows that the second odd eigenvalue is larger relative to the leading odd eigenvalue when duration is higher and there are more free adjustments. A smaller gap between the leading and second eigenvalues generally means that it takes longer for the leading eigenvalue to dominate and for the survival function to become Calvo-like, making Calvo a worse approximation overall. (This reverses once the eigenvalues are so close that the survival function is always nearly Calvo.)



(a) Golosov-Lucas.

(b) Nakamura-Steinsson.

Figure 10: Decomposing the generalized Phillips curve into intensive and extensive margin

Note: Generalized Phillips curves for intensive and extensive pass-through matrices in GL and NS models, calibrated as in table 1.

the actual pass-through matrix and the Calvo pass-through matrix scales with $\alpha\Phi_t^e + (1-\alpha)\Phi_t^i - \Phi_t^{\text{Calvo}}$. In other words, if the virtual survival functions are not individually too far from Calvo, and their average is close to Calvo, then the pass-through matrix (and consequently the generalized Phillips curve via (13)) will be close to Calvo as well.

In figure 6, particularly for the GL model, these conditions are satisfied, explaining why Calvo is such a good approximation: the extensive and intensive survivals are not far from Calvo, and their mixture is even closer. By proposition 2 and remark 1, we expect this to be true quite generally: the two hazard rates always converge to the same constant, and prior to convergence they deviate in offsetting directions.

It is important that the deviations from Calvo in the extensive and intensive survival functions offset each other when averaged, since individually these deviations are larger. In figure 10, we separately plot the generalized Phillips curves corresponding to the intensive and extensive margin time-dependent models. We see that the two margins separately produce fairly different GPCs, deviating from the New Keynesian Phillips curve by far more than in figure 6. In particular, there is persistence in the extensive margin and anti-persistence in the intensive margin. This difference is most pronounced for the NS model.

4.5 Forward-lookingness in the generalized Phillips curve

Although the generalized Phillips curves in figure 10 are distinct from the NKPC, one similarity is striking: as we go backwards in time from the quarter of the shock, both of these margins appear to be decaying at the same rate β as the Calvo Phillips curve. As the following proposition shows, this turns out to be a general result for both time-dependent and menu cost models.

Proposition 3. *Let* $\mathbf{K} = (K_{t,s})$ *be the generalized Phillips curve of an arbitrary convex combination of TD or canonical menu cost pass-through matrices. Then, the columns of* $\mathbf{K}$ *converge to a two-sided sequence*

$\{k_j\}$ around the diagonal, i.e. $K_{s+j,s} \to k_j$ as $s \to \infty$, for each $j \in \mathbb{Z}$. Going backward, this sequence decays at rate β asymptotically, i.e.

$$\lim_{j\to\infty} \frac{k_{-j}}{\beta^j} = C$$

for some constant C.

This proposition shows that the extreme "forward-lookingness" of the NKPC, with future shocks discounted at rate β irrespective of the horizon—which plays an major role in the forward guidance puzzle (Del Negro et al., 2013)—is present in all price-setting models we have introduced in this paper.

4.6 Which Calvo frequency fits best?

So far, we have recovered the Calvo model that most closely approximates a given menu cost model by simulating the latter. Here, we show that it is possible to completely side-step the need for simulation, and instead use a result by Alvarez et al. (2016) to directly recover the slope κ.

Figure 9(b) shows the Calvo duration that provides the best fit to each model across the parameter space of the canonical menu cost model. From any Calvo duration d, we can back out the equivalent Calvo frequency $\text{freq} = 1/(1+d)$, and therefore the slope κ using the standard formula,

$$\kappa = \frac{\text{freq}\,(1-\beta\,(1-\text{freq}))}{1-\text{freq}} = \frac{1-\beta\frac{d}{1+d}}{d} \tag{34}$$

Observe that the relation between menu cost duration and Calvo duration in figure 9(b) is close to linear. This is an instance of the Alvarez et al. (2016) result. Alvarez et al. (2016) showed that, in continuous time, the cumulative impulse response of the price level to a permanent nominal cost shock depends only on the ratio of the kurtosis of price changes to the frequency. Because the Calvo model provides a close approximation to the menu cost model, it must approximately have the same CIR, and therefore the same ratio of kurtosis to frequency,

$$\frac{\text{Kur}^{\text{Calvo}}}{\text{freq}^{\text{Calvo}}} \simeq \frac{\text{Kur}^{\text{MC}}}{\text{freq}^{\text{MC}}} \tag{35}$$

In continuous time, $\text{Kur}^{\text{Calvo}}$ is equal to 6, and Kur^{MC} is a constant less than 6 that depends only on the share of free adjustments, and is equal to 1 in the Golosov-Lucas case. Hence, (35) implies a linear relationship between Calvo and menu cost duration, with a slope equal to $\frac{1}{6}$ under zero free adjustments and increasing as the share of free adjustment rises. These properties are all apparent in figure 9(b). The dashed lines provide a numerical approximation based on the simulated values of $\text{Kur}^{\text{Calvo}}$ and Kur^{MC} in the discrete-time model (where these values are no longer independent of frequency) and show that this formula provides an excellent quantitative fit.[30]

[30] In the discrete-time Calvo model, we have $\text{Kur}^{\text{Calvo}} = 3\left(2 - \text{freq}^{\text{Calvo}}\right)$, while in the discrete-time menu cost model there is no analytical expression and Kur^{MC} must be simulated numerically.

In conclusion, equations (34) and (35), combined with the relationship between Calvo kurtosis and frequency, allow us to obtain a Phillips curve based entirely on the ratio of kurtosis to frequency in the menu cost model.[31] In the limit as $\beta \to 1$, this becomes:

$$\kappa \simeq \frac{4}{\left(\frac{1}{3}\frac{\text{Kur}^{MC}}{\text{freq}^{MC}}\right)^2 - 1} \tag{36}$$

The quantitative implications of (36) are worth stressing. In the data, the frequency of price changes is usually found to be around 0.2 and 0.3 at the quarterly frequency, and the kurtosis of price changes is typically thought to be between 3 and 4. Implementing (36) with these values delivers $\kappa \in [0.1; 0.4]$. By contrast, our menu cost models generate kurtosis of 1.3 for GL and 2.3 for NS at our calibrated frequency of 0.239. Applying (36), we obtain a κ of 1.75 for GL and 0.53 for NS, close to the values delivered by the best-fitting Calvo model. These values are high compared to the $\kappa = 0.08$ implied by a Calvo model with this frequency of price change, and also high compared to typical direct estimates of κ from macro data. We return to this point in the conclusion.

4.7 Additional robustness exercises and extensions

In appendix D.4, we show that the numerical equivalence result between the canonical model and Calvo appears to be quite robust by considering several extensions to our analysis.

First, we consider first-order shocks in alternative menu cost models. This includes models with (a) leptokurtic shocks, (b) two products as in Midrigan (2011), and (c) steady state inflation.[32] The first-order aggregate behavior of these models remains to close that of a suitably parametrized Calvo model. We also consider the multi-sector menu cost model of Nakamura and Steinsson (2010), and show that its aggregate behavior is closely approximated by a multi-sector Calvo model.

One interesting prediction of our model with steady state inflation is that the slope of the Phillips curve should depend on the level of steady state inflation. We show in figure D.3 that the slope increases in steady state inflation for both the GL and NS model.

Second, we consider nonlinear shocks in the canonical menu cost model. In figure D.7 we show that the responses to large shocks to nominal marginal cost are still well approximated by the Calvo model. Figure D.8 shows that the same is true for real marginal cost shocks. This figure also explores aggregate state-dependence, that is, whether large past shocks can influence the impulse responses to additional shocks later on. We find limited evidence of such effects in the context of our calibrations of the canonical menu cost model.

[31] This corresponds to the value of κ when $\frac{1}{\text{freq}^{\text{Calvo}}} = \frac{1}{6}\frac{\text{Kur}^{\text{MC}}}{\text{freq}^{\text{MC}}} + \frac{1}{2}$.

[32] For the model with leptokurtic shocks, our exact equivalence result in proposition 1 still applies. For the model with steady state inflation, a version of proposition 1 applies that allows for three time-dependent models. See the proof of proposition 4 for the idea behind this result.

In the next section, we turn to another, important extension of our baseline model: One that allows for a non-quadratic firm objective function and embeds the model into a general equilibrium setting.

5 General Equilibrium

So far, we have set up both state- and time-dependent models assuming a quadratic objective and linear aggregation. In the analytical menu cost literature, this is sometimes taken as a primitive environment for convenience, and is usually viewed as the correct approximation to a deeper microfounded price-setting problem (e.g. Alvarez and Lippi 2014). We have also studied the generalized Phillips curve as solution to a particular fixed point, solving for inflation as a function of real marginal cost in (13), by analogy to the New Keynesian Phillips curve.

In this section, we justify the use of both the quadratic approximation and the generalized Phillips curve in the context of fully microfounded general equilibrium DSGE models with menu cost price-setting.[33] We show that the first-order perturbation solution of this model is, as idiosyncratic risk becomes small, exactly the same as that of the same model with the generalized Phillips curve **K** replacing the entire price-setting model. We formally show this first in the context of the standard New Keynesian model, with and without strategic complementarity, and then discuss how the result extends to a more complex DSGE model.[34]

5.1 Textbook New Keynesian model with menu costs

Our model is set in discrete time. We closely follow Galí (2008) in terms of model structure and notation, except for the price-setting behavior of the firm. We continue to write the model under perfect foresight over aggregate variables, and to denote log-deviations from the steady state with a hat.

Households. The model is populated by a representative household maximizing the utility function

$$\sum_{t=0}^{\infty} \beta^t \left[\frac{C_t^{1-\sigma}}{1-\sigma} - b \frac{N_t^{1-\varphi}}{1+\varphi} \right]$$

over paths of consumption and hours $\{C_t, N_t\}$ subject to the flow budget constraint

$$P_t C_t + B_t \leq (1 + i_{t-1}) B_{t-1} + W_t N_t + P_t \Pi_t$$

[33] Earlier examples of DSGE models with menu cost pricing are Dotsey et al. (1999) and Costain and Nakov (2011).

[34] As pointed out by Fernández-Villaverde (2010), GE menu cost models are hard to simulate: "The bad news is, of course, that handling a state-dependent pricing model is rather challenging (we have to track a non-trivial distribution of prices), which limits our ability to estimate it. Being able to write, solve, and estimate DSGE models with better pricing mechanisms is, therefore, a first order of business."

and a standard No-Ponzi condition $\lim_{T\to\infty} B_T \geq 0$. The first-order conditions of this problem are given by the usual expressions

$$C_t^{-\sigma} = \frac{P_t}{P_{t+1}}(1+i_t)\, C_{t+1}^{-\sigma} \qquad \text{and} \qquad bN_t^{\varphi} = \frac{W_t}{P_t} C_t^{-\sigma} \tag{37}$$

Consumption C_t is an index bundling many varieties i,

$$C_t \equiv \left(\int_0^1 \left(\frac{C_{it}}{A_{it}} \right)^{\frac{\zeta-1}{\zeta}} di \right)^{\frac{\zeta}{\zeta-1}} \tag{38}$$

where $\zeta > 1$ is the elasticity of substitution between varieties; and A_{it} are idiosyncratic preference shifters. We define aggregate output to be equal to consumption, $Y_t = C_t$. Demand for variety i and the aggregate price index are then given by

$$Y_{it} = A_{it}^{1-\zeta} \left(\frac{P_{it}}{P_t} \right)^{-\zeta} Y_t \qquad \text{and} \qquad P_t = \left(\int_0^1 (A_{it} P_{it})^{1-\zeta} di \right)^{\frac{1}{1-\zeta}} \tag{39}$$

where P_{it} denotes the price of variety i.

Firms. There is a continuum of monopolistically competitive firms. Firm i produces quantity Y_{it} of variety i with linear production function $Y_{it} = A_{it} N_{it}$ from hours N_{it}. Importantly, variety i's preference shifter A_{it} is also firm i's productivity shock. $\log A_{it}$ evolves according to a random walk,

$$\log A_{it} = \log A_{it-1} + \sigma_\epsilon \epsilon_{it}$$

where ϵ_{it} has density $\bar{f}$ satisfying the same restrictions as in section 2. Firm i's real profits at date t are given by

$$\Pi_{it} = \frac{P_{it}}{P_t} Y_{it} - \frac{W_t}{P_t} N_{it} = \left(\frac{P_{it}}{P_t} - \frac{W_t}{P_t} \frac{1}{A_{it}} \right) \cdot A_{it}^{1-\zeta} \left(\frac{P_{it}}{P_t} \right)^{-\zeta} Y_t \tag{40}$$

The firm's statically optimal price, which we denote by $P_{it}^* W_t$ (separating into idiosyncratic P_t^* times the aggregate W_t), is therefore given by the usual constant markup rule

$$P_{it}^* W_t \equiv \frac{\zeta}{\zeta - 1} \frac{W_t}{A_{it}} \tag{41}$$

Substituting out A_{it} from (40) using (41), we can express profits as

$$\Pi_{it} = \left(\frac{\zeta}{\zeta - 1} \frac{W_t}{P_t} \right)^{1-\zeta} Y_t \cdot \left(\left(\frac{P_{it}}{P_{it}^* W_t} \right)^{1-\zeta} - \frac{\zeta - 1}{\zeta} \left(\frac{P_{it}}{P_{it}^* W_t} \right)^{-\zeta} \right) \tag{42}$$

As in section 2, we define firm i's idiosyncratic price gap as

$$x_{it} = \log P_{it} - \log P_{it}^*$$

With this notation, profits can be written entirely as a function of the price gap and aggregate variables,[35]

$$\begin{aligned}\Pi_{it} &= \left(\frac{\zeta}{\zeta-1}\frac{W_t}{P_t}\right)^{1-\zeta} Y_t \cdot \left(e^{(1-\zeta)(x_{it}-\log W_t)} - \frac{\zeta-1}{\zeta}e^{-\zeta(x_{it}-\log W_t)}\right) \\ &\equiv \left(\frac{\zeta}{\zeta-1}\frac{W_t}{P_t}\right)^{1-\zeta} Y_t \cdot F\left(x_{it}-\log W_t\right) \end{aligned} \tag{43}$$

where we have introduced the function $F(x) \equiv e^{(1-\zeta)x} - \frac{\zeta-1}{\zeta}e^{-\zeta x}$. F has a local maximum at 0, that is, $F'(0) = 0$ and $F''(0) < 0$. We can also express the price level P_t from (39) in terms of price gaps,

$$P_t = \frac{\zeta}{\zeta-1}\left(\int_0^1 e^{(1-\zeta)x_{it}}di\right)^{\frac{1}{1-\zeta}} \tag{44}$$

Inflation is still defined as $\pi_t = P_t/P_{t-1} - 1$.

As in section 2, we assume that firms have to pay a random menu cost $\bar{\xi}_{it} \in \{0, \bar{\xi}\}$ when changing their prices, where as before, the probability of a free adjustment, $\bar{\xi}_{it} = 0$, is parametrized by $\lambda \in [0,1)$, and $\bar{\xi} > 0$. Following Golosov and Lucas (2007) and Nakamura and Steinsson (2010), we assume the menu cost are stated in units of labor required to change prices. Moreover, we scale the menu cost by σ_ϵ^2, so that the model is well behaved in the limit of small σ_ϵ. Given this, firm i's profit maximization problem reads

$$\min_{\{x_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t C_t^{-\sigma}\left[\left(\frac{\zeta}{\zeta-1}\frac{W_t}{P_t}\right)^{1-\zeta} Y_t \cdot F\left(x_{it}-\log W_t\right) + \sigma_\epsilon^2 \bar{\xi}_{it}\frac{W_t}{P_t} 1_{\{x_{it}\neq x_{it-1}-\sigma_\epsilon\epsilon_{it}\}}\right] \tag{45}$$

where $\beta^t C_t^{-\sigma}$ is the representative agent's stochastic discount factor up to a multiplicative constant.

The aggregate amount of labor required for menu costs is given by

$$\Xi_t \equiv \int_0^1 \sigma_\epsilon^2 \bar{\xi}_{it} 1_{\{x_{it}\neq x_{it-1}-\sigma_\epsilon\epsilon_{it}\}}di \tag{46}$$

Aggregate profits $\Pi_t \equiv \int_0^1 \Pi_{it}di$ are paid directly to the representative agent. With the help of (44), aggregate labor demand by firms can be written as

$$N_t^d \equiv Y_t\Delta_t + \Xi_t \tag{47}$$

where $\Delta_t \equiv \left(\int_0^1 e^{(1-\zeta)x_{it}}di\right)^{\frac{\zeta}{1-\zeta}} \int_0^1 e^{-\zeta x_{it}}di \geq 1$ captures the productivity loss due to price dispersion.

Monetary policy rule. We assume the central bank operates a standard Taylor rule, $i_t = \rho + \phi\pi_t + v_t$ where $\rho = \beta^{-1} - 1$ is the discount rate, $\phi > 1$, and v_t is a monetary policy shock.

[35] Without introducing A_{it} as simultaneous preference and technology shocks, this would not be feasible.

Market clearing and equilibrium. The goods market clearing condition is simply given by $C_t = Y_t$. Labor market clearing is given by $N_t = N_t^d$. Asset market clearing is given by $B_t = 0$. A competitive equilibrium is an allocation $\{C_t, N_t, N_t^d, Y_t, B_t, \Xi_t, Y_{it}, N_{it}, \Pi_t\}$ together with prices $\{P_t, P_{it}, W_t, \pi_t, i_t\}$ such that the representative agent maximizes utility, the central bank follows its rule, and all firms maximize the present discounted value of their profits.

Steady state with no aggregate shocks. A steady-state equilibrium with no aggregate shocks ($\nu_t \equiv 0$) is characterized by a set of constant aggregates $\{N_{ss}, Y_{ss}, \Xi_{ss}, P_{ss}, W_{ss}, i_{ss}, \Delta_{ss}\}$. It follows from the monetary policy rule and steady-state Euler equation (37) that steady-state inflation must be zero and $\beta(1 + i_{ss}) = 1$. We resolve indeterminacy of steady-state prices and wages with the normalization $W_{ss} = 1$.[36]

In the case with no idiosyncratic shocks or menu costs ($\sigma_\epsilon = 0$), then all price gaps are zero, and we also have $\Delta_{ss} = 1$, $\Xi_{ss} = 0$, $P_{ss} = \frac{\zeta}{\zeta-1}$, $Y_{ss} = N_{ss}$, and $bN_{ss}^\varphi = \frac{\zeta}{\zeta-1} Y_{ss}^{-\sigma}$. In appendix E, we show that all steady-state aggregates converge to these $\sigma_\epsilon = 0$ levels as we take the limit $\sigma_\epsilon \to 0$.

First-order response to aggregate shocks around steady state. Following a vast literature (see, in particular, Reiter 2009), we are interested in the first-order perturbation solution in aggregates around the steady state described above. In particular, we consider an arbitrary bounded perturbation $\{d\nu_t\}_{t=0}^\infty$ to the intercept of the Taylor rule from date 0 onward, assuming that the economy begins in the steady state, and we solve for the implied perturbations to endogenous variables, e.g. $\{dY_t\}$, $\{d\pi_t\}$, and $\{di_t\}$.

In appendix E.1, we describe the equations that characterize this solution in the sequence space. We note that this solution depends on the σ_ϵ that scales idiosyncratic risk. The following proposition, however, shows that in the limit of small idiosyncratic risk, the impulse responses of $\hat{Y}_t \equiv dY_t/Y_{ss}$, $\hat{\pi}_t \equiv d\pi_t$, $\hat{i}_t \equiv di/(1 + i_{ss})$, and $\hat{\nu}_t \equiv d\nu_t$ satisfy a simple analog to the standard three-equation New Keynesian model.[37]

Proposition 4. *As $\sigma_\epsilon \to 0$, the equations characterizing $\{\hat{Y}_t, \hat{\pi}_t, \hat{i}_t, \hat{\nu}_t\}$ converge to*

$$\hat{Y}_t = \hat{Y}_{t+1} - \frac{1}{\sigma}(\hat{i}_t - \hat{\pi}_{t+1}) \tag{48}$$

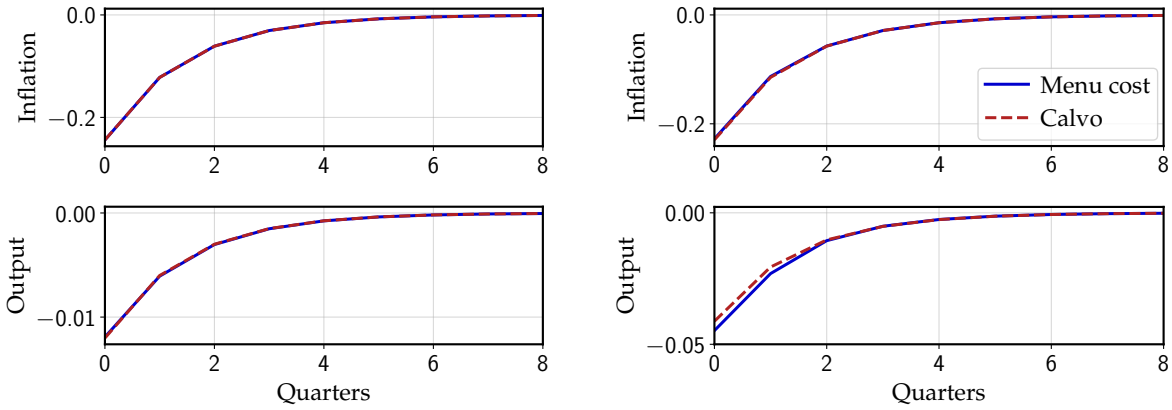
$$\hat{\boldsymbol{\pi}} = (\varphi + \sigma)\, \mathbf{K} \cdot \hat{\mathbf{Y}} \tag{49}$$

$$\hat{i}_t = \phi \hat{\pi}_t + \hat{\nu}_t \tag{50}$$

where $\mathbf{K}$ is the generalized Phillips curve implied by the canonical menu cost model in section 2.1, given the same share of free adjustments λ, idiosyncratic innovations to x/σ_ϵ distributed as $\bar{f}$, and a ratio of menu cost to idiosyncratic risk $\frac{\bar{\xi}}{\sigma_\epsilon^2} = \left(\frac{\zeta-1}{\zeta}\right)^{1-\zeta} \left(\frac{W_{ss}}{P_{ss}}\right)^{\zeta} \frac{1}{Y_{ss}} \frac{2\bar{\xi}}{F''(0)}$.

[36] The remaining equations characterizing the steady state are the labor-consumption FOC $bN_{ss}^\varphi = \frac{W_{ss}}{P_{ss}} Y_{ss}^{-\sigma}$, labor demand plus market clearing $N_{ss} = Y_{ss}\Delta_{ss} + \Xi_{ss}$, and three equations for P_{ss}, Δ_{ss}, and Ξ_{ss} from the price-setting problem.

[37] Here, the ss subscripts refer to the steady state with no idiosyncratic or aggregate risk.



(a) Golosov-Lucas.

(b) Nakamura-Steinsson.

Figure 11: Impulse responses for the standard New Keynesian model with state-dependent pricing.

Note: both pricing blocks were calibrated as in table 1. The approximating Calvo models are constructed in section (4). The other dynamics are given by equations (48) — (50).

Relative to the standard three-equation New Keynesian model, the only change in (48)–(50) is that the New Keynesian Phillips curve, which in this context is $\hat{\pi}_t = (\varphi + \sigma)\kappa\hat{Y}_t + \beta\hat{\pi}_{t+1}$, has been replaced by the generalized Phillips curve (49). In short, for small enough idiosyncratic risk, the entire pricing side of the model can be summarized by (49) for the purpose of characterizing first-order aggregate impulse responses.

Intuitively, why does proposition 4 hold? In most respects, our model is identical to the standard New Keynesian framework, leading to the same intertemporal Euler equation, and real marginal cost $\widehat{mc}_t = (\varphi + \sigma)\hat{Y}_t$. The key difference is that Calvo pricing is replaced by a more complex menu cost model, which leads to several complications. For instance, for $\sigma_\epsilon > 0$, both price dispersion and aggregate menu costs are time-varying and enter into the log-linearized aggregate equations; also, first-order changes in the real wage W_t/P_t and level of production Y_t enter into the firm decision problem and affect aggregate pricing. All these terms, however, vanish from the first-order aggregate system as σ_ϵ goes to zero. The only aggregate relationship that remains is between aggregate wages and aggregate prices, just as in the canonical model. Moreover, for small σ_ϵ, the firm profit objective (43) becomes quadratic and price aggregation (44) becomes linear, both as in the canonical model, leading to the same generalized Phillips curve **K**.

Figure 11 implements (48)–(50), plotting the response of the model to an AR(1) monetary policy shock v with magnitude 0.25 on impact and persistence 0.5. The calibration used is the same as that in Galí (2008): $\sigma = 1, \varphi = 5, \phi = 1.5, \rho = 0.01$. As expected, the NS model predicts an output response that is about three times as large as the one predicted by GL. Both impulse responses are closely matched when (49) is replaced by the New Keynesian Phillips curve for the best-fitting Calvo approximation found in section 4.

In appendix E.4, we show that (48)–(50) continue to provide an excellent approximation to the fully nonlinear case even when σ_ϵ is set to match our original calibration, which targets the

average size of price changes.

5.2 Strategic complementarities

Both output responses in figure 11 are relatively modest. As pointed out in the literature, this partly reflects the lack of strategic complementarities.

Following Nakamura and Steinsson (2010), we now introduce strategic complementarities to the model by assuming roundabout production of a particular type.[38] We modify firm i's production function to be $Y_{it} = A_{it} N_{it}^{\chi} X_{it}^{1-\chi}$, where X_{it} is the amount of an intermediate input used by firm i. The intermediate input itself is produced from the same CES (38) aggregate as consumption. Observe that $1-\chi$ measures the extent of strategic complementarity in price-setting, since it makes firms' marginal cost more dependent on their competitors' prices.

In appendix E.5, we show the following.

Proposition 5. *In the strategic complementarity model, proposition 4 continues to apply unchanged, except that the generalized Phillips curve (49) is now replaced by*

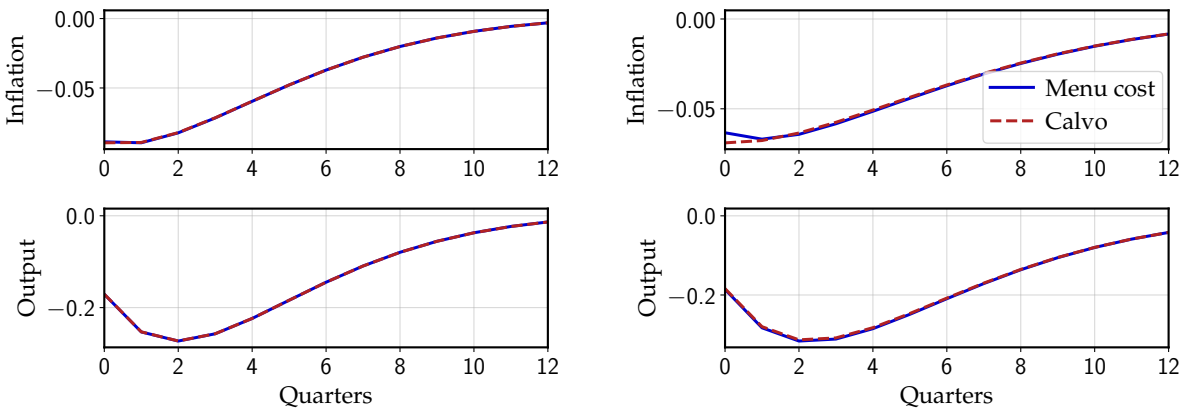
$$\boldsymbol{\pi} = (\varphi + \sigma)\, \chi \mathbf{K} \cdot \hat{\mathbf{Y}} \tag{51}$$

This generalizes an existing result from the Calvo literature that strategic complementarities scale down the slope parameter κ in the New Keynesian Phillips curve—exactly the same as one would obtain with less frequent price adjustment. Similarly, proposition 5 shows that in the menu cost model, strategic complementarity scales down the generalized Phillips curve $\mathbf{K}$ by χ. Since we have found that $\mathbf{K}$ is close to the Calvo NKPC, this amounts to scaling down κ, as in the standard result.

While the proof of proposition 5 requires the same formal $\sigma_\epsilon \to 0$ limit as in proposition 4, the basic logic only requires the concepts from section 2. With strategic complementarity, prices are given by $\hat{\mathbf{P}} = \Psi(\chi \widehat{\mathbf{MC}} + (1-\chi)\hat{\mathbf{P}})$, which can be rewritten in terms of real marginal cost as $\hat{\mathbf{P}} = \Psi\left(\chi \widehat{\mathbf{mc}} + \hat{\mathbf{P}}\right)$, where $\widehat{\mathbf{MC}}$ and $\widehat{\mathbf{mc}}$ are shocks to the marginal cost of labor. This is identical to (12), except with $\widehat{\mathbf{mc}}$ scaled down by χ. Hence the mapping $\mathbf{K}$ from $\widehat{\mathbf{mc}}$ and $\boldsymbol{\pi}$ derived in (13) is also scaled down by χ.

This result complements parallel work by Alvarez et al. (2022b), who characterize, in continuous time, the impulse response of prices $\hat{\mathbf{P}}$ in models with strategic complementarity with respect to permanent *nominal* marginal cost shocks $\widehat{\mathbf{MC}}$. Because this impulse response satisfies $\hat{\mathbf{P}} = \chi \sum_{k\geq 0} \left((1-\chi)^k \Psi^{k+1}\right) \widehat{\mathbf{MC}}$, no simple scaling result comparable to (51) is attainable. Instead, their characterization exploits the fact that Ψ is self-adjoint and compact in a well-chosen norm.

[38] Alternative forms of strategic complementarities considered in the menu-cost literature include kinked demand curves (Klenow and Willis 2016) and oligopolistic competition (Mongey 2021). These "micro" strategic complementarities act differently from the "macro" strategic complementarity we consider here because they also narrow the *Ss* bands for given idiosyncratic shocks and menu costs. With an appropriate recalibration of the steady state, these can provide alternative microfoundations for our χ. Under a Calvo assumption, Gopinath and Itskhoki (2011) derive the implications of kinked demand curves for the aggregate Phillips curve, and Wang and Werning (2022) derive the more complex effects of oligopolistic competition.



(a) Golosov-Lucas.

(b) Nakamura-Steinsson.

Figure 12: Impulse response to monetary shock for Smets-Wouters model with state-dependent pricing.

Note: both pricing blocks were calibrated as in table 1. The approximating Calvo models are constructed in section (4). The other dynamics are those in Smets and Wouters (2007).

5.3 Smets-Wouters model with menu costs

The logic behind proposition 4 continues to apply to a broader set of DSGE models: in the limit of small idiosyncratic shocks, the model with menu costs is equivalent to the model with Calvo pricing, but with the NKPC replaced by the generalized Phillips curve (49). To illustrate this result, figure 12 simulates a Smets and Wouters (2007) model with menu cost pricing. In this model, all equations and parameters are those from Smets and Wouters (2007) (estimated parameters are equal to their posterior means), with the exception of the price Phillips curve, which we replace by the generalized Phillips curve $\mathbf{K}$ of either the GL or the NS model, as well as by the respective approximating Calvo models. Now, the output responses to a monetary shock are more comparable across GL and NS, reflecting the presence of wage rigidities as an additional source of nominal rigidity. However, replacing the menu-cost model with its approximating Calvo model still provides an extremely close fit.

6 Obtaining the Generalized Phillips Curve from Micro Data

Our results so far have focused on the canonical menu cost model, with a two-point distribution of menu costs $\{0, \xi\}$. While this is a workhorse model in the literature, it has difficulty matching the empirical distribution of price changes. Instead, the data appears to call for a model with a generalized hazard function, as implied by a more general distribution of menu costs (Alvarez et al., 2022a).[39]

In this section, we extend our analysis to this case. We generalize our exact equivalence result to generalized hazards, and show that the pass-through matrix and GPC of the model can be

[39] See Berger and Vavra (2018), Caballero and Engel (1993), Gagnon, López-Salido and Vincent (2013), Luo and Villar (2021) for papers that estimate the empirical hazard function.

computed directly from the data without the need to resort to model simulation. This makes the empirical distribution of price changes, together with the overall frequency of adjustment, a sufficient statistic for the first-order relationship between real marginal cost and inflation.

Allowing for a general distribution of menu costs. As in section 2.1, we consider a continuum of firms, each solving the cost minimization problem (2). Now, however, we assume that ξ_{it} is iid drawn from a general distribution with continuous cdf $H(\cdot)$. The main implication of this change is that the law of motion is now no longer described by *Ss* bands $[\underline{x}_t, \overline{x}_t]$ and a reset price gap x_t^*; instead, there is a state-dependent generalized hazard function $\Lambda_t(x) \in [0,1]$ that captures the adjustment probability for a given price gap x at time t. The law of motion of price gaps is then given by

$$x_{it} = \begin{cases} x_t^* & \text{with probability } \Lambda_t(x_{it-1} - \epsilon_{it}) \\ x_{it-1} - \epsilon_{it} & \text{otherwise, with } \epsilon_{it} \sim \mathcal{N}(0, \sigma_\epsilon^2) \end{cases} \tag{52}$$

Note that here we assume that ϵ_{it} is drawn from a normal distribution with variance σ_ϵ^2, as in our calibrations of the canonical menu cost model in section 2.5.

In the steady state, $\Lambda(x)$ is symmetric and $x^* = 0$. We continue to denote the stationary distribution of price gaps before adjustment by $g(x)$. The steady state distribution of price changes has the density $\Delta p \mapsto \Lambda(-\Delta p)g(-\Delta p)$. We continue to denote the frequency of adjustment by $\text{freq} = \int \Lambda(x)g(x)dx$, and expected price gaps by $E^t(x) \equiv \mathbb{E}[x_{it}|x_{i0} = x]$.

Generalizing proposition 1. In the exact equivalence result of section 3, only two TD models were necessary to describe the aggregate pricing behavior of the menu cost model. This is because there were only two margins of adjustment of policies in response to shocks: *Ss* bands could shift in parallel (the extensive margin), and the reset gap could shift (the intensive margin).

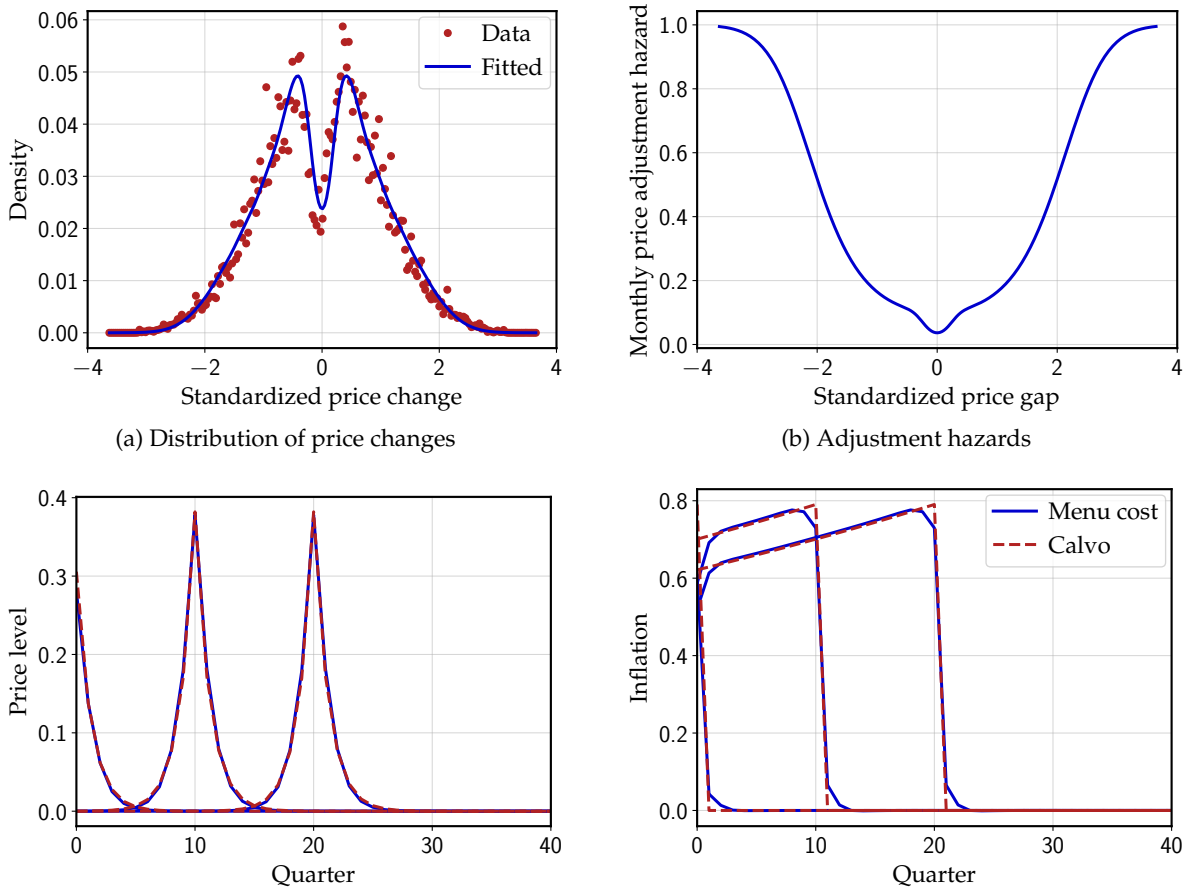
In the extended model, the entire hazard function shifts in response to shocks. Intuitively, there are more margins of adjustment, one for each level of the price gap x. Proposition 1 then has the following generalization.

Proposition 6. *The pass-through matrix of a generalized hazard model can be written as*

$$\Psi = \mathit{freq} \cdot \sum_{t=0}^{\infty} E^{t\prime}(0) \cdot \Psi^{\Phi^i} + \int \Lambda'(x)g(x) \cdot \left(\sum_{t=0}^{\infty} E^t(x) \right) \cdot \Psi^{\Phi^e(x)} dx \tag{53}$$

where $\Phi_t^i = E^{t\prime}(0)$ *as before; and* $\Phi_t^e(x) = E^t(x)/x$.

Here, the extensive margin in (53) depends on an entire integral of TD pass-through matrices with different survival functions $\Phi_t^e(x)$. However, as we demonstrate next, all objects in (53) can be directly extracted from data on price changes, without any model simulation. In other words, the result in proposition 6 lets us compute the pass-through matrix, and thus also the generalized Phillips curve, based on the distribution as price changes as a sufficient statistic.



(a) Distribution of price changes

(b) Adjustment hazards

(c) Pass-through matrix

(d) Generalized Phillips curve

Figure 13: Backing out the generalized Phillips curve from price change data alone.

Backing out generalized hazard and stationary distribution. To back out the objects in (53) from price change data, we proceed as follows. The frequency freq on the right hand side of (53) is readily observable. Conservation of variance implies that $\sigma_\epsilon^2 = \text{freq} \cdot \text{Var}(\Delta p)$. Next, we guess a symmetric generalized hazard function $\Lambda(x)$. Given σ_ϵ^2 and $\Lambda(x)$, we compute the stationary distribution $g(x)$ and compare the observed density of price changes Δp with the theoretical density, equal to $\Lambda(-\Delta p)g(-\Delta p)$. We iterate this procedure until we find a suitable generalized hazard function $\Lambda(x)$. Finally, we note that the expected price gap function $E^t(x)$ can be directly computed based on the recovered $\Lambda(x)$ and σ_ϵ^2. This gives us everything needed to evaluate the right hand side of (53), without any model simulation.

Example from Israel. We show how this approach works for data on supermarket prices from Israel. The top row in figure 13 shows the observed distribution of daily standardized price changes in the data (red) as well as the fitted curve. The hazard function is U shaped. The pass-through matrix and generalized Phillips curve are both well approximated by Calvo models, just as we had found for the canonical menu cost model.

7 Conclusion

In the past two decades, the growing availability of micro data on prices has spurred the development of a large literature that models price-setting decisions in presence of idiosyncratic shocks and menu costs. In this paper, we show that these new models have the same first-order aggregate implications as older time-dependent models, provided that the hazard rates of price adjustment are suitably chosen. We provide sufficient statistic formulas to recover these virtual hazard rates—and therefore the generalized Phillips Curve of the menu cost model—either directly from price change data, or from simulations of the steady-state of the menu cost model.

We find that the generalized Phillips curve of these menu-cost models is very close to the Calvo Phillips curve, but with a higher slope. In our benchmark calibrations of the Golosov-Lucas and the Nakamura-Steinsson models, the slopes are $\kappa = 1.71$ and $\kappa = 0.47$, compared to a slope of $\kappa = 0.08$ in the Calvo model with the same frequency of price adjustment. By contrast, estimates based on macro data suggests that the slope of the aggregate Phillips curve may be even below this Calvo slope. For instance, Hazell, Herreño, Nakamura and Steinsson (2022) recently estimated $\kappa = 0.0031$, and pointed out that typical values in the macro literature are all below 0.05.[40]

We showed that strategic complementarities can, in principle, reconcile the micro and macro estimates: in our roundabout production model, they simply scale the generalized Phillips curve. It remains an open question, however, whether empirically plausible complementarities can lower the Phillips curve slope enough to match the recent macro estimates.

Simple strategic complementarities, however, cannot solve two broader issues with the New Keynesian Phillips curve: the lack of intrinsic inflation persistence (e.g. Fuhrer and Moore 1995, Galí et al. 2001), and the extreme forward-lookingness at the heart of the forward guidance puzzle (e.g. Del Negro et al. 2013). Multi-sector models with complex input-output linkages, or deviations from full information rational expectations, could be fruitfully combined with menu cost models to continue matching micro data on price changes while solving these broader issues that arise when confronting the generalized Phillips curve with the macro data.

On the theoretical side, our work also leaves open questions. First, comparing the second-order implications of menu cost vs Calvo models would shed light on their relative implications for optimal monetary policy. Finally, the equivalence between state-dependent and time-dependent models may also find applications in other fields where fixed costs are an important component of decisions, such as those of adjusting capital (e.g. Khan and Thomas 2008) or purchasing a durable good (e.g. Berger and Vavra 2015).

[40] These numbers converts their Table III estimates by assuming that the elasticity of real marginal cost to unemployment is 2, as follows from a calibration of the textbook New Keynesian model in section 5.1 with $\varphi + \sigma = 2$.

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Appendix for "New Pricing Models, Same Old Phillips Curves"

A Continuous-Time Version of Our Results

In this appendix, we extend our equivalence result between time- and state-dependent pricing models to a continuous time setting. We start by setting up a random menu cost model in continuous time, based on Alvarez et al. (2016) and Alvarez et al. (2022b), then move to time-dependent models, and finish by exploring the connection between both.

A.1 A random menu cost model

There is a continuum of firms, indexed by $i \in [0,1]$, each one selling a single product, whose at price at instant t is denoted p_{it}. Each firm has a static optimal price that is the sum of an idiosyncratic term p^*_{it} and a common nominal marginal cost component $MC(t)$. The idiosyncratic component is assumed to follow an i.i.d. Brownian motion without drift:

$$dp^*_{it} = -\sigma dW_{it}, \tag{54}$$

where W_{it} is a standard Wiener process. As in our discrete time setting, we work in a perfect-foresight environment, in which at $t = 0$ a path for $MC(t)$ is announced. Prior to $t = 0$, the economy is at steady state.

Firms may adjust their prices either by paying a fixed menu cost ξ or by receiving a random free adjustment opportunity, which arrives at a Poisson rate $\lambda \in [0, \infty)$. At any given instant, firms face economic losses for not charging their optimal prices. As in the discrete time case, define the price gap $x_{it} = p_{it} - p^*_{it}$. Losses are then given by $\frac{1}{2}(x_{it} - MC(t))^2$.

In the absence of price adjustments, x_{it} follows the Brownian motion

$$dx_{it} = \sigma dW_{it}.$$

Moreover, it is well known that the presence of a fixed menu cost generates an optimal policy that takes the form of an inaction region a reset point. Since the common shock $MC(t)$ evolves over time, the optimal policy is also time-varying, with the inaction interval taking the form $(\underline{x}(t), \overline{x}(t))$ and the reset point denoted $x^*(t)$.

We can state the firm problem recursively in terms of the state variable x, as follows. There is a value function $V(t,x)$, which obeys the following Hamilton-Jacobi-Bellman (HJB) equation inside the inaction region:

$$\rho V(t,x) = \frac{1}{2}\left(x - MC(t)\right)^2 + \frac{\sigma^2}{2}\partial_{xx}V(t,x) + \lambda\left(V(t,x^*(t)) - V(t,x)\right) + \partial_t V(t,x), \text{ for } x \in (\underline{x}(t), \overline{x}(t)), \tag{55}$$

where ρ is the discount rate. At the boundaries of the inaction region, we have the following value matching and smooth pasting conditions, which, together with the optimality condition for the reset point $x^*(t)$, complete the recursive characterization of the problem:

$$V(t, \underline{x}(t)) = V(t, \overline{x}(t)) = V(t, x^*(t)) + \xi,$$

$$\partial_x V(t, \underline{x}(t)) = \partial_x V(t, \overline{x}(t)) = \partial_x V(t, x^*(t)) = 0.$$

Given the optimal policies in response to the shock $MC(t)$, the next step is to compute the distribution of price gaps. Let $g(t, x)$ be the probability density function of price gaps at time t. It evolves according to a Kolmogorov forward equation:

$$\partial_t g(t, x) = \frac{\sigma^2}{2} \partial_{xx} g(t, x), \tag{56}$$

equipped with the following conditions:

$$g(t, \underline{x}(t)) = g(t, \overline{x}(t)) = 0,$$

$$g(t, x) \text{ continuous at } x^*(t),$$

$$\int_{\underline{x}(t)}^{\overline{x}(t)} g(t, x)\, dx = 1.$$

This equation is solved forward, with the initial condition at $t = 0$ being steady state distribution. As in the discrete time case, deviations of the price level to its steady state values, in logs, are given by

$$p(t) = \int x\, g(t, x)\, dx. \tag{57}$$

By first applying the HJB equation (55), followed by the KFE (56), one can compute the price level response to any nominal marginal cost shock.

A.2 Time-dependent models

As in discrete time, price setting in a time-dependent model is governed by a survival function $\Phi(s)$. Prices are randomly selected to adjust depending only on the time elapsed since the last adjustment, and $\Phi(s)$ is the probability that a price remains fixed for a time interval of length $\geq s$. This immediately implies $\Phi(0) = 1$. Again, each firm has a price gap $x_{it} = p_{it} - p_{it}^*$, with p_{it}^* evolving as in (54). Upon adjustment, firms choose a reset gap that solves

$$x^*(t) = \arg\max_x \frac{1}{2} \mathbb{E}_t \int_t^\infty e^{-\rho(s-t)} \Phi(s-t) \left(x + p_{it}^* - p_{is}^* - MC(s)\right)^2 ds,$$

which is given by

$$x^*(t) = \frac{1}{\int_0^\infty e^{-\rho s}\Phi(s)\,ds} \int_0^\infty e^{-\rho s}\Phi(s)MC(t+s)\,ds. \tag{58}$$

One can compute the log of the aggregate price level from past pricing decisions as

$$p(t) = \frac{1}{\int_0^\infty \Phi(s)\,ds} \int_0^\infty \Phi(s)\,x^*(t-s)ds. \tag{59}$$

There is a clear analogy between the above expressions and their discrete time counterparts from section 2.

A.3 The pass-through operator

Both classes of models above generate a mapping from the aggregate marginal cost path $MC(t)$ to the price level $p(t)$, which we denote

$$p(t) = \mathcal{P}(t; \{MC(s)\}).$$

This can be linearized around $MC(t) = 0$ to obtain the first-order impulse response

$$p(t) = \int_0^\infty \Psi(t,s)MC(s)\,ds. \tag{60}$$

We call the operator on the right hand side of (60) the *pass-through operator*. Similarly to the discrete time case, for time-dependent models it is given by the composition of the operators in (58) and (59).

Before proceeding to the exact equivalence result in continuous time, it is necessary to generalize the notion of a survival function. From the definition of a survival function, it is clear that $\Phi(0) = 1$. Expressions (58) and (59), however, still define mathematically consistent mappings when $\Phi(s) \neq 1$ and even in cases where $\Phi(s) \to \infty$ as $s \to 0$, as long as this function has a finite integral on $[0, \infty)$.[41] When working with time-dependent pass-through operators, we allow for this possibility and refer to Φ as a *generalized survival function*.

A.4 Exact equivalence in continuous time

Consider a random menu cost model in steady state. Given the symmetry of the problem, the inaction region can be written as $(-\overline{x}, \overline{x})$ and the reset point is $x^* = 0$. Let x_t be the price gap of a

[41] Of course, it must still satisfy the other required properties of a survival function: it must be non-increasing, converge to zero as $s \to \infty$, and start at a positive (but not necessarily finite) $\Phi(0) > 0$.

firm that follows this optimal policy and define

$$E(t,x) = \mathbb{E}\left[x_t | x_0 = 0\right].$$

Exactly as in discrete time, the pass-through operator of the state-dependent model Ψ can be written as

$$\Psi = \alpha \Psi^{\Phi^e} + (1-\alpha)\,\Psi^{\Phi^i}.$$

The intensive margin pass-through operator Ψ^{Φ^i} is associated with the following generalized survival function:

$$\Phi^i(t) = \partial_x E(t,0),$$

while extensive margin component arises from the generalized survival function

$$\Phi^e(t) = \partial_x E(t,\overline{x}).$$

As we explain in more detail below, even though we call Φ^i a generalized survival function, it satisfies $\Phi^i(0) < \infty$ and could therefore be normalized to become a proper survival function. On the other hand, we have $\Phi^e(0) = \infty$, and so we must interpret the extensive margin component in the generalized sense. The weight α is given by

$$\alpha = f \times \int_0^\infty \partial_x E(t,0)\, dt,$$

where f is the flow of price adjustments, i.e.,

$$f = \lim_{\Delta t \to 0} \frac{\text{fraction of prices that change in } (t, t+\Delta t)}{\Delta t}.$$

The advantage of the continuous time approach is that it is possible to solve for $E(t,x)$ explicitly. First, it satisfies the Kolmogorov backward equation:

$$\frac{\partial E}{\partial t}(t,x) = \frac{\sigma^2}{2}\frac{\partial^2 E}{\partial x^2}(t,x) - \lambda E(t,x), \tag{61}$$

$$E(t,\underline{x}) = E(t,\overline{x}) = 0 \text{ for } t > 0,$$

$$E(0,x) = x.$$

Alvarez and Lippi (2022) provide a closed-form solution to this equation, which we reproduce here. Define

$$\eta_j = -\left[\lambda + \frac{\sigma^2}{2}\left(\frac{j\pi}{2\overline{x}}\right)^2\right],$$

$$\varphi_j(x) = \frac{1}{\sqrt{\overline{x}}} \sin\left(\frac{x+\overline{x}}{2\overline{x}} j\pi\right),$$

for $j = 1, 2, 3, \ldots$. These are the eigenvalues and corresponding eigenfunctions of the operator on the right hand side of (61). Moreover, let

$$b_j = \frac{4\overline{x}^{3/2}}{j\pi},$$

which are the coefficients one obtains from projecting the function $f(x) = x$ onto the eigenfunctions above.

Having defined these objects, we can express $E(t, x)$ as

$$E(t, x) = \sum_{j \text{ even}} e^{\lambda_j t} b_j \varphi_j(x).$$

Only even terms appear in the above summation because the function $f(x) = x$ is odd, and is therefore orthogonal to the eigenfunctions with odd indices, which are even functions.

From the previous result, we can compute $\Phi^i(t)$ as

$$\partial_x E(t, 0) = 2 \sum_{j \text{ even}} (-1)^{j/2} e^{\eta_j t}$$

and $\Phi^e(t)$ as

$$\partial_x E(t, \overline{x}) = 2 \sum_{j \text{ even}} e^{\eta_j t}.$$

Note that it immediately follows that $\Phi^e(0) = \infty$. We can also compute the associated adjustment hazards, defined as

$$\lambda^e(t) = -\frac{\partial}{\partial t} \log \Phi^e(t) = -\frac{\sum_{j \text{ even}} \eta_j e^{\eta_j t}}{\sum_{j \text{ even}} e^{\eta_j t}},$$

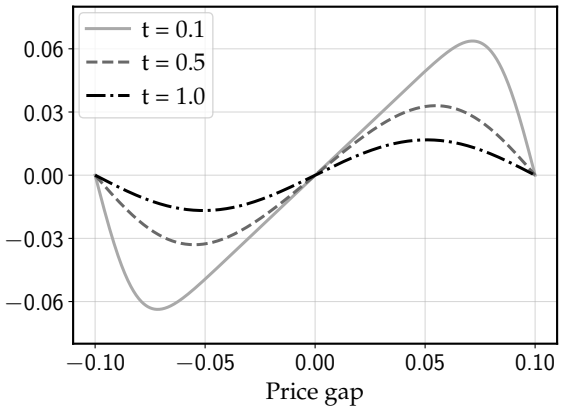
$$\lambda^i(t) = -\frac{\partial}{\partial t} \log \Phi^i(t) = -\frac{\sum_{j \text{ even}} (-1)^{j/2} \eta_j e^{\eta_j t}}{\sum_{j \text{ even}} (-1)^{j/2} e^{\eta_j t}}.$$

From the expressions above, it follows immediately that

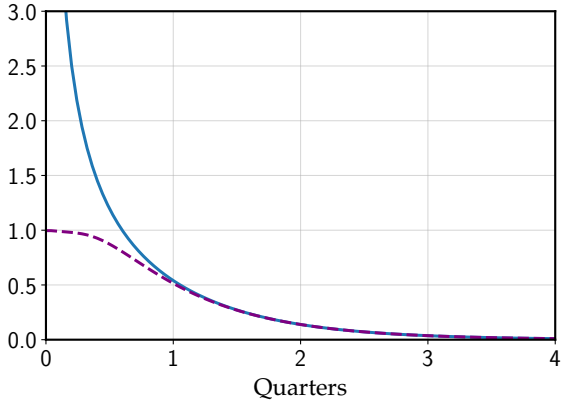
$$\lim_{t \to \infty} \lambda^e(t) = \lim_{t \to \infty} \lambda^i(t) = -\lambda_2,$$

echoing our analogous result for the discrete time case (proposition 2). Figure A.1 shows $E(t, x)$, the generalized survival functions, and the corresponding adjustment hazards for illustrative parameter values. Notice that the extensive margin adjustment hazard $\lambda^e(t)$ must also be interpreted in a generalized sense, since $\lim_{t \to 0} \lambda^e(t) = \infty$.[42]

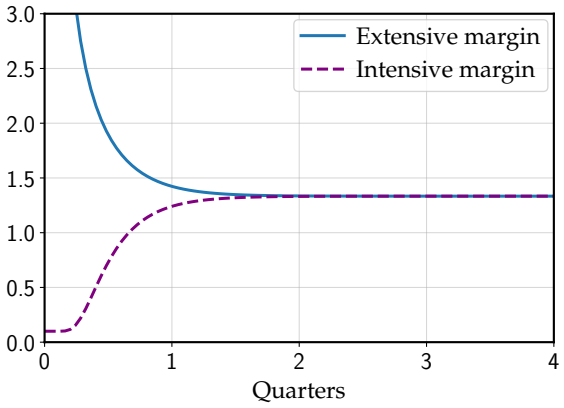
[42] We conjecture that $\lambda^e(t)$ can also be interpreted as the arrival hazard of a point process with countably many points but infinite average density.



(a) $E(t, x)$.



(b) $\Phi^e(t)$ and $\Phi^i(t)$.



(c) $\lambda^e(t)$ and $\lambda^i(t)$.

Figure A.1: Expected price gaps and generalized survival functions and hazards.

Note: illustrative calibration with parameter values $\sigma = 0.05$, $\lambda = 0.1$, and the menu cost is such that $\overline{x} = 0.1$.

B Appendix to Section 2

B.1 Characterizing steady-state policy and distribution

We can rewrite the steady-state version of (2) recursively with the Bellman equation

$$V^n(x) \equiv \frac{1}{2}x^2 + \beta(1-\lambda)\mathbb{E}\left[\min(V^{n-1}(x+\epsilon), \xi + \min_{x^*} V^{n-1}(x^*))\right] + \beta\lambda \min_{x^*} V^{n-1}(x^*) \tag{62}$$

whose fixed point is the value function $V(x)$ given a post-adjustment price gap of x (not including any costs already paid to adjust).

Reducing to bounded V on an interval $[-M, M]$. First, we observe that any value function V should satisfy $V(x) \geq \frac{1}{2}x^2$. Second, we have $V(0) \leq \frac{\beta}{1-\beta}(1-\lambda)\xi$, where the right is the value from the feasible policy of always adjusting to stay at $x = 0$.

It follows that for sufficiently large x (i.e. $|x| \geq M$ for some M), $V(x)$ must be strictly greater than $\xi + V(0)$. Hence, for these x the pricesetter strictly prefers to adjust, and we have $\min(V(x), \xi + \min_{x^*} V(x^*)) = \min_{x^*} V(x^*)$. It is therefore not necessary to keep track of V outside $[-M, M]$ to evaluate (62) inside $[-M, M]$, or to obtain the optimal policy anywhere. Hence, when analyzing (62), we restrict ourselves to $[-M, M]$. Further, we note that the value function satisfies $V(x) \leq \frac{1}{2}M^2 + \frac{\beta}{1-\beta}(1-\lambda)\xi$ for all $x \in [-M, M]$, so that we can restrict our attention to bounded V.

From now on, our restriction to $[-M, M]$ will be implicit. We will assume that M is picked to be large enough that, for all parameters we consider, the firm always adjusts for $|x| \geq m$, for some $m < M$.

Characterizing value function steps. Suppose that $V^{n-1}(x)$ is nonnegative, symmetric around 0, continuously differentiable, and satisfies $(V^{n-1})'(x) > 0$ for $x > 0$. Suppose also that it satisfies $V^{n-1}(x) \geq \frac{1}{2}x^2$ and $V^{n-1}(0) \leq \frac{\beta}{1-\beta}(1-\lambda)\xi$.

It follows that the minimum will be at $x^* = 0$, and also that there will be some $0 < \bar{x} < M$[43] such that $V^{n-1}(x) < \xi + V^{n-1}(0)$ for all $x > \bar{x}$, and symmetrically for $x < -\bar{x}$. This allows us to replace (62) by the more specific

$$\begin{aligned} V^n(x) = \frac{1}{2}x^2 &+ \beta(1-\lambda)\int_{-\bar{x}}^{\bar{x}} f(x'-x)V^{n-1}(x')dx' \\ &+ \beta(1-\lambda)(V^{n-1}(0)+\xi)\left(1 - \int_{-\bar{x}}^{\bar{x}} f(x'-x)dx'\right) + \beta\lambda V^{n-1}(0) \end{aligned} \tag{63}$$

where $\bar{x}$ is implicitly determined by the equation $V^{n-1}(\bar{x}) = \xi + V^{n-1}(0)$. It follows directly from (63) and the symmetry of f that V^n will also be nonnegative, symmetric around 0, and satisfy

[43] $\bar{x} < M$ follows from the choice of M above, while $0 < \bar{x}$ follows from the continuity of $V^{n-1}(x)$, since for x close enough to 0, $V^{n-1}(x)$ gets arbitrarily close to $V^{n-1}(0)$ and therefore below $\xi + V^{n-1}(0)$.

$V^n(x) \geq \frac{1}{2}x^2$ and $V^n(0) \leq \frac{\beta}{1-\beta}(1-\lambda)\xi$. All that remains is investigate the derivative.

Substituting $u = x' - x$, (63) can be rewritten as

$$V^n(x) = \frac{1}{2}x^2 + \beta(1-\lambda)\int_{-\bar{x}-x}^{\bar{x}-x} f(u)V^{n-1}(x+u)du + \beta(1-\lambda)(V^{n-1}(0)+\xi)\left(1 - \int_{-\bar{x}-x}^{\bar{x}-x} f(u)du\right) + \beta\lambda V^{n-1}(0)$$

Now, differentiating with respect to x using Leibniz's rule, we find

$$\begin{aligned}(V^n)'(x) &= x + \beta(1-\lambda)\left(-f(\bar{x}-x)V^{n-1}(\bar{x}) + f(-\bar{x}-x)V^{n-1}(-\bar{x}) + \int_{-\bar{x}-x}^{\bar{x}-x}(V^{n-1})'(x+u)du\right) \\ &\quad - \beta(1-\lambda)(\xi + V^{n-1}(0))\left(-f(\bar{x}-x)V^{n-1}(\bar{x}) + f(-\bar{x}-x)V^{n-1}(-\bar{x})\right) \\ &= x + \beta(1-\lambda)\int_{-\bar{x}}^{\bar{x}} f(x'-x)(V^{n-1})'(x')dx' \end{aligned} \tag{64}$$

where the cancellation follows from $V^{n-1}(\bar{x}) = V^{n-1}(-\bar{x}) = \xi + V^{n-1}(0)$. It follows that V^n is continuously differentiable.

Now, note that using the symmetry of f, we can rewrite (64) as

$$(V^n)'(x) = x + \beta(1-\lambda)\int_0^{\bar{x}} (f(x'-x) - f(-x'-x))(V^{n-1})'(x')dx' \tag{65}$$

The single-peakedness of f implies that $f(x'-x) - f(-x'-x) > 0$ for all $x, x' > 0$, so $(V^n)'(x) > 0$ for $x > 0$ follows from $(V^{n-1})'(x') > 0$ for $x' > 0$.

Explicitly constructing V through value function iteration and obtaining properties of the optimal policy. Write $V^0(x) \equiv \frac{1}{2}x^2$, which satisfies all hypotheses put on V^{n-1} in the previous discussion, and construct the series $\{V^n\}$ recursively. By induction, each V^n must be nonnegative, symmetric around 0, continuously differentiable, satisfy $(V^n)'(x) > 0$ for $x > 0$, and satisfy $V^n(x) \geq \frac{1}{2}x^2$ and $V^n(0) \leq \frac{\beta}{1-\beta}(1-\lambda)\xi$.

Now, by standard arguments, the right side of (62) is a contraction (in the sup norm) of modulus β. Hence the V^n converge uniformly to some fixed point V. This V must be nonnegative, symmetric around 0, weakly increasing for $x > 0$, and satisfy $V(x) \geq \frac{1}{2}x^2$ and $V(0) \leq \frac{\beta}{1-\beta}(1-\lambda)\xi$. Following the same logic as before, the set of points $x \geq 0$ for which $V(x) = \xi + V(0)$ must a closed subset of $(0, M)$. Let the minimum of this set be $\bar{x}$; then (63) holds with this $\bar{x}$.

Now, directly differentiating (63), the continuous differentiability of V follows from that of f. Hence (65) holds as a fixed point for V as well.

V is weakly increasing and must increase by at least ξ from $V(0)$ to $V(\bar{x})$, so we have $V'(x) \geq 0$ everywhere with $x > 0$ and $V'(x) > 0$ for some subset of $x > 0$ of positive measure. It then follows from (65) that since $f(x'-x) - f(-x'-x) > 0$ for all $x, x' > 0$, we have $V'(x) > 0$ for all $x > 0$ (and similarly $V'(x) < 0$ for $x < 0$ and $V'(0) = 0$).

This implies that there is a unique $\bar{x}$ satisfying $V(\bar{x}) = \xi + V(0)$. Hence, we have derived an optimal *Ss* policy, where there is no adjustment when x is in the interval $[-\bar{x}, \bar{x}]$, and always adjustment to 0 outside of this interval.

Finally, we note that differentiating (64) around the fixed point, we get

$$V''(x) = x + \beta(1-\lambda)\int_0^{\bar{x}} (f'(-x'-x) - f'(x'-x))V'(x')dx' \tag{66}$$

so that the continuous differentiability of V' follows from that of f. For the special case $x = 0$, we note that by assumption $f'(-x') = -f'(x') > 0$ for all $x' > 0$, so that the integral in (66) is positive and $V''(0) > 0$.

Steady-state distribution. We have shown above that in the steady-state version of the pricing problem, firms follow an *Ss* policy with adjustment to 0 whenever the price gap is outside the interval $[-\bar{x}, \bar{x}]$ (or there is a free adjustment with probability λ).

This implies a law of motion $\mathcal{T}$ for the density g *prior to adjustment* given by

$$(\mathcal{T}g)(x') = \int_{-\infty}^{\infty} p(x, x')g(x)dx \tag{67}$$

where the transition density $p(x, x')$ from x to x', satisfying $\int p(x, x')dx' = 1$, is given by

$$p(x, x') \equiv \begin{cases} f(x'-x) & |x| \leq \bar{x} \\ f(x') & |x| > \bar{x} \end{cases} \tag{68}$$

Defining $v(x') \equiv \min_{|x|\leq\bar{x}} f(x'-x)$, we note that by our assumptions on f that $v(x') > 0$ for all x'. Defining $h(x') \equiv \min(f(x'), v(x'))$, we have $p(x, x') \geq h(x') > 0$ for all x, x', and we can rewrite (67) for any density g with integral 1 as

$$(\mathcal{T}\pi)(x') = h(x') + \int_{-\infty}^{\infty} \left(p(x, x') - h(x')\right) g(x)dx$$

where $p(x, x') - h(x') \geq 0$. It follows that for any two densities g_1 and g_2 that we have

$$\begin{aligned}
\int_{-\infty}^{\infty} |(\mathcal{T}(g_1 - g_2))(x')|dx' &= \int_{-\infty}^{\infty} \left| \int_{-\infty}^{\infty} \left(p(x, x') - h(x')\right) (g_1(x) - g_2(x))dx \right| dx' \\
&\leq \int_{-\infty}^{\infty} \int_{-\infty}^{\infty} \left(p(x, x') - h(x')\right) |g_1(x) - g_2(x)|dxdx' \\
&= \left(\int_{-\infty}^{\infty} |g_1(x) - g_2(x)| \left(\int_{-\infty}^{\infty} \left(p(x, x') - h(x')\right) dx' \right) dx \right) \\
&= \left(1 - \int_{-\infty}^{\infty} h(x')dx'\right) \int_{-\infty}^{\infty} |g_1(x) - g_2(x)|dx
\end{aligned}$$

so that, defining $\|g\| \equiv \int_{-\infty}^{\infty} |g(x)|dx$ to be the L^1 norm and $\mathcal{H} \equiv \int_{-\infty}^{\infty} h(x')dx' > 0$, we have

$$\|\mathcal{T}(\pi_1 - \pi_2)\| \leq (1 - \mathcal{H})\|\pi_1 - \pi_2\| \tag{69}$$

implying that $\mathcal{T}$ is a contraction on densities in the L^1 norm with modulus $1 - \mathcal{H}$.

It follows that there is a unique stationary density g that is a fixed point of the contraction $\mathcal{T}$, and that we will reach this density by starting with any $g^0 \in L^1$ and repeatedly iterating. Since $\mathcal{T}$ with symmetric f preserves symmetry around 0, it follows that the stationary g must be symmetric as well (since we can start with symmetric g^0 and iterate). It also follows from (67)–(68) and the continuous differentiability of f that g is continuously differentiable.

B.2 Envelope result and contraction

In this section, we obtain some useful further technical results for the canonical menu cost model. In particular, we show that the backward mapping on V is differentiable, and indeed a contraction in a certain norm that regulates both the level and derivative of V. Hence, iterating backward in response to any sequence of first-order aggregate cost shocks, we retain Ss policies $(\underline{x}, \bar{x}, x^*)$, which are differentiable with respect to the shocks.

To start, consider the space of value functions V on $[-M, M]$ that are bounded and have bounded first derivative, endowed with the norm

$$\|V\| \equiv \sup_x |V(x)| + \zeta \sup_x |V'(x)| \tag{70}$$

for some $\zeta > 0$. Note that this space is complete (a Banach space).[44] Note also that in this norm, in a neighborhood around the steady-state V derived in the previous section, the adjustment policy will still be Ss. Indeed, if we write the mapping $T : (V_+, c) \to V$ from V_+ in this space and a cost scalar c to V also in this space[45], given locally by the Bellman equation

$$V(x) = \frac{1}{2}(x-c)^2 + \min_{x^*, \underline{x}, \bar{x}} \left[\beta(1-\lambda) \int_{\underline{x}}^{\bar{x}} f(x'-x) V_+(x') dx' \right.$$
$$\left. + \beta(1-\lambda)(V_+(x^*) + \xi) \left(1 - \int_{\underline{x}}^{\bar{x}} f(x'-x)dx'\right) + \beta\lambda V_+(x^*) \right] \tag{71}$$

then the optimum is still characterized by the value matching conditions $V_+(\bar{x}) + \zeta = V_+(0)$ and $V_+(\underline{x}) + \zeta = V_+(0)$ and the first-order condition $V_+'(x^*) = 0$; and from the implicit theorem, these optima are differentiable with respect to V_+ in this norm around the steady state, with $d\bar{x} =$

[44] To see this, start by noting that for any Cauchy sequence $\{V_n\}$ in this norm, $\{V_n\}$ and $\{V_n'\}$ will also be Cauchy sequences in the ordinary sup norm, and therefore both individually converge to some limits. Then, the only remaining question to determine whether $\{V_n\}$ converges in our norm is whether the limit of V_n' equals the derivative of the limit of V_n; this, in turn, is a standard result in real analysis when there is uniform convergence (see e.g. Rudin (1976), Theorem 7.17).

[45] Boundedness of V follows immediately from the Bellman equation, and of of V' follows from differentiating as in (64).

$-dV_+(\bar{x})/V'_+(\bar{x})$, $d\underline{x} = -dV_+(-\bar{x})/V'_+(-\bar{x})$, and $dx^* = -dV'_+(0)/V''_+(0)$.

Since the policy is differentiable with respect to V_+, we have a simple envelope result (obtainable simply by differentiating (71)), where in response to a perturbation dV_+, (71) becomes

$$dV(x) = \beta(1-\lambda)\int_{-\bar{x}}^{\bar{x}} f(x'-x)dV_+(x')dx' + \beta(1-\lambda)\left(1 - \int_{\underline{x}}^{\bar{x}} f(x'-x)dx'\right)dV_+(0) + \beta\lambda dV_+(0) \tag{72}$$

Note that this is a bounded map from dV_+ to dV in our normed space. First, it is immediate from (72) that $\sup_x |dV(x)| \leq \beta \sup_x |dV_+(x)|$.

Second, if we differentiate (72), we obtain

$$\begin{aligned} dV'(x) = \beta(1-\lambda)\int_{-\bar{x}}^{\bar{x}} f(x'-x)dV'_+(x')dx' - \beta(1-\lambda)f(\bar{x}-x)\left(dV_+(\bar{x}) - dV_+(0)\right) \\ + \beta(1-\lambda)f(-\bar{x}-x)\left(dV_+(-\bar{x}) - dV_+(0)\right) \end{aligned}$$

and hence

$$\sup_x |dV'(x)| \leq \beta(1-\lambda)\sup_x |dV'_+(x)| + \beta(1-\lambda)\left(\sup_x f(\bar{x}-x) + f(-\bar{x}-x)\right)4\sup_x |dV_+(x)|$$

and if we define the weight ζ in our norm (70) to be $\zeta \equiv \frac{(1-\beta)/2}{4\beta(1-\lambda)(\sup_x f(\bar{x}-x)+f(-\bar{x}-x))}$, this reduces to just

$$\sup_x |dV'(x)| \leq \beta(1-\lambda)\sup_x |dV'_+(x)| + \frac{1-\beta}{2}\zeta^{-1}\sup_x |dV_+(x)|$$

and we have

$$\begin{aligned} \|V\| &= \sup_x |dV(x)| + \zeta \sup_x |dV'(x)| \\ &\leq \beta \sup_x |dV_+(x)| + \beta(1-\lambda)\zeta \sup_x |dV'_+(x)| + \frac{1-\beta}{2}\sup_x |dV_+(x)| \\ &< \frac{1+\beta}{2}\left(\sup_x |dV_+(x)| + \zeta \sup_x |dV'_+(x)|\right) \\ &= \frac{1+\beta}{2}\|V_+\| \end{aligned}$$

and we conclude that the derivative mapping dV_+ to dV is a contraction with modulus $\frac{1+\beta}{2}$ in our norm.

C Appendix to Section 3

C.1 Envelope results for proof of proposition 1

Starting around the steady state, if there is a contemporaneous shock dc where $c \equiv \log MC$, then clearly $\frac{dV(x)}{dc} = -x$ from (71). Then, letting $V_n(x)$ denote the value function with n periods of

anticipation of this shock, so that $dV_0(x) = -xd\log MC$, (72) gives the recursion from dV_{n-1} to dV_n. Further, this recursion preserves the property that $dV_n(0) = 0$ always, and hence simplifies to just

$$dV_n(x) = \beta(1-\lambda)\int_{-\bar{x}}^{\bar{x}} f(x'-x)dV_{n-1}(x')dx' \tag{73}$$

which is equivalent to our envelope result (22).

Observing that (73) is exactly the recursion that defines $E^n(x)$ given the same base case (times -1) of $E^0(x) = x$, but with an extra β added on each iteration, we conclude that

$$\frac{dV_n(x)}{dc} = -\beta^n E^n(x) \tag{74}$$

and also

$$\frac{dV_n'(x)}{dc} = -\beta^n (E^n)'(x)$$

Furthermore, the recursion (73) is the same as the recursion (64) obeyed by the steady-state $V'(x)$, except that the latter adds x on every iteration (rather than just the base case). Since we have shown that (64) is a contraction with the norm (70), it follows that the steady state obeys both

$$V'(x) = \sum_{n=0}^{\infty} \beta^n E^n(x) \equiv F(x)$$

and

$$V''(x) = \sum_{n=0}^{\infty} \beta^n (E^n)'(x) \equiv F'(x)$$

which both converge uniformly.

C.2 Proof that virtual survival is positive and decreasing

For the time-dependent models characterized in proposition 1 to be standard time-dependent models, their survival functions (which we call *virtual* survival functions) must be nonnegative and nonincreasing. Here, we will show that given our assumptions, they are indeed *strictly* positive and decreasing.

First, we introduce an operator that will be useful both here and in the proof of proposition 2 in the next subsection. Define $T : L^2([-\bar{x},\bar{x}]) \to L^2([-\bar{x},\bar{x}])$ by

$$(Tg)(x) = (1-\lambda)\int_{-\bar{x}}^{\bar{x}} f(x'-x)g(x')dx' \tag{75}$$

given free adjustment rate λ and shock density f, and some policy bands $\bar{x}$. Recall the conditions we assumed in section 2.1 on the density f: differentiable, symmetric around 0, and single-peaked at 0, with $f'(x) < 0$ for $x > 0$ and vice versa (implying that $f(x) > 0$ everywhere).[46]

[46] These assumptions are essential for our result, and it is possible to break the result when they are violated. To take a simple example that retains symmetry but breaks single-peakedness, suppose that $f(x) = \frac{1}{2}\delta(x-2\bar{x}) + \frac{1}{2}\delta(x+2\bar{x})$,

We note that T can be used to define expectation functions, since the recursion (2.1) is equivalent to $E^n = TE^{n-1}$. It can also be used to iterate on the density of price gaps, dropping readjusters: given an end-of-period density ϕ^{n-1} yesterday, the end-of-period density of non-readjusting firms is $\phi^n = T\phi^{n-1}$ today.

Properties of the operator T. We can obtain from (75) several properties of T. Of these, a) through c) will be needed for this proof, while d) and e) will be used to characterize eigenvalues in the next section.

a) T is a Hilbert-Schmidt integral operator on $L^2([-\bar{x}, \bar{x}])$ with symmetric kernel $k(x, x') = f(x' - x)$, and therefore is self-adjoint. Since the kernel is continuous, Tg is continuous for any g.

b) T maps even g to even g, and odd g to odd g.

c) For any odd g where $g(x) \geq 0$ for all $x \geq 0$, and where $g(x) > 0$ for some positive-measure subset, $Tg(x) > 0$ for all $x > 0$. To see this, for any $x > 0$ exploit oddness to write $(Tg)(x) = \int_0^{\bar{x}} \left(f(x' - x) - f(-x' - x)\right) g(x')dx' > 0$, where the inequality follows because single-peakedness implies $f(x' - x) - f(-x' - x) > 0$ for all $x, x' > 0$, and g is strictly positive on some subset of $[0, \bar{x}]$ of positive measure.

d) Eigenfunctions ψ of T with nonzero eigenvalues are continuously differentiable. If (ψ, μ) be any eigenfunction-eigenvalue pair with $\mu \neq 0$, note that $\psi = \mu^{-1}T\psi$, and so ψ must be C^0 by a). Applying $\psi = \mu^{-1}T\psi$ and (75) again shows that it is C^1.

e) Eigenvalues of T must have magnitude strictly less than 1. To see this, let (ψ, μ) be any eigenfunction-eigenvalue pair with $\mu \neq 0$. From property d), ψ is continuous and attains its maximum on $[-\bar{x}, \bar{x}]$ at some x^*. Then we observe that $|\lambda||\psi(x^*)| = |(T\psi)(x^*)| \leq |\psi(x^*)| \int_{-\bar{x}}^{\bar{x}} f(x' - x^*)dx' < |\psi(x^*)|$, and hence $|\lambda| < 1$.

Characterizing the expectation functions. We note that $E^0(x) = x$ is odd and satisfies $E^0(x) > 0$ for all $x > 0$. Hence, applying b) and c) above, it follows recursively that $T^n E^0 = E^n$ is odd and satisfies $E^n(x) > 0$ for all $x > 0$. It also follows from a) that E^n is continuous.

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where δ is a Dirac delta. Here, without adjustment, x either declines by $2\bar{x}$ or increases by $2\bar{x}$. Hence, starting at $\bar{x}$, there is a $\frac{1}{2}$ chance of declining to $-\bar{x}$ and not adjusting, and a $\frac{1}{2}$ chance of increasing to $3\bar{x}$ and adjusting back to 0. Iterating forward, we see that $E^n(\bar{x}) = (-\frac{1}{2})^n \bar{x}$, implying a virtual survival function that is both sometimes negative and nonmonotonic.

We observe that $E^1(x) < x$ for all $0 < x \leq \bar{x}$:

$$\begin{aligned}
E^1(x) &= \int_{-\bar{x}}^{\bar{x}} f(x'-x)x'dx' \\
&= \int_{x-(\bar{x}-x)}^{x+(\bar{x}-x)} f(x'-x)x'dx' + \int_{-\bar{x}}^{x-(\bar{x}-x)} f(x'-x)x'dx' \\
&= x\int_{x-(\bar{x}-x)}^{x+(\bar{x}-x)} f(x'-x)dx' + \int_{-\bar{x}}^{x-(\bar{x}-x)} f(x'-x)x'dx' \\
&\leq x\int_{-\bar{x}}^{\bar{x}} f(x'-x)dx' < x
\end{aligned}$$

Here, the equality in the third line follows from the symmetry of f, and the first inequality in the fourth line follows from $x' \leq x$ on the interval $[-\bar{x}, x-(\bar{x}-x)]$.

Now, for $n \geq 1$ define $\phi_x^n(x')$ to be the density of price gaps assuming that the price gap n periods ago was x, dropping all firms that have adjusted prices. This can be defined recursively using the base case $\phi_x^1(x') = f(x'-x)$ and $\phi_x^n = T\phi_x^{n-1}$. We observe that $(\phi_x^1 - \phi_{-x}^1)(x') = f(x'-x) - f(x'+x)$ is an odd function by symmetry of f, and that it also satisfies $(\phi_x^1 - \phi_{-x}^1)(x') > 0$ for all $x' > 0$ by single-peakedness of f. Hence, like above with E^n, it follows recursively from b) and c) that for all n, $\phi_x^n - \phi_{-x}^n$ is odd and satisfies $(\phi_x^n - \phi_{-x}^n)(x') > 0$ for all x'. Symmetry also implies that $\phi_{-x}^n(x') = \phi_x^n(-x')$.

Next, we note that we can write any E^n either directly as the mean of x' given $\phi_x^n(x')$

$$E^n(x) = \int_{-\bar{x}}^{\bar{x}} \phi_x^n(x')x'dx' = \int_0^{\bar{x}} (\phi_x^n(x') - \phi_{-x}^n(x'))x'dx' \tag{76}$$

or as the mean of the one-period-ahead expectation $E^1(x')$ given $\phi_x^{n-1}(x')$

$$E^n(x) = \int_{-\bar{x}}^{\bar{x}} \phi_x^{n-1}(x')E^1(x')dx' = \int_0^{\bar{x}} (\phi_x^{n-1}(x') - \phi_{-x}^{n-1}(x'))E^1(x')dx' \tag{77}$$

We can then combine (76), (77), and our result that $E^1(x') < x'$ for $0 < x' < \bar{x}$ write for any $0 < x \leq \bar{x}$:

$$\begin{aligned}
E^n(x) &= \int_0^{\bar{x}} (\phi_x^{n-1}(x') - \phi_{-x}^{n-1}(x'))E^1(x')dx' \\
&< \int_0^{\bar{x}} (\phi_x^{n-1}(x') - \phi_{-x}^{n-1}(x'))x'dx' \\
&= E^{n-1}(x)
\end{aligned} \tag{78}$$

Since extensive margin virtual survival is proportional to $E^n(\bar{x})$, (78) combined with our earlier result that $E^n(x)$ was positive for $x > 0$ implies that extensive margin virtual survival is strictly positive and strictly declining, as desired.

Intensive margin virtual survival is $(E^n)'(0)$. Differentiating $E^n(x) = \int_{-\bar{x}}^{\bar{x}} f(x'-x)E^{n-1}(x')dx'$

around $x = 0$, we obtain

$$\begin{aligned}(E^n)'(0) &= -\int_{-\bar{x}}^{\bar{x}} f'(x')E^{n-1}(x')dx' \\ &= 2\int_0^{\bar{x}} (-f'(x'))E^{n-1}(x')dx' \end{aligned} \tag{79}$$

We observe that (79) integrates $E^{n-1}(x')$ with weights $-f'(x')$ that do not depend on n and are strictly positive on the interval $0 < x' \leq \bar{x}$. We know from above that for $0 < x' \leq \bar{x}$, both $E^{n-1}(x') > 0$ and $E^n(x') < E^{n-1}(x')$. It follows that $(E^n)'(0)$ is strictly positive for all n and strictly declining in n, as desired.

C.3 Proof of proposition 2

Applying the spectral theorem. Since T is self-adjoint and (like all Hilbert-Schmidt integral operators) compact from property a), we can apply the spectral theorem for separable infinite-dimensional Hilbert spaces, which states that $L^2([-\bar{x}, \bar{x}])$ has a countably infinite orthonormal basis $\{\psi_n\}$ of eigenfunctions of T, with corresponding real eigenvalues $\{\mu_n\}$, where the only accumulation point of μ_n is 0.

Indeed, since by property b), T preserves evenness and oddness, we can also define it on the even and odd subspaces of $L^2([-\bar{x}, \bar{x}])$, and then apply the spectral theorem separately on each subspace, to get separate orthonormal bases for the even subspace and the odd subspace. Since the sum of the even and odd subspaces is the entire function space, these bases combine to form an orthonormal basis for all of $L^2([-\bar{x}, \bar{x}])$. Hence, we can further refine our statement in the first paragraph, and conclude that all eigenfunctions ψ_n in the orthonormal basis are either even or odd.

Extensive and intensive margin survival curves. Using the above, we project E^0 onto the basis of eigenfunctions

$$E^0 = \sum_n \langle E^0, \psi_n \rangle \psi_n \tag{80}$$

where $\langle \cdot, \cdot \rangle$ is the usual inner product on L^2. Note that $\langle E^0, \psi_n \rangle$ will be zero for all even ψ_n, and only nonzero for some odd ψ_n.

Applying T to (80) gives

$$E^s(x) = \sum_n \langle E^0, \psi_n \rangle \mu_n^s \psi_n(x) \tag{81}$$

which now holds pointwise for any $s > 0$.[47]

Define $\bar{\mu}$ to be the eigenvalue μ_n of maximum magnitude such that $\langle E^0, \psi_n \rangle$ is nonzero, and

[47] Normally this projection could differ on a set of measure 0, but from properties 1 and 3 we know that $E^1 = TE^0$ is continuous and also that ψ_n is continuous for any $\mu_n \neq 0$, and continuous functions cannot differ on a set of only measure 0.

define $\bar{\psi}$ to be the projection of E^0 onto the corresponding eigenspace, i.e.

$$\bar{\psi}(x) \equiv \sum_{\{n:\mu_n=\bar{\mu}\}} \langle E^0, \psi_n \rangle \psi_n(x)$$

where we note that $\bar{\psi}(x)$ is odd. Then it follows from (81) that

$$\lim_{s\to\infty} \frac{E^s(x)}{\bar{\mu}^s} = \bar{\psi}(x) \tag{82}$$

Since $E^0(x) = x > 0$ for all $x > 0$, repeatedly applying property c) it must also be true that $E^s(x) > 0$ for all $x > 0$. Taking the limit (82), we must have $\bar{\psi}(x) \geq 0$ for all $x > 0$ and also $\bar{\mu} > 0$. Further, given that $\bar{\psi}$ is continuous and by construction is not identically zero, we must have $\bar{\psi}(x) > 0$ for some subset of $[0, \bar{x}]$ of positive measure, and so $(T\bar{\psi})(x) = \lambda\bar{\psi}(x) > 0$ for all $x > 0$. We conclude that $\bar{\psi}(x) > 0$ for all $x > 0$.

Using this result, we can also write

$$\begin{aligned}\mu\bar{\psi}'(0) = (T\bar{\psi})'(0) &= -\int_{-\bar{x}}^{\bar{x}} \phi'(x')\bar{\psi}(x')dx' \\ &= -2\int_0^{\bar{x}} \phi'(x')\bar{\psi}(x')dx' > 0\end{aligned}$$

and we conclude that $\bar{\psi}'(0) > 0$ as well.

The intensive and extensive margin "virtual survival" curves are given by $\Phi_t^i \equiv (E^t)'(0)$ and $\Phi_t^e \equiv E^t(\bar{x})/\bar{x}$, which using (82) and the preceding results have the limits

$$\begin{aligned}\lim_{s\to\infty} \frac{\Phi_t^i}{\bar{\mu}^s} &= \bar{\psi}'(0) > 0 \\ \lim_{s\to\infty} \frac{\Phi_t^e}{\bar{\mu}^s} &= \frac{\bar{\psi}(\bar{x})}{\bar{x}} > 0\end{aligned}$$

It follows that both Φ_t^i and Φ_t^e asymptotically decay at the rate $\bar{\mu}$, and that their asymptotic hazards are both $1 - \bar{\mu}$.

The asymptotic hazard of virtual survival is strictly greater than that of actual survival. The subset of weakly positive functions is a total cone in $L^2([-\bar{x}, \bar{x}])$, and from property c), applying T to any of these functions that is nonzero gives a function that is strictly positive everywhere and therefore in the interior of the cone. In other words, T is strongly positive with respect to this cone, and we can apply a standard extension of the Krein-Rutman theorem[48] to conclude that the eigenvalue $\hat{\mu}$ of T with largest magnitude is simple, strictly positive, and has a corresponding eigenfunction $\hat{\psi}$ that is strictly positive. Since $\hat{\psi}$ is strictly positive, we note that it must be even rather than odd.

[48] See Theorem 19.3 in Deimling (1985).

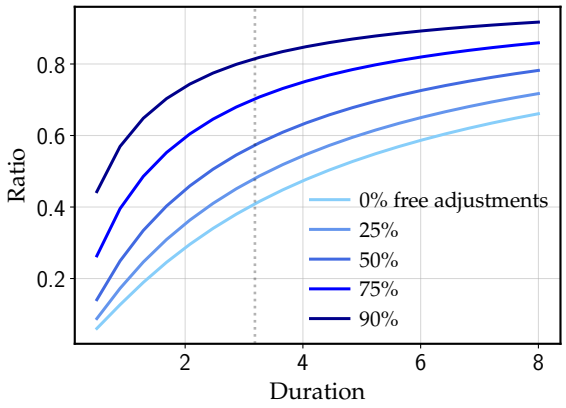


Figure C.1: Ratio of second to first odd eigenvalues of the transition operator across the parameter space of the menu cost model.

Now, let the probability of survival s periods from now starting at some point x be $\Phi_s^{actual}(x)$, where $\Phi_0^{actual}(x) \equiv 1$ and $\Phi_s^{actual} = T^s \Phi_0^{actual}$. We know that

$$\Phi_s^{actual}(x) = \sum_n \langle \Phi_0^{actual}, \psi_n \rangle \mu_n^s \psi_n(x)$$

and note that since $\hat{\psi}$ is strictly positive, $\langle \Phi_0^{actual}, \hat{\psi} \rangle > 0$, so that taking the limit as $s \to \infty$ we have

$$\lim_{s \to \infty} \frac{\Phi_s^{actual}(x)}{\hat{\mu}^s} = \langle \Phi_0^{actual}, \hat{\psi} \rangle \hat{\psi}(x)$$

so that the asymptotic hazard rate of actual survival is $1 - \hat{\mu}$.

Since $\hat{\mu}$ is the (simple) dominant eigenvalue and corresponds to an even eigenfunction, it must be strictly larger than $\bar{\mu}$, which was associated with odd eigenfunctions. Hence the asymptotic hazard of actual survival, $1 - \hat{\mu}$, is less than that of virtual survival, $1 - \bar{\mu}$.

C.4 State-dependent models that are exactly equivalent to Calvo

Here, we revisit the question of whether there are more SD models that are exactly equivalent to Calvo models, in the spirit of Gertler and Leahy (2008).

To investigate this, we look for densities $f(\epsilon)$ of the idiosyncratic shock ϵ_{it} that generate $E^t(x) = \phi^t x$ for some $\phi \in [0, 1)$ and for all $x \in [\underline{x}, \overline{x}]$. This is sufficient, but not necessary for Calvo, since Calvo only requires that $E^{t\prime}(0) = \phi^t = E^t(\overline{x})/\overline{x}$. Moreover, notice $E^t(x) = \phi^t x$ follows from $E^1(x) = \phi x$ by induction since if $E^t(x) = \phi^t x$ holds, then it is also the case that

$$E^{t+1}(x) = \int_{\underline{x}}^{\overline{x}} f(x' - x) E^t(x') dx' = \int_{\underline{x}}^{\overline{x}} f(x' - x) \phi^t x' dx' = \phi^t E^1(x) = \phi^{t+1} x$$

So which densities $f(\epsilon)$ guarantee that $E^1(x) = \phi x$? It needs to be the case that

$$\phi x = \int_{\underline{x}}^{\overline{x}} f(x' - x) x' dx'$$

for any $x \in [\underline{x}, \overline{x}]$. Taking derivatives and integrating by parts, this implies

$$\phi + f(\overline{x} - x)\overline{x} - f(\underline{x} - x)\underline{x} = F(\overline{x} - x) - F(\underline{x} - x) \tag{83}$$

where we denote the cdf of f by F. Taking derivatives one more time, we find

$$-f'(\overline{x} - x)\overline{x} + f'(\underline{x} - x)\underline{x} = -f(\overline{x} - x) + f(\underline{x} - x)$$

Using $\underline{x} = -\overline{x}$ and the fact that f is symmetric and f' is anti-symmetric, we find

$$f(\overline{x} - x) - f'(\overline{x} - x)\overline{x} = f(\overline{x} + x) - f'(\overline{x} + x)\overline{x} \tag{84}$$

This equation has to hold for any $x \in [0, \overline{x}]$.

Observe that without loss, we can normalize $\overline{x}$ to 1. Why? Because if and only if we find a density $\hat{f}(\epsilon)$ for which (84) holds with $\overline{x} = 1$, then $f(\epsilon) \equiv \hat{f}(\epsilon/\overline{x})$ satisfies (84) with any other $\overline{x} > 0$. With $\overline{x} = 1$, (84) is

$$f(1 - x) - f'(1 - x) = f(1 + x) - f'(1 + x) \tag{85}$$

Now, let us define the following function: $g(\epsilon) \equiv e^{-\epsilon} f(\epsilon)$ for $\epsilon \in [0, 2]$. Its derivative is equal to

$$g'(\epsilon) = -e^{-\epsilon} \left(f(\epsilon) - f'(\epsilon) \right)$$

which is convenient since terms involving $f - f'$ are exactly what appears in (85). In particular, we can write

$$\begin{aligned} g'(1 + x) &= -e^{-(1+x)} \left(f(1 + x) - f'(1 + x) \right) \\ g'(1 - x) &= -e^{-(1-x)} \left(f(1 - x) - f'(1 - x) \right) \end{aligned}$$

so that (85) can be rewritten as

$$g'(1 - x) = e^{2x} g'(1 + x) \tag{86}$$

Any positive differentiable g, defined on $[0, 2]$ that satisfies (86) gives us a density $f(\epsilon) = e^{\epsilon} g(\epsilon)$ (up to scale) of an SD model that is exactly equivalent to Calvo.

A simple example. We guess $g'(1 + x) = -be^{-c(1+x)}$ for some constants $c \in (0, 1]$ and $b > 0$. Then, by (86) it has to be that

$$g'(1 - x) = -be^{-c+(2-c)x}$$

Integrating g', we therefore find

$$g(\epsilon) = \begin{cases} a + \frac{b}{2-c} e^{2-2c-(2-c)\epsilon} & \epsilon \leq 1 \\ a + \frac{b}{2-c} e^{-c} - \frac{b}{c} \left(e^{-c} - e^{-c\epsilon} \right) & \epsilon > 1 \end{cases}$$

where for simplicity of this example we set the constant $a = 0$. Multiplying with e^{ϵ} gives the density f for $\epsilon \geq 0$ (and symmetrically for $\epsilon \leq 0$)

$$f(\epsilon) = \begin{cases} \frac{b}{2-c} e^{2-2c-(1-c)\epsilon} & \epsilon \leq 1 \\ \frac{b}{2-c} e^{-c+\epsilon} - \frac{b}{c} \left(e^{-c} - e^{-c\epsilon} \right) e^{\epsilon} & \epsilon > 1 \end{cases}$$

Using this expression, we see that f has positive support on $[-\overline{y}, \overline{y}]$, where $\overline{y} = 1 - \frac{1}{c} \log \frac{2-2c}{2-c}$. To normalize f, we can choose b such that $2 \int_0^{\overline{y}} f(y) dy = 1$. This gives a closed form expression for b. And with that, we can compute the Calvo hazard $1 - \phi$, where ϕ follows from (83)

$$\phi = 2 \frac{b}{2-c} \frac{1}{1-c} e^{2-2c} \left[1 - (2-c) e^{-(1-c)} \right]$$

where we simply used (83) with $x = 0$ (any value of x works).

D Appendix to Section 4

D.1 NKPC regressions with simulated data

In this section, we use simulated data from our two baseline SD models – Golosov-Lucas and Nakamura-Steinsson – to run the standard NKPC regression below:

$$\pi_t = \beta \mathbb{E}_t \pi_{t+1} + \gamma \pi_{t-1} + \kappa \hat{mc}_t + u_t \tag{87}$$

The simulation procedure works as follows. We first posit a stochastic process for the real marginal cost $\hat{mc}_t$. Then, using the generalized Phillips curve (13), it is straightforward to jointly simulate paths for $\hat{mc}_t$, inflation π_t, lagged inflation π_{t-1}, and inflation expectations $\mathbb{E}_t \pi_{t+1}$. We then use these simulated paths to estimate equation (87) via ordinary least squares. We simulate a sample of size 10,000.

We assume that $\hat{mc}_t$ is given by the sum of an AR(1) process with persistence 0.8 and an i.i.d. shock term, both with the same unconditional variance.[49] For each SD model, we analyze four different specifications of (87). First, we fix β and κ at the values suggested by approximating the generalized Phillips curve **K**, as in the main text, and compute only the R^2 of the fit. Then, we fix $\beta = 0.99$ and $\gamma = 0$, and estimate only the slope κ. In the third specification, we fix $\gamma = 0$ and estimate β and κ. Finally, in the last specification we impose no parameter restrictions.

[49] In a Calvo model, having only an AR(1) component generates perfect multicollinearity between $\mathbb{E}_t \pi_t$ and $\hat{mc}_t$. This problem extends to our SD models, hence the need for the i.i.d. term.

	Golosov-Lucas				Nakamura-Steinsson			
	K approx.	$\beta = 0.99$ $\gamma = 0$	$\gamma = 0$	Unrestricted	**K** approx.	$\beta = 0.99$ $\gamma = 0$	$\gamma = 0$	Unrestricted
κ	1.709	1.743	1.762	1.763	0.468	0.454	0.472	0.472
β	0.99	0.99	0.979	0.981	0.99	0.99	0.949	0.935
γ	0	0	0	-0.002	0	0	0	0.014
R^2	1.000	1.000	1.000	1.000	0.998	0.998	0.999	0.999

Table D.1: Regression results with simulated data.

Table D.1 shows results. Standard errors of parameter estimates are negligible, and therefore omitted. There are several interesting features in these results. First, the estimated values of κ are close to the ones suggested by approximating the whole generalized Phillips curve, which is not surprising. Second, the estimated forward coefficient β may differ from the value 0.99 used in simulations, and the backward coefficient may slightly differ from zero when unrestricted. Finally, all regressions have very high R^2. It is not surprising, however, that the **K** approximation does not generate the highest R^2. This approximation maximizes the minimum R^2 of an NKPC regression among all possible finite-variance $\hat{mc}_t$ stochastic processes, which is not necessarily attained for a process similar to the one we use in this simulation exercise. Nevertheless, these simulations provide a concrete example of the extremely good fit of the Calvo approximation for SD models.

D.2 Approximate equivalence to Calvo when the average survival function is exponential

Define $\mathcal{L}(\{a^s\})$, for any sequence $\{a^s\}$, to be the lower triangular Toeplitz matrix with first column $\{a^s\}$, and similarly define $\mathcal{U}(\{a^s\})$ to be the upper triangular Toeplitz matrix with first row $\{a^s\}$. In this notation the definition (10) of pass-through matrix for a TD model, for instance, is $\left(\sum_s \Phi_s\right)^{-1}\left(\sum_s \beta^s\Phi_s\right)^{-1}\mathcal{L}(\{\Phi_s\})\mathcal{U}(\{\beta^s\Phi_s\})$.

The equivalence result (14) can be written in this notation as

$$\Psi = \alpha\frac{\mathcal{L}(\{\Phi_s^e\})\mathcal{U}(\{\Phi_s^e\})}{\left(\sum_s \Phi_s^e\right)\left(\sum_s \beta^s\Phi_s^e\right)} + (1-\alpha)\frac{\mathcal{L}(\{\Phi_s^i\})\mathcal{U}(\{\Phi_s^i\})}{\left(\sum_s \Phi_s^i\right)\left(\sum_s \beta^s\Phi_s^i\right)} \tag{88}$$

Now, suppose that $\Phi_s^e = \Phi_s^{\text{Calvo}} + \eta_s^e$ and $\Phi_s^i = \Phi_s^{\text{Calvo}} + \eta_s^i$, with η_s^e and η_s^i small and $\Phi_s^{\text{Calvo}} \equiv (1-\lambda)^s$, i.e. that both the extensive and intensive margin virtual survival functions are close to exponential (Calvo). Then to first order in the ηs, (88) can be approximated as

$$\begin{aligned}\Psi \approx \left(1 - \frac{\sum_s \alpha\eta_s^e + (1-\alpha)\eta_s^i}{\sum_s \Phi_s^{\text{Calvo}}} - \frac{\sum_s \beta^s(\alpha\eta_s^e + (1-\alpha)\eta_s^i)}{\sum_s \beta^s\Phi_s^{\text{Calvo}}}\right)\Psi^{\text{Calvo}} \\ + \frac{\mathcal{L}(\{\alpha\eta_s^e + (1-\alpha)\eta_s^i\})\mathcal{U}(\{\Phi_s^{\text{Calvo}}\}) + \mathcal{L}(\{\Phi_s^{\text{Calvo}}\})\mathcal{U}(\{\alpha\eta_s^e + (1-\alpha)\eta_s^i\})}{\left(\sum_s \Phi_s^{\text{Calvo}}\right)\left(\sum_s \beta^s\Phi_s^{\text{Calvo}}\right)}\end{aligned} \tag{89}$$

where Ψ^{Calvo} is the Calvo pass-through matrix associated with Φ_s^{Calvo}.

Note that in (89), the η_s^e and η_s^i only appear together in the form $\alpha\eta_s^e + (1-\alpha)\eta_s^i$, which equals the discrepancy between the *average* survival function of the mixture and the Calvo survival function:

$$\alpha\eta_s^e + (1-\alpha)\eta_s^i = \alpha\Phi_s^e + (1-\alpha)\Phi_s^i - \Phi_s^{\text{Calvo}} \tag{90}$$

If the average survival function equals the Calvo exponential survival function, then to first order in the ηs the pass-through matrix of the menu cost model is the *same* as Calvo.

More generally, to first order in the ηs, the discrepancy between the menu cost pass-through matrix and the Calvo pass-through matrix is of the same magnitude as the gap between the average survival function of the mixture and the Calvo exponential survival function. If this gap is small (and the ηs are not too big), then the two pass-through matrices should be close, which carries over to the generalized Phillips curve.

D.3 Proof of proposition 3 and of the convergence of $\sum_k \Psi^k$

Here, we prove that $\sum_k \Psi^k$ converges, as claimed in footnote 12, and establish proposition 3. Since, in proposition 1, we prove the equivalence of an SD model to a mixture of TD models, we can restrict our attention to an arbitrary mixture of (finitely many) TD models. For simplicity, we will start by proving these results for a single TD model, and then show in Step 4 of the proof how the argument extends to a mixture.

For a TD model with survival function Φ_s, let us interpret the pass-through matrix Ψ defined in (10), whose columns sum to weakly less than 1, as the transpose of a Markov transition matrix P on the state space of nonnegative integers. In this interpretation, we use the generalized notion of denumerable Markov chain from Kemeny, Snell and Knapp (1976), where the sum of transition probabilities from a state can be less than 1, corresponding to the termination of the chain. (We will use notation and ideas from Kemeny et al. (1976) as well.)

Given Ψ defined in (10), we can write $P = \Psi'$ as

$$P = AB$$

where

$$A = \frac{1}{\sum_{s\geq 0}\beta^s\Phi_s}\begin{pmatrix} \Phi_0 & 0 & 0 & \cdots \\ \beta\Phi_1 & \Phi_0 & 0 & \cdots \\ \beta^2\Phi_2 & \beta\Phi_1 & \Phi_0 & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix}$$

and

$$B = \frac{1}{\sum_{s\geq 0}\Phi_s}\begin{pmatrix} \Phi_0 & \Phi_1 & \Phi_2 & \cdots \\ 0 & \Phi_0 & \Phi_1 & \cdots \\ 0 & 0 & \Phi_0 & \cdots \\ \vdots & \vdots & \vdots & \ddots \end{pmatrix}$$

The sum $\Psi + \Psi^2 + \ldots$ is then the transpose of the object $\bar{N} \equiv P + P^2 + \ldots$, where $\bar{N}_{ij}$ gives the expected number of visits to state j after being in state i today.

Although $\bar{N}$ is positive, it is not necessarily finite. Our strategy to characterize $\bar{N}$ will be to construct an alternative "shift-invariant" Markov chain with simpler structure and weakly higher transition probabilities, and show that its expected number of visits $\bar{N}^{SI}$ is finite, implying that $\bar{N} \leq \bar{N}^{SI}$ is as well. We will then show that asymptotically, the gap between $\bar{N}$ and $\bar{N}^{SI}$ falls to zero, and so that the asymptotic properties of $\bar{N}^{SI}$ extend to $\bar{N}$.

To do so, let us first extend P, A, and B to cover the state space of all integers, filling in all other transition probabilities with zeros. (This does not alter $\bar{N}_{ij}$ when i and j are both nonnegative.) We then construct the *shift-invariant* Markov chain P^{SI} on the integers[50] with matrix

$$P^{SI} = A^{SI}B^{SI}$$

where A^{SI} and B^{SI} are each defined on all integers $i, j \in \mathbb{Z}$ such that

$$A^{SI}_{i,j} = \begin{cases} \frac{\beta^{i-j}\Phi_{i-j}}{\sum_{s\geq 0}\beta^s\Phi_s} & i \geq j \\ 0 & i < j \end{cases}$$

and

$$B^{SI}_{i,j} = \begin{cases} 0 & i > j \\ \frac{\Phi_{j-i}}{\sum_{s\geq 0}\Phi_s} & i \leq j \end{cases}$$

Note that both A^{SI} and B^{SI} agree with A and B within the nonnegative integers, but whereas the only nonzero entries in A and B are from the nonnegative integers to themselves, A^{SI} and B^{SI} both have other positive entries. Hence $A^{SI} \geq A$, $B^{SI} \geq B$, and $P^{SI} \geq P$, implying that $\bar{N}^{SI} \geq \bar{N}$ as well.

Also note that both A^{SI} and B^{SI}, and therefore P^{SI}, are *shift-invariant*: all entries along a diagonal are the same, and the probability $P^{SI}_{i,i+j}$ of moving to the right by j only depends on j. Denote this common probability by ψ_j. Similarly, define $a_j \equiv A_{i,i-j}$ and $b_j \equiv B_{i,i+j}$.

[50] To interpret (abandoning our Markov chain language for a minute and returning to the original meaning of the pass-through matrix): recall that $P_{s,s+j} = \Psi_{s+j,s}$ gives the amount by which prices will increase at date $s+j$, given a first-order increase in nominal marginal cost at date s that firms learned at date 0. $P^{SI}_{s,s+j}$ is the same, except that all changes in cost are perfectly anticipated going back to date $-\infty$.

Step 1: characterizing the z-transform $\psi(z)$ of P^{SI}. Defining the z-transforms $a(z) \equiv \sum_{j=0}^{\infty} a_j z^{-j}$, $b(z) \equiv \sum_{j=0}^{\infty} b_j z^j$, $\psi(z) \equiv \sum_{j=-\infty}^{\infty} \psi_j z^j$, and $\Phi(z) \equiv \sum_{j=0}^{\infty} \Phi_j z^j$, we can write

$$\psi(z) = a(z)b(z) = \frac{\Phi(\beta z^{-1})\Phi(z)}{\Phi(\beta)\Phi(1)} \tag{91}$$

where we use the fact that the product of two infinite shift-invariant matrices is given by convolution of their coefficients, and that this convolution becomes multiplication when applying the z-transform.

We recall that by our regularity assumption on TD models (see footnote 11), $\Phi(z)$ has a radius of convergence of at least $v > 1$. Hence $\Phi(\beta z^{-1})$ is analytic for $|z| > \beta v^{-1}$, and $\psi(z)$ is analytic on the annulus $\beta v^{-1} < |z| < v$.

Note also that $\psi(z)$ is strictly convex on $(\beta v^{-1}, v)$, since its Laurent expansion has all positive coefficients (being the product of $\Phi(\beta z^{-1})/\Phi(\beta)$ and $\Phi(z)/\Phi(1)$). It also satisfies $\psi(\beta) = \psi(1) = 1$, and it follows that $\psi(z) < 1$ for all $z \in (\beta, 1)$, and that β and 1 are simple zeros of $\psi(z) - 1$ because $\psi'(\beta)$ and $\psi'(1)$ are nonzero (strictly negative and positive, respectively). Further, for all non-real z such that $\beta \leq |z| \leq 1$, we must have $\psi(z) \neq 1$, since $\psi(z)$ being real for z complex implies that the triangle inequality holds strictly[51], $|\psi(z)| < \psi(|z|) \leq 1$.

Next, we argue that there is some $\gamma > 1$ such that on the annulus $\beta\gamma^{-1} < |z| < \gamma$, $z = \beta$ and $z = 1$ are the only zeros of $\psi(z) - 1$. We have already shown this for $\beta \leq |z| \leq 1$. Suppose to the contrary that there is no such γ, and that there exist zeros for $|z| > 1$ arbitrarily close to 1 or $|z| < \beta$ arbitrarily close to β. These zeros z must have limit points on the circles $|z| = 1$ or $|z| = \beta$, respectively, both of which are impossible since ψ is analytic and not identically zero on the annulus $\beta v^{-1} < |z| < v$.

We conclude that $\psi(z) - 1$ is analytic and has two simple zeros on some annulus $\beta\gamma^{-1} < |z| < \gamma$, with the zeros at $z = \beta$ and $z = 1$.

Step 2: characterizing $\bar{N}^{SI}$ and its first difference. Since the product of shift-invariant matrices on the integers is given by convolution, and this convolution becomes multiplication when applying the z-transform, it follows that the probability of moving to the right by j after n periods, $[(\bar{P}^{SI})^n]_{s,s+j}$, is equal to the jth coefficient of $\psi(z)^n$.

We know from above that $\psi(z)$ has two simple zeros at β and 1 and is strictly less than 1 in the annulus $\beta < |z| < 1$. Hence, picking any z_l, z_h satisfying $\beta < z_l < z_h < 1$, we have $|\psi(z)| \leq M < 1$ for $z_l \leq |z| \leq z_h$. On this closed annulus, $\psi(z) + \psi(z)^2 + \ldots$ therefore converges uniformly to $\frac{\psi(z)}{1-\psi(z)}$. Hence, the expected number of future visits $[\bar{N}^{SI}]_{s,s+j} \equiv [\bar{P}^{SI} + (\bar{P}^{SI})^2 + \ldots]_{s,s+j}$, to a state j to the right of the current one, is given by the jth coefficient of the Laurent series of $\bar{n}(z) \equiv \frac{\psi(z)}{1-\psi(z)} = \sum_{j=-\infty}^{\infty} \bar{n}_j z^j$ in this region. It follows that $\bar{N}^{SI}$ is finite, and hence $\bar{N} \leq \bar{N}^{SI}$ is as well. In particular, this proves the claim in footnote 12 that $\sum_k \Psi^k$ converges.

[51] More explicitly: if $\pi(z) = 1$ and z is complex, then $\pi(z) = |\text{Re}\pi(z)| \leq \sum_{j=-\infty}^{\infty} \pi_j |\text{Re} z^j| < \sum_{j=-\infty}^{\infty} \pi_j |z|^j = \pi(|z|)$, where the final strict inequality holds because we know that, for instance, $\pi_1 > 0$ (which follows from $\Phi_1 > 0$), and for that term $\pi_1 |\text{Re} z| < \pi_1 |z|$ whenever z is not real.

Suppose that we are interested in the first difference of the entries of $\bar{N}^{SI}$, i.e. $[\bar{N}^{SI}]_{s,s+j} - [\bar{N}^{SI}]_{s,s+j-1}$. This equals $\bar{n}_j - \bar{n}_{j-1}$, which will be the jth coefficient of the Laurent series

$$k(z) \equiv (1-z)\bar{n}(z) = (1-z)\frac{\psi(z)}{1-\psi(z)} = \sum_{j=-\infty}^{\infty} k_j z^j$$

Since $\frac{\psi(z)}{1-\psi(z)}$ has a simple pole at $z = 1$ (corresponding to the simple zero of $1 - \pi(z)$), multiplying by $(1-z)$ removes this pole, and $k(z)$ is therefore meromorphic on the annulus $\beta\gamma^{-1} < |z| < \gamma$, with the only singularity being a simple pole at $z = \beta$.

It immediately follows that $\limsup_{j\to\infty} |k_j|^{1/j} \leq \gamma^{-1} < 1$, i.e. that asymptotically as $j \to \infty$ the coefficients k_j are bounded above by some decaying exponential function. (Since the coefficients $\bar{n}_j$ are the cumulative sums of k_j, this has the useful additional implication that $\bar{n}_j$ are bounded as $j \to \infty$ as well.) Similarly, it follows that $\limsup_{j\to-\infty} |k_j|^{1/j} = \beta$.

Now consider multiplying $k(z)$ by $(\beta - z)$, to get

$$(\beta - z)k(z) \equiv \sum_{j=-\infty}^{\infty} (\beta k_j - k_{j-1})z^j \tag{92}$$

This removes the simple pole at $z = \beta$, and hence (92) is analytic on the annulus $\beta\gamma^{-1} < |z| < \gamma$. It follows that $\limsup_{j\to-\infty} |\beta k_j - k_{j-1}|^{1/j} = \beta\gamma^{-1}$, so that there exists some $M > 0$ and $n < 0$ such that $|\beta k_j - k_{j-1}| < M\beta^{-j}\gamma^j$ for all $j < n$. Extending this inequality, we note that

$$\begin{aligned}
|k_j - \beta^{-l}k_{j-l}| &\leq |k_j - \beta^{-1}k_{j-1}| + \ldots + |\beta^{-l+1}k_{j-l+1} - \beta^{-l}k_{j-l}| \\
&\leq \beta^{-1}M\beta^{-j}\gamma^j + \ldots + \beta^{-l}M\beta^{-j+l-1}\gamma^{j-l} \\
&= \beta^{-j-1}\gamma^j M\left(1 + \beta^{-1}\gamma^1 + \ldots + \beta^l\gamma^{-l}\right) \\
&< \beta^{-j-1}\gamma^j\frac{M}{1-\beta^{-1}\gamma}
\end{aligned}$$

and hence that

$$\lim_{j\to-\infty}\sup_{l\geq 0}|\beta^j k_j - \beta^{j-l}k_{j-l}| \leq \lim_{j\to-\infty}\beta^{-1}\gamma^j\frac{M}{1-\beta^{-1}\gamma} = 0 \tag{93}$$

i.e. that $\{\beta^j k_j\}$ is a Cauchy sequence as $j \to -\infty$. It therefore converges to some limit $\lim_{j\to-\infty}\beta^j k_j = c$. The (weaker) statement that $\lim_{j\to-\infty}\frac{k_{j-1}}{k_j} = \beta$ also immediately follows.

Step 3: using this to characterize the generalized Phillips curve K. Above, we have already characterized $\bar{N}^{SI}$ and its first difference (in rows). Our goal is now to prove that asymptotically, $\bar{N}^{SI}$ and $\bar{N}$ coincide, in the sense that for any j,

$$\lim_{i\to\infty}[\bar{N}^{SI} - \bar{N}]_{i,i+j} = 0 \tag{94}$$

To prove this, first we derive an expression for $\bar{N}^{SI} - \bar{N}$, writing

$$\begin{aligned}(I-P)P^{SI} - P(I-P^{SI}) &= P^{SI} - P \\ P^{SI}(I-P^{SI})^{-1} - P(I-P)^{-1} &= (I-P)^{-1}(P^{SI}-P)(I-P^{SI})^{-1} \\ \bar{N}^{SI} - \bar{N} &= N(P^{SI}-P)N^{SI} \end{aligned} \tag{95}$$

where in the last line we use $\bar{N} = P + P^2 + \ldots = P(I-P)^{-1}$, $N \equiv I + \bar{N} = (I-P)^{-1}$, and so on.

Let us first characterize the matrix in the middle on the right of (95), $P^{SI} - P$. We recall that $P^{SI} = A^{SI}B^{SI}$ and $P = AB$, and note that actually also $P = AB^{SI}$, since B^{SI} and B coincide for transition probabilities from the nonnegative integers, and A has zero transition probability to negative integers. Hence $P^{SI} = (A^{SI} - A)B^{SI}$.

We next observe that

$$\sum_j (P^{SI}_{ij} - P_{ij}) = \sum_j (A^{SI}_{ij} - A_{ij}) = \frac{\sum_{r=i+1}^{\infty} \beta^r \Phi_r}{\sum_{r=0}^{\infty} \beta^r \Phi_r} \tag{96}$$

where the first equality follows because B^{SI} is stochastic and preserves row sums, and the second equality follows directly from the definitions of A^{SI} and A. We observe that for some sufficiently large C and all $i \geq 0$, (96) is bounded above by $C\beta^i$.

From our earlier characterization, we know that $\bar{N}^{SI}$ and therefore $N^{SI} = I + \bar{N}^{SI}$ has all entries bounded above by some M. It follows that all entries in the ith row of $(P^{SI} - P)N^{SI}$ are bounded by $MC\beta^i$. Using (95), we conclude that

$$\begin{aligned}\lim_{i\to\infty}[\bar{N}^{SI} - \bar{N}]_{i,i+j} &= \lim_{i\to\infty}[N(P^{SI}-P)N^{SI}]_{i,i+j} \\ &\leq \lim_{i\to\infty}[N^{SI}(P^{SI}-P)N^{SI}]_{i,i+j} \\ &\leq \lim_{i\to\infty} \sum_{k=0}^{\infty} N^{SI}_{i,k} MC\beta^k \\ &= MC \sum_{k=0}^{\infty} \beta^k \lim_{i\to\infty} N^{SI}_{i,k} = 0\end{aligned}$$

which, since $\bar{N}^{SI} \geq \bar{N}$, implies that $\lim_{i\to\infty}[\bar{N}^{SI} - \bar{N}]_{i,i+j} = 0$. It follows that

$$\lim_{i\to\infty}(\bar{N}^{SI}_{i,i+j} - \bar{N}^{SI}_{i,i+j-1}) - (\bar{N}_{i,i+j} - \bar{N}_{i,i+j-1}) = 0$$

as well. Since the generalized Phillips curve $\mathbf{K} = (I-L)(\Psi + \Psi^2 + \ldots)$ is the transpose of $\bar{N}_{i,i+j} - \bar{N}_{i,i+j-1}$, it follows that its columns asymptotically approach the same two-sided sequence around the diagonal as in the rows of $\bar{N}^{SI}_{i,i+j} - \bar{N}^{SI}_{i,i+j-1}$, which we already characterized in the previous step as the sequence $\{k_j\}$.

Step 4: extending to a mixture of multiple time-dependent models. Suppose we have a mixture of multiple time-dependent models $\ell = 1, \ldots, n$, each with its own survival function Φ^ℓ and pass-through matrix Ψ^ℓ, with weights c_ℓ summing to 1. This mixture will have pass-through matrix $\Psi = c_1\Psi^1 + \ldots + c_n\Psi^n$.

Like before, let us interpret the transpose of each pass-through matrix as a Markov transition matrix P^ℓ, and then let us define $P = c_1P^1 + \ldots + c_nP^n$, which is the transpose of Ψ. We will now go through all steps of the previous proof with this P.[52]

First, we can construct $P^{SI,\ell}$ as before for each ℓ, and combine to obtain $P^{SI} = c_1P^{SI,1} + \ldots + c_nP^{SI,n}$, which is still shift-invariant. We then obtain the same characterization of the z-transform $\psi(z)$ of P^{SI} as before. In particular, since $\psi(z)$ is a mixture of the underlying ℓ, it is still analytic in some annulus $\beta v^{-1} < |z| < v$ for $v > 1$ (where we can take the minimum v^ℓ across all ℓ) and remains convex on $(\beta v^{-1}, v)$ with simple zeros at β and 1. It follows from our arguments in step 1 that $\psi(z) - 1$ is analytic, strictly smaller than 1 for $\beta < |z| < 1$, and has two simple zeros $z = \beta$ and $z = 1$ on some annulus $\beta\gamma^{-1} < |z| < \gamma$. Given these properties of $\psi(z)$, step 2 is unchanged.

For step 3, the identity (95) remains unchanged, and we can use the argument from (96) to show that for each ℓ, $P^{SI,\ell} - P^\ell$ is bounded above by $C^\ell\beta^i$ for some constant C^ℓ. Taking $C \equiv \max_\ell C^\ell$, it follows that $P^{SI} - P$ is bounded above by $C\beta^i$, and the rest of the proof goes through as before, concluding our argument.

D.4 Robustness of the numerical equivalence result

This appendix provides robustness exercises for the numerical equivalence result from section 4. We show that the approximate numerical equivalence holds for several extensions of the baseline menu cost model used in the main text.

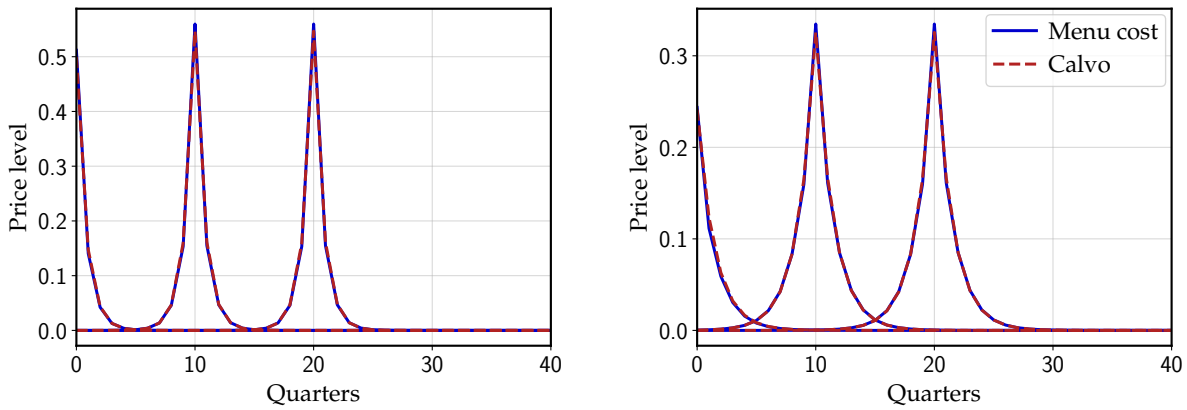
First, we introduce steady state inflation. This can be done by adding a drift term $\mu > 0$ to the law of motion for the static optimal price (1), which becomes:

$$p^*_{it} = p^*_{it-1} + \mu + \epsilon_{it}.$$

Since the time unit is one quarter, the drift μ corresponds to an annual inflation rate of 4μ. Figure D.1 shows pass-through and Phillips curve matrices for both Golosov-Lucas and Nakamura-Steinsson models with annual inflation rate of 2%, while figure D.2 does the analogous exercise for a 5% annual inflation rate. The state-dependent pass-through matrices are still indistinguishable from the corresponding Calvo approximations. For the Phillips curve matrices, it is visible that the Calvo approximation is slightly better for lower inflation, although the fit is still very good for moderate inflation levels.

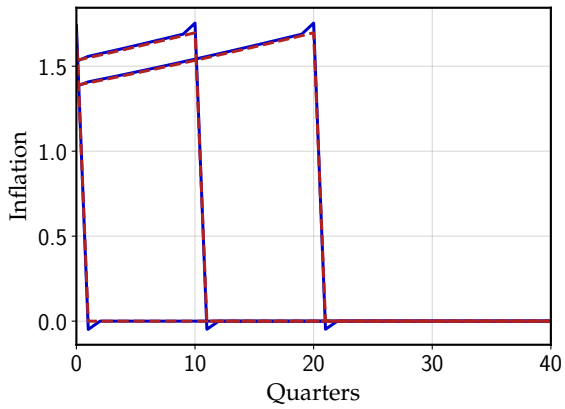
Finally, Figure D.3 shows the best-fitting κ when we calibrate the baseline GL and NS models, and then vary the level of trend inflation μ. The figures show that the slope modestly increases

[52] Note that P corresponds to a Markov chain where steps are taken according to a random draw from $P^1, \ldots, P^n$, according to the weights $c_1, \ldots, c_n$.

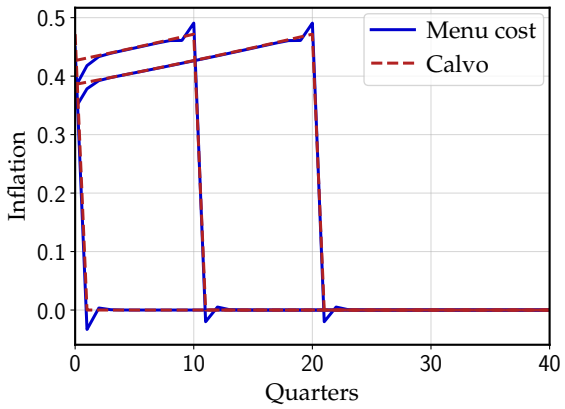


(a) Golosov-Lucas pass-through matrix

(b) Nakamura-Steinsson pass-through matrix



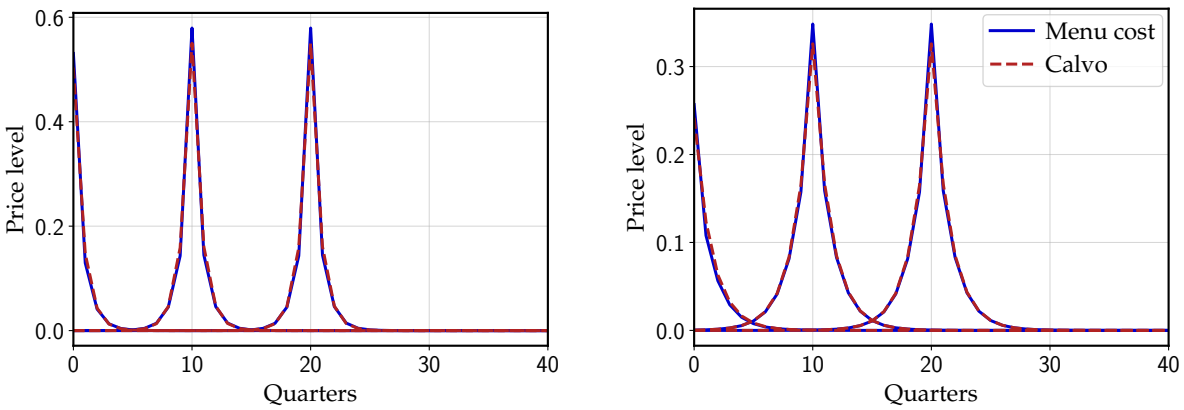
(c) Golosov-Lucas generalized Phillips curve



(d) Nakamura-Steinsson generalized Phillips curve

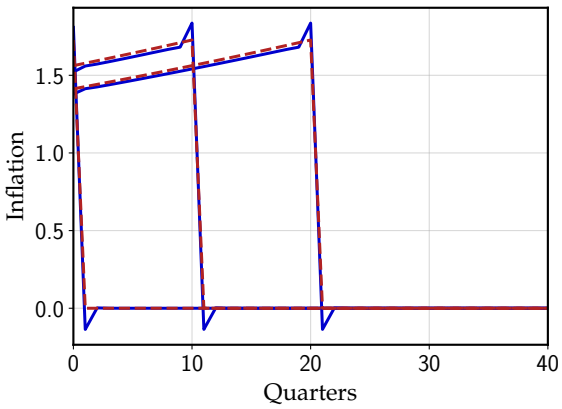
Figure D.1: Menu cost models and Calvo approximations with 2% annual steady state inflation.

Note: columns $s \in \{0, 10, 20\}$ of the pass-through and Phillips curve matrices for the GL and NS models, calibrated to match the same empirical moments as in the main text, as well as the best-fitting Calvo approximations.

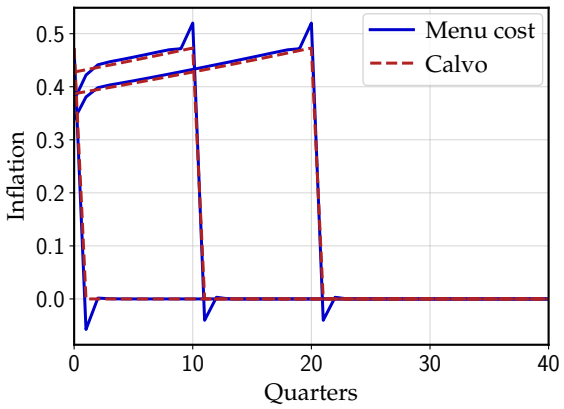


(a) Golosov-Lucas pass-through matrix

(b) Nakamura-Steinsson pass-through matrix



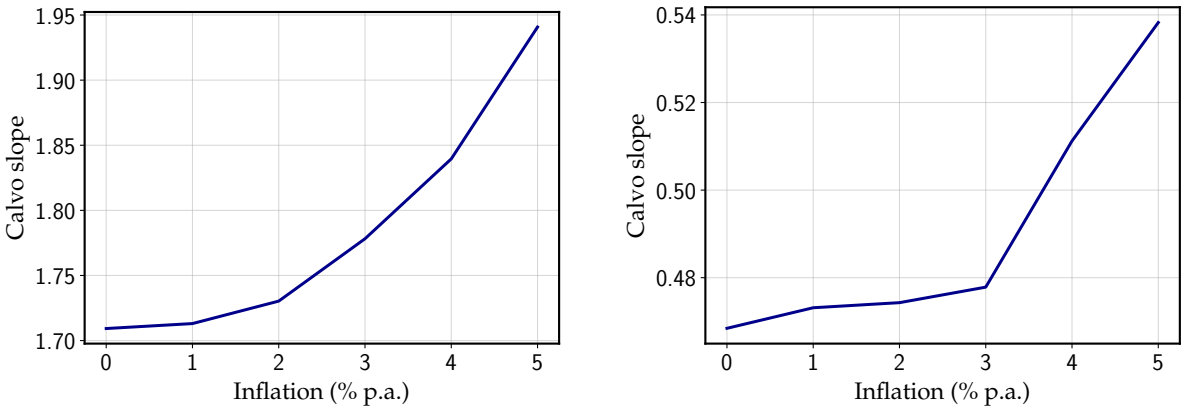
(c) Golosov-Lucas generalized Phillips curve



(d) Nakamura-Steinsson generalized Phillips curve

Figure D.2: Menu cost models and Calvo approximations with 5% annual steady state inflation.

Note: columns $s \in \{0, 10, 20\}$ of the pass-through and Phillips curve matrices for the GL and NS models, calibrated to match the same empirical moments as in the main text, as well as the best-fitting Calvo approximations.



(a) Golosov-Lucas model

(b) Nakamura-Steinsson model

Figure D.3: Best-fitting Calvo Phillips curve slope for various levels of trend inflation μ

with trend inflation, consistent with the fact that trend inflation increases the steady-state frequency of price adjustment (see, e.g., Alvarez, Beraja, Gonzalez-Rozada and Neumeyer 2019).

Now we return to the model with no trend inflation, and instead introduce infrequent shocks, as in Midrigan (2011). More specifically we assume that idiosyncratic shocks follow

$$\epsilon_{it} = \begin{cases} 0 & \text{with probability } 1-p \\ N(0,\sigma_\epsilon^2) & \text{with probability } p \end{cases}.$$

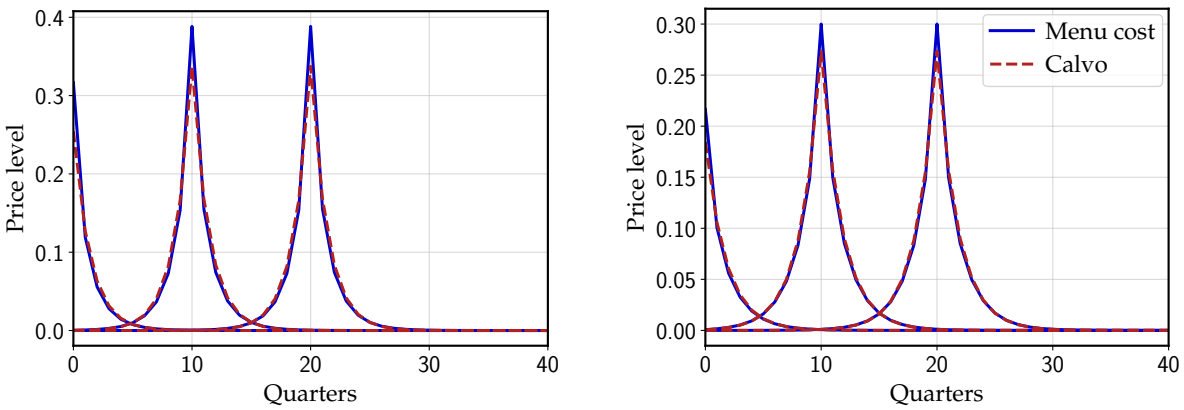
This effectively increases the kurtosis of the (unconditional) shock distribution, so this feature is often referred to in the literature as leptokurtic shocks.[53] Figure D.4 shows results. Similarly to the trend inflation case, the pass-through matrices of the menu cost models are still indistinguishable from their Calvo approximations. The fit of the generalized Phillips curve slightly deteriorates, but is still very good.

The next extension we explore is a multi-product model, as in Midrigan (2011) and Alvarez and Lippi (2014). We revert to our baseline model, without trend inflation or leptokurtic shocks, and now assume each firm sells two distinct products. The state variable of the firm optimization problem is now a pair of price gaps $(x_{it,1}, x_{it,2})$, each one evolving independently as a random walk without drift, although both are subject to the same aggregate marginal cost shock. The loss function is now given by

$$\frac{1}{2}\left(x_{it,1} - \log MC_t\right)^2 + \frac{1}{2}\left(x_{it,2} - \log MC_t\right)^2.$$

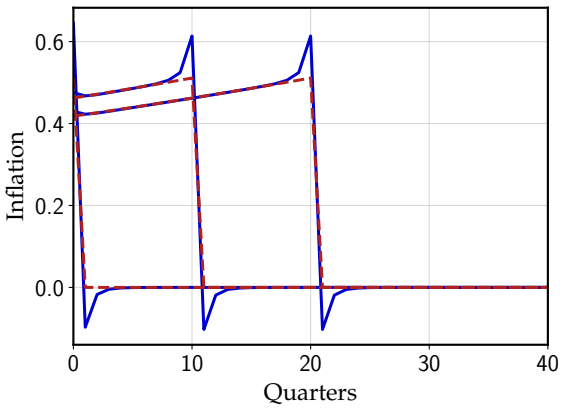
Importantly, firms face economies of scope in price adjustments – there is a single menu cost whose payment allows the firm to adjust the prices of both its products. Otherwise, aggregate dynamics would be the same as in a single-product model. Figure D.5 shows results for this case. Again, the

[53] An alternative approach in Karadi and Reiff (2019) assumes a mixture of two normal distributions.

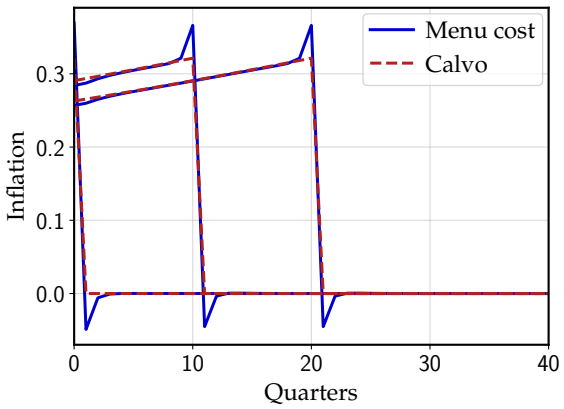


(a) Golosov-Lucas pass-through matrix

(b) Nakamura-Steinsson pass-through matrix



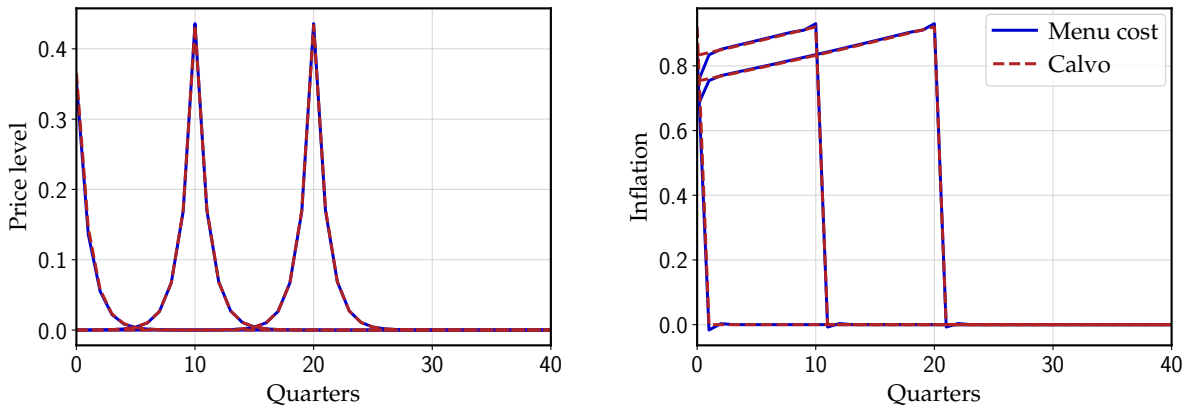
(c) Golosov-Lucas generalized Phillips curve



(d) Nakamura-Steinsson generalized Phillips curve

Figure D.4: Menu cost models and Calvo approximations with infrequent shocks ($p = 0.5$).

Note: columns $s \in \{0, 10, 20\}$ of the pass-through and Phillips curve matrices for the GL and NS models, calibrated to match the same empirical moments as in the main text, as well as the best-fitting Calvo approximations.



(a) Pass-through matrix

(b) Generalized Phillips curve

Figure D.5: Multi-product model and Calvo approximations.

Note: columns $s \in \{0, 10, 20\}$ of the pass-through and Phillips curve matrices for the multi-product model, calibrated to match the moments in table 1, as well as the best-fitting Calvo approximation.

Calvo approximation is very precise.

The next extension we analyze is a multi-sector economy. Consider an economy composed of N economic sectors, each one characterized by its own parameter values, i.e., potentially different menu costs, probabilities of free adjustments, and volatility of idiosyncratic shocks. Each sector, indexed by $j \in \{1, \ldots, N\}$, has weight ω_j in the price index, in such a way that the log aggregate price level is

$$p_t = \sum_{j=1}^{N} \omega_j p_{jt},$$

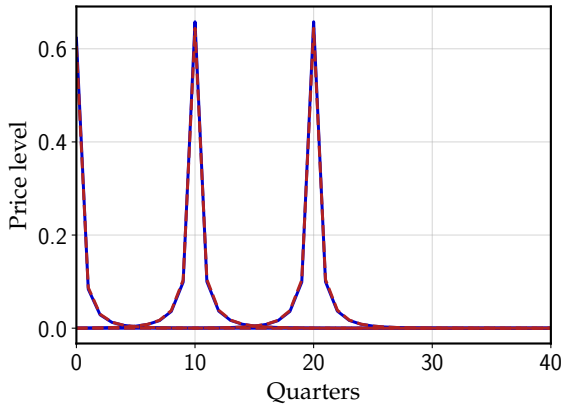
where p_{jt} is the sectoral price level of sector j. From the above equation, it follows that the pass-through matrix of the multi-sector economy Ψ is given by the same weighted average of the sectoral pass-through matrices Ψ_j:

$$\Psi = \sum_{j=0}^{J} \omega_j \Psi_j.$$

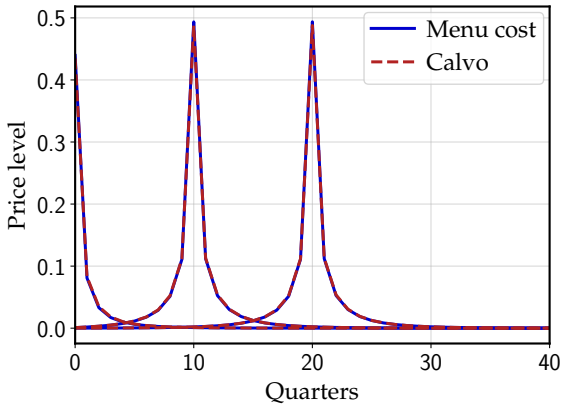
Once we have this pass-through matrix, we can apply the same transformation 13 to obtain the generalized Phillips curve. Consequently, if each Ψ_k can be well approximated by a Calvo model, then the multi-sector state-dependent economy will be close to a multi-sector Calvo one.

Following the approach outlined above, we calibrate a 14-sector menu cost economy using the same moments as Nakamura and Steinsson (2010), reproduced in table D.2. For each sector, we find the best-fitting Calvo model and compute the corresponding aggregate pass-through and Phillips curve matrices. Figure D.6 shows results. For both our main specifications – with and without free adjustments –, the two models are again almost identical.

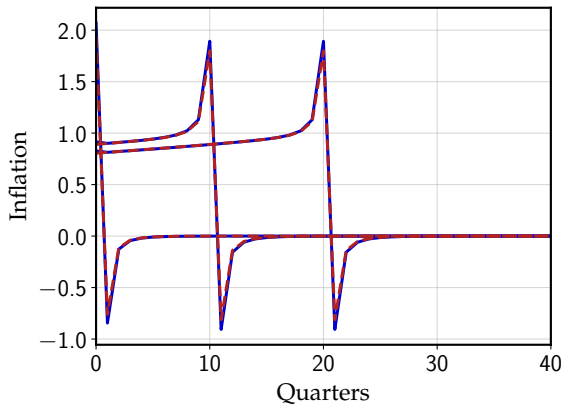
Finally, we study how well the Calvo approximation fares in comparison to large, nonlinear marginal cost shocks in state-dependent models. State-dependent models are well-known for featuring nonlinearities: a large aggregate shock may endogenously trigger many price adjustments,



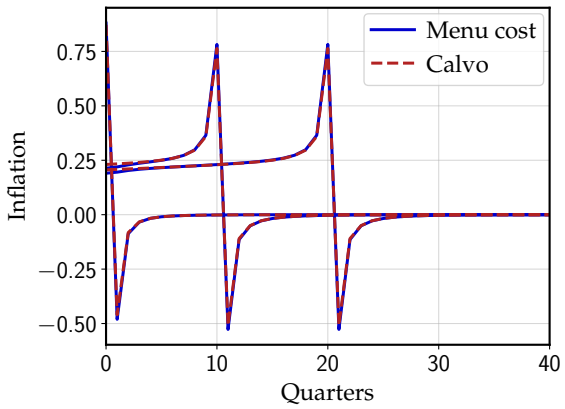
(a) Multi-sector Golosov-Lucas pass-through matrix



(b) Multi-sector Nakamura-Steinsson pass-through matrix



(c) Multi-sector Golosov-Lucas generalized Phillips curve



(d) Multi-sector Nakamura-Steinsson generalized Phillips curve

Figure D.6: Multi-sector menu cost models and Calvo approximations.

Note: columns $s \in \{0, 10, 20\}$ of the pass-through and Phillips curve matrices for the multi-sector GL and NS models, calibrated to match the moments in table D.2, as well as the best-fitting Calvo approximations.

Sector	Weight (%)	Frequency (%)	Abs. size (%)
Vehicle fuel, used cars	7.7	91.6	4.9
Utilities	5.3	49.4	6.4
Travel	5.5	43.7	18.4
Unprocessed food	5.9	25.4	15.9
Transport goods	8.3	21.3	8.9
Services (1)	7.7	21.7	4.0
Processed food, other goods	13.7	11.9	11.4
Services (2)	7.5	8.4	6.7
Household furnishings	5.0	6.5	10.1
Services (3)	7.8	6.2	8.8
Rec. goods	3.6	6.1	10.2
Services (4)	7.6	4.9	8.1
Apparel	6.5	3.6	12.4
Services (5)	7.9	2.9	13.5

Table D.2: Sectoral pricing moments.

Note: this table reproduces the data from Nakamura and Steinsson (2010), and shows CPI weights, monthly frequency and mean absolute size of price changes for each sector. Services are sorted into five groups according to entry-level adjustment frequency in the CPI. See Nakamura and Steinsson (2010) for more details. For our calibration, we convert monthly frequencies $f_{monthly}$ into quarterly frequencies $f_{quarterly} = 1 - (1 - f_{monthly})^3$.

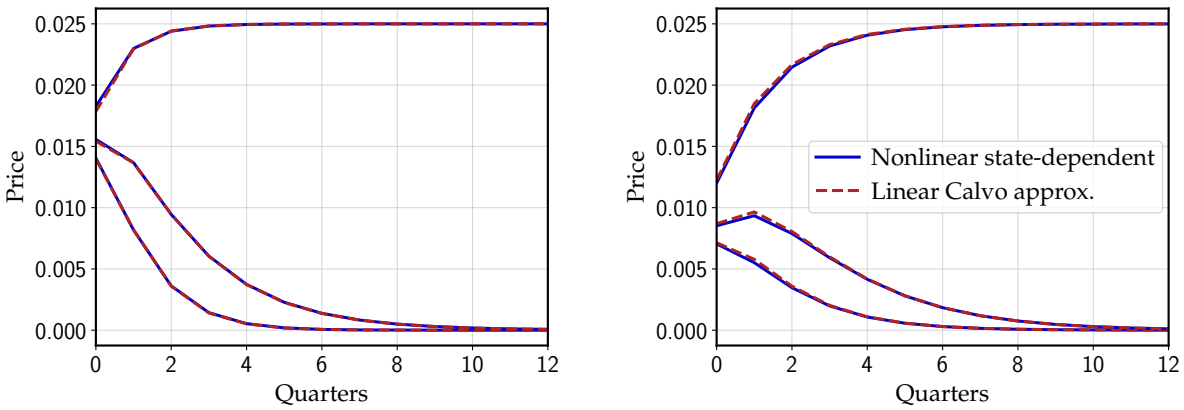
increasing the flexibility of the aggregate price level in response to it. In order to assess this effect, we compute the nonlinear price responses to nominal marginal cost shocks of the form

$$MC_t = MC_0 \rho^t$$

for $MC_0 \in \{2.5\%, 5\%\}$. We compare the price responses to the best-fitting linear Calvo approximation.[54] Results are shown in figure D.7. For shocks of initial size 2.5%, nonlinearities are negligible and the Calvo approximation again provides almost identical impulse responses. For a large shock of initial size 5%, we start to see some discrepancies for the Golosov-Lucas model, in which the extensive margin of adjustment is stronger. For the Nakamura-Steinsson model, on the other hand, the Calvo model still provides indistinguishable responses.

Figure D.8 examines the extent of aggregate nonlinearity in the generalized Phillips curve for our two main calibrations of the canonical menu cost model. We conduct two exercises. In the top graphs, panels (a) and (b), starting from the steady state, we consider a large AR(1) shock to real marginal cost that increases annual inflation on impact by 5% (quarterly by 1.25%). We compare the resulting nonlinear impulse reponse in the menu cost model to the linear impulse response in the same model, and to the linear impulse response of the approximating Calvo model from section 4. We find that the three impulse responses all closely match, with the nonlinear menu cost slightly above the linear in the first period and very close thereafter.

[54] For simplicity, we study only shocks to nominal marginal costs, as shocks to real marginal costs require solving a fixed point problem.



(a) Golosov-Lucas, 2.5% nominal shocks.

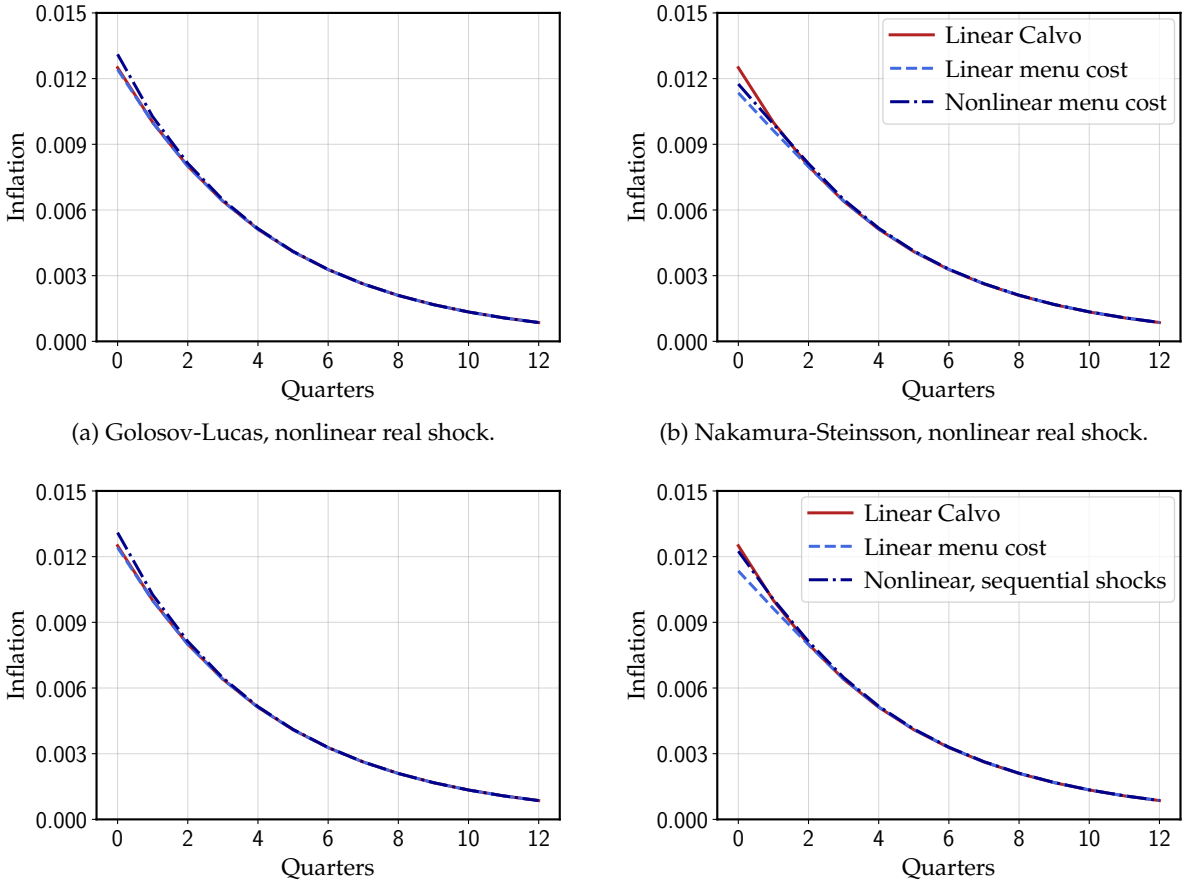
(b) Nakamura-Steinsson, 2.5% nominal shocks.

(c) Golosov-Lucas, 5% nominal shocks.

(d) Nakamura-Steinsson, 5% nominal shocks.

Figure D.7: Price level responses to AR(1) nonlinear nominal marginal cost shocks.

Note: nonlinear impulse responses to AR(1) marginal cost shocks for GL and NS models, calibrated as in table 1, as well as linear responses for the best-fitting Calvo approximations. Shock persistence values are $\{0.3, 0.6, 1\}$.



(a) Golosov-Lucas, nonlinear real shock.

(b) Nakamura-Steinsson, nonlinear real shock.

(c) Golosov-Lucas, sequential nonlinear real shocks.

(d) Nakamura-Steinsson, sequential nonlinear real shocks.

Figure D.8: Aggregate nonlinearity of the generalized Phillips curve

Note: linear and nonlinear impulse responses to AR(1) real marginal cost shocks for multi-sector GL and NS models, calibrated as in table 1, as well as linear responses for the best-fitting Calvo approximations. The shock persistence is 0.8 and the size is determined so as to generate a 5% annualized increase in inflation in the Calvo model. In panels (c) and (d), this shock comes after an identically-sized shock at date -5.

In the bottom graphs, panels (c) and (d), we perform a similar exercise, but assuming that the shock at date 0 comes on top of a same-sized shock at date -5, so that the initial distribution of price gaps is away from the steady state coming into date 0. Again, we find limited departure between this nonlinear impulse response and the linear impulse responses, although the initial gap between nonlinear and linear menu cost is now slightly larger in the NS model, indicating only mild state dependence.

E Appendix to Section 5

E.1 The log-linearized system for non-infinitesimal $\sigma_\epsilon > 0$

We begin by collecting all the equilibrium conditions of the model. There are 9 conditions for 9 unknown sequences, $\{w_t, W_t, P_t, Y_t, N_t, \Delta_t, \Xi_t, i_t, \pi_t\}$. The conditions are:

- **Optimal pricing behavior of firms:** Price setters solve (45) for given $\{W_t, w_t, Y_t\}$,

$$\min_{\{x_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t Y_t^{-\sigma} \left[\left(\frac{\zeta}{\zeta - 1} w_t \right)^{1-\zeta} Y_t \cdot F\left(x_{it} - \log W_t\right) + \sigma_\epsilon^2 \xi_{it} w_t 1_{\{x_{it} \neq x_{it-1} - \sigma_\epsilon \epsilon_{it}\}} \right] \tag{97a}$$

  From the optimal price gaps x_{it} we can then compute the path of the price level, as in (44),

$$P_t = \frac{\zeta}{\zeta - 1} \left(\int_0^1 e^{(1-\zeta) x_{it}} di \right)^{\frac{1}{1-\zeta}}$$

  as well as price dispersion

$$\Delta_t \equiv \left(\int_0^1 e^{(1-\zeta) x_{it}} di \right)^{\frac{\zeta}{1-\zeta}} \int_0^1 e^{-\zeta x_{it}} di \geq 1$$

  and the aggregate amount of labor used for menu cost, as in (46),

$$\Xi_t \equiv \int_0^1 \sigma_\epsilon^2 \xi_{it} 1_{\{x_{it} \neq x_{it-1} - \sigma_\epsilon \epsilon_{it}\}} di$$

  Together, we can summarize the pricing behavior as three sequence-space functions,

$$P_t = \mathcal{P}_t\left(\{W_s, w_s, Y_s\}\right), \quad \Delta_t = \mathcal{D}_t\left(\{W_s, w_s, Y_s\}\right), \quad \Xi_t = \mathcal{X}_t\left(\{W_s, w_s, Y_s\}\right) \tag{97b}$$

- **Labor demand:** Labor needs to be consistent with optimal labor demand by firms, (47),

$$N_t = Y_t \Delta_t + \Xi_t \tag{97c}$$

- **Labor supply:** Labor needs to be consistent with optimal labor supply by households, (37)

$$b N_t^{\varphi} = w_t Y_t^{-\sigma} \tag{97d}$$

  where we already substituted out consumption using goods market clearing $C_t = Y_t$.

- **Monetary policy rule:** The nominal interest rate follows the Taylor rule

$$i_t = i_{ss} + \phi \pi_t + \nu_t \tag{97e}$$

- **Euler equation:** Output follows the household's Euler equation (37)

$$Y_t^{-\sigma} = \frac{P_t}{P_{t+1}} (1 + i_t) Y_{t+1}^{-\sigma} \tag{97f}$$

- **Real wage:** The real wage is defined as

$$w_t = W_t / P_t \tag{97g}$$

- **Inflation:** Inflation is given by

$$\pi_t = P_t / P_{t-1} - 1 \tag{97h}$$

We log-linearize equations (97b)–(97h) around a deterministic steady state in which $\nu_t = \nu_{ss} = 0$. We find

$$\hat{\mathbf{P}} = \mathbf{J}^{P,W} \hat{\mathbf{W}} + \mathbf{J}^{P,Y} \hat{\mathbf{Y}} + \mathbf{J}^{P,w} \hat{\mathbf{w}}$$

$$\hat{\mathbf{\Delta}} = \mathbf{J}^{\Delta,W} \hat{\mathbf{W}} + \mathbf{J}^{\Delta,Y} \hat{\mathbf{Y}} + \mathbf{J}^{\Delta,w} \hat{\mathbf{w}}$$

$$\hat{\mathbf{\Xi}} = \mathbf{J}^{\Xi,W} \hat{\mathbf{W}} + \mathbf{J}^{\Xi,Y} \hat{\mathbf{Y}} + \mathbf{J}^{\Xi,w} \hat{\mathbf{w}}$$

$$\hat{N}_t = \frac{Y_{ss}\Delta_{ss}}{Y_{ss}\Delta_{ss} + \Xi_{ss}} \left(\hat{Y}_t + \hat{\Delta}_t\right) + \frac{\Xi_{ss}}{Y_{ss}\Delta_{ss} + \Xi_{ss}} \hat{\Xi}_t$$

$$\varphi \hat{N}_t = \hat{w}_t - \sigma \hat{Y}_t$$

$$\hat{i}_t = \phi \hat{\pi}_t + \hat{\nu}_t$$

$$\hat{Y}_t = \hat{Y}_{t+1} - \frac{1}{\sigma}(\hat{i}_t - \hat{\pi}_{t+1})$$

$$\hat{w}_t = \hat{W}_t - \hat{P}_t$$

$$\hat{\pi}_t = \hat{P}_t - \hat{P}_{t-1}$$

Here, we denote by $\mathbf{J}^{P,X}$ the Jacobian of $\{\mathcal{P}_t\}$ with respect to sequence $\{X_s\}$, and similarly for $\mathbf{J}^{\Delta,X}$ and $\mathbf{J}^{\Xi,X}$.

E.2 Characterizing firm Jacobians in general case

The Jacobians $\mathbf{J}$ in the previous section are no longer given by an exact equivalence result of the simple form (26). Here, instead, we retrace the steps of proposition 1 to more generally characterize the Jacobian of an arbitrary aggregate outcome to an arbitrary shock, in the menu cost model where the period loss function is some arbitrary $F(\cdot)$—including, for instance, the case of non-infinitesimal $\sigma_\epsilon > 0$.

Law of motion for arbitrary aggregate. Suppose that we have some aggregate outcome $Y(g^{end})$ where g^{end} is the end-of-period density over x (and is an ordinary smooth density plus a Dirac

delta at x^*). The examples that will ultimately be relevant to us are the price level $P(g^{end}) = \frac{\zeta}{\zeta-1}\left(\int e^{(1-\zeta)x} g^{end}(x)dx\right)^{\frac{1}{1-\zeta}}$, the price dispersion index $\Delta(g^{end}) = \left(\int e^{(1-\zeta)x} g^{end}(x)dx\right)^{\frac{\zeta}{1-\zeta}} \int e^{-\zeta x} g^{end}(x)dx$, and the total number of adjusters $ADJ(g^{end}) = \int \mathbf{1}_{x=0} g^{end}(x)dx$ (which determines menu costs paid Ξ).[55]

Now, define $E^{Y,0}(x)$ to be the gradient of Y with respect to g^{end} around the steady state, and $E^{Y,t}(x)$ recursively as the expectation of $E^{Y,t-1}(x)$ given the steady-state policies. Following the proof of proposition 1, suppose that at date $t-s$, there is a one-time change in policies $\overline{x}_{t-s}$, $\underline{x}_{t-s}$, and x^*_{t-s}. Then we have

$$dY_t = (E^{Y,s}(\overline{x}) - E^{Y,s}(x^*))g^{end}(\overline{x})d\overline{x}_{t-s} - (E^{Y,s}(\underline{x}) - E^{Y,s}(x^*))g^{end}(\underline{x})d\underline{x}_{t-s} + \text{freq} \cdot (E^{Y,s})'(x^*)dx^*_{t-s}$$

Combining across all periods, and noting that $g^{end}(x) = (1-\lambda)g(x)$ at all points inside the adjustment bands (except that g^{end} also has a Dirac delta at x^*), we have the law of motion

$$\begin{aligned} dY_t = (1-\lambda)g(\overline{x}) \sum_{s=0}^{t} (E^{Y,s}(\overline{x}) - E^{Y,s}(x^*))d\overline{x}_{t-s} \\ - (1-\lambda)g(\underline{x}) \sum_{s=0}^{t} (E^{Y,s}(\underline{x}) - E^{Y,s}(x^*))d\underline{x}_{t-s} + \text{freq} \cdot \sum_{s=0}^{t} (E^{Y,s})'(x^*)dx^*_{t-s} \end{aligned} \quad (98)$$

Policy function for arbitrary input. Now suppose that the flow payoff function, excluding the menu cost, is given by some arbitrary $F(x, Z)$, where Z is any time-varying aggregate input. We define $E^{Z,0}(x)$ to be the derivative of $F(x, Z)$ with respect to Z around the aggregate steady state, and $E^{Z,t}(x)$ recursively given $E^{Z,t-1}(x)$. Similarly, we define $E^{F,0}(x)$ to be the derivative of $F(x, Z)$ with respect to x around the aggregate steady state, and $E^{F,t}(x)$ recursively.

Now, following the proof, we suppose there is a shock dZ at date s. Then we have $dV_s(x) = E^{Z,0}(x)dZ$, and by the same envelope argument, $dV_t(x) = \beta^{s-t} E^{Z,s-t}(x)dZ$. We also have $V'(x) = \sum_{u=0}^{\infty} \beta^u E^{F,u}(x)$, using the same envelope argument as in appendix C.1.

Similarly, if there is a shock $d\xi$ at date s, we have a change in total value at time s of $E^{ADJ,0}(x)d\xi$, where x is the end-of-period choice, and analogously to above we have $dV_t(x) = \beta^{s-t} E^{ADJ,s-t}(x)d\xi$ for all $t < s$.

At each date t, the optimal adjustment thresholds are given by value-matching conditions

$$\begin{aligned} V_t(\overline{x}_t) &= V_t(x^*_t) + \xi_t \\ V_t(\underline{x}_t) &= V_t(x^*_t) + \xi_t \end{aligned}$$

Totally differentiating these around the steady state and using $V'(x^*) = 0$, we have $d\overline{x}_t = -(dV_t(\overline{x}) - dV_t(x^*) - d\xi_t)/V'(\overline{x})$ and $d\underline{x}_t = -(dV_t(\underline{x}) - dV_t(x^*) - d\xi_t)/V'(\underline{x})$, which combined with the re-

[55] There are in principle firms who ended up at $x = 0$ not because they adjusted, but by chance pre-adjustment, but this is measure zero and does not affect the total number of adjusters.

sults above gives the following analogs to (23):

$$d\overline{x}_t = -\frac{\sum_{s\geq t}\beta^{s-t}\left((E^{Z,s-t}(\overline{x}) - E^{Z,s-t}(x^*))dZ_s + (E^{ADJ,s-t}(\overline{x}) - E^{ADJ,s-t}(x^*))d\xi_s\right)}{\sum_{s\geq t}\beta^{s-t}E^{F,s-t}(\overline{x})} \tag{99}$$

$$d\underline{x}_t = -\frac{\sum_{s\geq t}\beta^{s-t}\left((E^{Z,s-t}(\underline{x}) - E^{Z,s-t}(x^*))dZ_s + (E^{ADJ,s-t}(\underline{x}) - E^{ADJ,s-t}(x^*))d\xi_s\right)}{\sum_{s\geq t}\beta^{s-t}E^{F,s-t}(\underline{x})} \tag{100}$$

Similarly, the optimal reset point is given by the first-order condition $V_t'(x_t^*) = 0$. Totally differentiating gives $dx_t^* = -dV_t(x^*)/V''(x^*)$, which gives the following analog to (24):

$$dx_t^* = -\frac{\sum_{s\geq t}\beta^{s-t}(E^{Z,s-t})'(x^*)dZ_s}{\sum_{s\geq t}\beta^{s-t}(E^{F,s-t})'(x^*)} \tag{101}$$

Substituting (99)–(101) into (98), we have that the Jacobian of Y with respect to Z is:

$$\begin{aligned}
&-\frac{(1-\lambda)g(\overline{x})}{\sum_{t=0}^{\infty}\beta^t E^{F,t}(\overline{x})}\begin{pmatrix} E^{Y,0}(\overline{x}) - E^{Y,0}(x^*) & 0 & \cdots \\ E^{Y,1}(\overline{x}) - E^{Y,1}(x^*) & E^{Y,0}(\overline{x}) - E^{Y,0}(x^*) & \cdots \\ \vdots & \vdots & \ddots \end{pmatrix}\begin{pmatrix} E^{Z,0}(\overline{x}) - E^{Z,0}(x^*) & \beta(E^{Z,1}(\overline{x}) - E^{Z,1}(x^*)) & \cdots \\ 0 & E^{Z,0}(\overline{x}) - E^{Z,0}(x^*) & \cdots \\ \vdots & \vdots & \ddots \end{pmatrix} \\
&-\frac{(1-\lambda)g(\underline{x})}{\sum_{t=0}^{\infty}\beta^t E^{F,t}(\underline{x})}\begin{pmatrix} E^{Y,0}(\underline{x}) - E^{Y,0}(x^*) & 0 & \cdots \\ E^{Y,1}(\underline{x}) - E^{Y,1}(x^*) & E^{Y,0}(\underline{x}) - E^{Y,0}(x^*) & \cdots \\ \vdots & \vdots & \ddots \end{pmatrix}\begin{pmatrix} E^{Z,0}(\underline{x}) - E^{Z,0}(x^*) & \beta(E^{Z,1}(\underline{x}) - E^{Z,1}(x^*)) & \cdots \\ 0 & E^{Z,0}(\underline{x}) - E^{Z,0}(x^*) & \cdots \\ \vdots & \vdots & \ddots \end{pmatrix} \\
&\qquad -\frac{\text{freq}}{\sum_{t=0}^{\infty}\beta^t E^{F,t\prime}(x^*)}\begin{pmatrix} E^{Y,0\prime}(x^*) & 0 & \cdots \\ E^{Y,1\prime}(x^*) & E^{Y,0\prime}(x^*) & \cdots \\ \vdots & \vdots & \ddots \end{pmatrix}\begin{pmatrix} E^{Z,0\prime}(x^*) & \beta E^{Z,1\prime}(x^*) & \cdots \\ 0 & E^{Z,0\prime}(x^*) & \cdots \\ \vdots & \vdots & \ddots \end{pmatrix}
\end{aligned} \tag{102}$$

The Jacobian of Y with respect to ξ is identical, but with E^Z replaced by E^{ADJ}.

Compared to equation (26) in the main text, we note that the products of lower and upper triangular matrices in (102) no longer have the same symmetry: in general, the sequences $E^{Y,s}(\cdot)$ and $E^{Z,s}(\cdot)$ need not be the same. Each product can be interpreted as corresponding to the pass-through matrix of a "pseudo-time-dependent" model, where agents assume a different survival function when choosing their policies than the survival function that actually governs prices. Since the symmetry between lower and upper adjustment bands is broken in the general case, there are also now three products rather than two—so that the most general form of the equivalence result away from the canonical case is that the menu cost model is equivalent to a mixture of three pseudo-time-dependent models.

E.3 Proof of proposition 4

E.3.1 Step 1: Convergence of steady state in limit $\sigma_\epsilon \to 0$

Take (97a) and, using the fact that the firm's profit maximization is invariant to an affine transformation, rewrite as

$$\min_{\{x_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t Y_t^{-\sigma} \left[\left(\frac{\zeta}{\zeta - 1} w_t \right)^{1-\zeta} Y_t \cdot \frac{F\left(x_{it} - \log W_t\right) - F(0)}{\sigma_\epsilon^2} + \xi_{it} w_t 1_{\{x_{it} \neq x_{it-1} - \sigma_\epsilon \epsilon_{it}\}} \right]$$

and then define $\hat{x}_{it} \equiv (x_{it} - \log W_{ss})/\sigma_\epsilon$ and $\hat{W}_t \equiv (\log W_t - \log W_{ss})/\sigma_\epsilon$, so that we get

$$\min_{\{\hat{x}_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t Y_t^{-\sigma} \left[\left(\frac{\zeta}{\zeta - 1} w_t \right)^{1-\zeta} Y_t \cdot \frac{F\left(\sigma_\epsilon(\hat{x}_{it} - \hat{W}_t)\right) - F(0)}{\sigma_\epsilon^2} + \xi_{it} w_t 1_{\{\hat{x}_{it} \neq \hat{x}_{it-1} - \epsilon_{it}\}} \right]$$

Now define $\mathcal{F}(\hat{x}; \sigma_\epsilon) \equiv \frac{F(\sigma_\epsilon \hat{x}) - F(0)}{\sigma_\epsilon^2}$, so that this is just

$$\min_{\{\hat{x}_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t Y_t^{-\sigma} \left[\left(\frac{\zeta}{\zeta - 1} w_t \right)^{1-\zeta} Y_t \cdot \mathcal{F}(\hat{x}_{it} - \hat{W}_t; \sigma_\epsilon) + \xi_{it} w_t 1_{\{\hat{x}_{it} \neq \hat{x}_{it-1} - \epsilon_{it}\}} \right] \tag{103}$$

Here, note that the only place that σ_ϵ enters is as a parameter to this $\mathcal{F}$ function. Further, in the limit as $\sigma_\epsilon \to 0$, it is very easy to show that $\mathcal{F}(\hat{x}; \sigma_\epsilon) \to \frac{1}{2} F''(0) \hat{x}^2$.

Explicitly, since F has a Taylor series representation around 0 and also has derivative $F'(0) = 0$, we can write

$$\lim_{\sigma_\epsilon \to 0} \mathcal{F}(\hat{x}; \sigma_\epsilon) = \lim_{\sigma_\epsilon \to 0} \frac{F\left(\sigma_\epsilon \hat{x}\right) - F(0)}{\sigma_\epsilon^2} = \lim_{\sigma_\epsilon \to 0} \frac{\frac{1}{2} F''(0) \sigma_\epsilon^2 \hat{x}^2}{\sigma_\epsilon^2} = \frac{1}{2} F''(0) \hat{x}^2$$

Note that we also get this convergence in the first derivative of $\mathcal{F}$, i.e.

$$\lim_{\sigma_\epsilon \to 0} \mathcal{F}'(\hat{x}; \sigma_\epsilon) = \lim_{\sigma_\epsilon \to 0} \frac{\sigma_\epsilon F'\left(\sigma_\epsilon \hat{x}\right) - \sigma_\epsilon F'(0)}{\sigma_\epsilon^2} = \lim_{\sigma_\epsilon \to 0} \frac{\sigma_\epsilon F''(0) \sigma_\epsilon \hat{x}}{\sigma_\epsilon^2} = F''(0) \hat{x}$$

Convergence to same steady state as quadratic objective. At the steady state, dividing both sides by $F''(0) Y^{1-\sigma} \left(\frac{\zeta}{\zeta - 1} w \right)^{1-\zeta}$, (103) becomes

$$\min_{\{\hat{x}_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left[\frac{\mathcal{F}(\hat{x}_{it} - \hat{w}; \sigma_\epsilon)}{F''(0)} + \xi_{it} \frac{\left(\frac{\zeta}{\zeta - 1} \right)^{\zeta - 1} w^\zeta}{F''(0) Y} 1_{\{\hat{x}_{it} \neq \hat{x}_{it-1} - \epsilon_{it}\}} \right] \tag{104}$$

which is identical to the original steady-state optimization problem 2 with the menu cost scaled by $\frac{\left(\frac{\zeta}{\zeta - 1} \right)^{\zeta - 1} w^\zeta}{F''(0) Y}$, except that we have $\frac{\mathcal{F}(\hat{x}_{it} - \hat{w}; \sigma_\epsilon)}{F''(0)}$ rather than the quadratic objective $\frac{1}{2} \hat{x}^2$. Hence we can rewrite the recursion (62) for the value function in this case, and we will denote the value function by $V(\hat{x}; \sigma_\epsilon)$.

By appendix B.2, if we use the norm $\|\cdot\|$ defined in (70), which is a linear combination of the sup norms on V and V', $V(\hat{x};\sigma_\epsilon)$ is differentiable in σ_ϵ around $\sigma_\epsilon = 0$, with $\|dV\| \leq \frac{\|\frac{d\mathcal{F}}{F''(0)}\|}{1-\frac{1+\beta}{2}}$ where we recall that backward iteration on V is a contraction with modulus $\frac{1+\beta}{2}$ in this norm.[56] Analogously to appendix B.2, this differentiablity implies differentiability of the policies $\underline{x}$, $\overline{x}$, and x^* in σ_ϵ, so that these all converge to their values under the quadratic objective as $\sigma \to 0$. Further, since by appendix B.1, forward iteration on beginning-of-period densities g is a contraction, and the one-period-ahead density is differentiable with respect to the policies, the steady-state density g also converges to the same as under the quadratic objective.

Aggregate price level, price dispersion, menu costs. We have verified that $\hat{x}$ approaches the same policies and distribution as $\sigma_\epsilon \to 0$. Now we also verify that all aggregate consequences are the same. In particular, we note that the aggregate price level $\frac{\zeta}{\zeta-1}\left(\int e^{(1-\zeta)\sigma_\epsilon \hat{x}_i} di\right)^{\frac{1}{1-\zeta}}$ approaches $\frac{\zeta}{\zeta-1}$ as $\sigma_\epsilon \to 0$, price dispersion $\left(\int e^{(1-\zeta)\sigma_\epsilon \hat{x}_i} di\right)^{\frac{\zeta}{1-\zeta}} \int e^{-\zeta\sigma_\epsilon \hat{x}_i} di$ approaches 1 as $\sigma_\epsilon \to 0$, and the total resources devoted to menu costs approach 0 as $\sigma_\epsilon \to 0$ (since the fraction of adjustments per period approaches a constant, but menu costs scale with σ_ϵ^2).

E.3.2 Step 2: The log-linearized system in the limit $\sigma_\epsilon \to 0$

Now, we consider the system from appendix E.1 and focus on the three equations for the firm block, $\hat{\mathbf{P}} = \mathbf{J}^{P,W}\hat{\mathbf{W}} + \mathbf{J}^{P,Y}\hat{\mathbf{Y}} + \mathbf{J}^{P,w}\hat{\mathbf{w}}$, $\hat{\mathbf{\Delta}} = \mathbf{J}^{\Delta,W}\hat{\mathbf{W}} + \mathbf{J}^{\Delta,Y}\hat{\mathbf{Y}} + \mathbf{J}^{\Delta,w}\hat{\mathbf{w}}$, $\hat{\mathbf{\Xi}} = \mathbf{J}^{\Xi,W}\hat{\mathbf{W}} + \mathbf{J}^{\Xi,Y}\hat{\mathbf{Y}} + \mathbf{J}^{\Xi,w}\hat{\mathbf{w}}$, which are the only equations directly affected by σ_ϵ. We will show that all the Jacobians in these equations converge to zero as $\sigma_\epsilon \to 0$, except for $\mathbf{J}^{P,W}$, which converges to the canonical model's pass-through matrix Ψ given the appropriately rescaled menu cost.

First, rewrite (103) as

$$\min_{\{\hat{x}_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left[\tilde{Y}_t^{1-\sigma} \tilde{w}_t^{1-\zeta} \cdot \frac{\mathcal{F}(\hat{x}_{it} - \hat{W}_t; \sigma_\epsilon)}{F''(0)} + \tilde{Y}_t^{-\sigma} \tilde{w} \frac{\left(\frac{\zeta}{\zeta-1}\right)^{\zeta-1} w^\zeta}{F''(0)Y} \xi_{it} 1_{\{\hat{x}_{it} \neq \hat{x}_{it-1} - \epsilon_{it}\}} \right]$$

where here we denote proportional deviations from steady state by tildes, e.g. $\tilde{Y}_t \equiv Y_t/Y$. At steady state, this is the same as (104), which we showed is identical to the original model in steady state, with the menu cost scaled by $\frac{\left(\frac{\zeta}{\zeta-1}\right)^{\zeta-1} w^\zeta}{F''(0)Y}$. Let us redefine ξ to incorporate this scaling (i.e. to

[56] If desired, we can compute $d\mathcal{F}$ in response to $d\sigma_\epsilon$ as follows. The derivative of $\mathcal{F}(\hat{x};\sigma_\epsilon) = \frac{F(\sigma_\epsilon \hat{x}) - F(0)}{\sigma_\epsilon^2}$ with respect to σ_ϵ around $\sigma_\epsilon = 0$, using $\mathcal{F}(\hat{x};0) = \frac{1}{2}F''(0)\hat{x}^2$ for the limit, is $\lim_{\sigma_\epsilon \to 0} \frac{F(\sigma_\epsilon \hat{x}) - F(0) - \sigma_\epsilon^2 \frac{1}{2}F''(0)\hat{x}^2}{\sigma_\epsilon^3}$, which applying L'Hopital's rule once equals $\lim_{\sigma_\epsilon \to 0} \frac{\hat{x}F'(\sigma_\epsilon \hat{x}) - \sigma_\epsilon F''(0)\hat{x}^2}{3\sigma_\epsilon^2}$, applying it again equals $\lim_{\sigma_\epsilon \to 0} \frac{\hat{x}^2(F''(\sigma_\epsilon \hat{x}) - F''(0))}{6\sigma_\epsilon}$, and a third time equals $\lim_{\sigma_\epsilon \to 0} \frac{\hat{x}^3 F'''(\sigma_\epsilon \hat{x})}{6} = \frac{\hat{x}^3 F'''(0)}{6}$, so that $\left.\frac{d\mathcal{F}(\hat{x};\sigma_\epsilon)}{d\sigma_\epsilon}\right|_{\sigma_\epsilon = 0} = \frac{\hat{x}^3 F'''(0)}{6}$.

be $\frac{\left(\frac{\zeta}{\zeta-1}\right)^{\zeta-1}w^{\zeta}}{F''(0)Y}$ times the original ξ), so that the above becomes just

$$\min_{\{\hat{x}_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left[\tilde{Y}_t^{1-\sigma} \tilde{w}_t^{1-\zeta} \cdot \frac{\mathcal{F}(\hat{x}_{it} - \hat{W}_t; \sigma_\epsilon)}{F''(0)} + \tilde{Y}_t^{-\sigma} \tilde{w}_t \xi_{it} 1_{\{\hat{x}_{it} \neq \hat{x}_{it-1} - \epsilon_{it}\}} \right] \tag{105}$$

For any given σ_ϵ, the first-order system in aggregates includes sequence-space Jacobians for three outcomes (the log aggregate price level $\log P_t$, price dispersion Δ_t, and menu costs incurred Ξ_t) and three shocks (log nominal wages $\sigma_\epsilon \hat{W}_t$, output $\tilde{Y}_t$, and wages $\tilde{w}_t$), all of which are given by (102).

We will argue, however, than in the $\sigma_\epsilon \to 0$ limit, only one of these sequence-space Jacobians remains nonzero: that for the log aggregate price level with respect to log wages. First, any change in price dispersion $\left(\int e^{(1-\zeta)\sigma_\epsilon \hat{x}_i} di\right)^{\frac{\zeta}{1-\zeta}} \int e^{-\zeta \sigma_\epsilon \hat{x}_i} di \approx 1 + \sigma_\epsilon \zeta \int \hat{x}_i di - \sigma_\epsilon \zeta \int \hat{x}_i di = 1$ is zero to first order in σ_ϵ, and menu costs paid, which scale with σ_ϵ^2, are trivially zero to first order in σ_ϵ. The $E^{Y,s}(\cdot)$ for these two outputs in (102) therefore scales with σ_ϵ^2 in the limit. For the log aggregate price level, on the other hand, we have $\log(\frac{\zeta}{\zeta-1}) + \frac{1}{1-\zeta} \log\left(\int e^{(1-\zeta)\sigma_\epsilon \hat{x}_i} di\right) \approx \log(\frac{\zeta}{\zeta-1}) + \sigma_\epsilon \int \hat{x}_i di$, with a nonzero term that is first order in σ_ϵ, corresponding to simple linear aggregation of price gaps. The $E^{\log P,s}(\cdot)$ for this output in (102) converges to σ_ϵ times the standard $E^s(\cdot)$ in the limit.

Meanwhile, for shocks to $\tilde{Y}_t$ and $\tilde{w}_t$, the $E^{Z,s}(\cdot)$ in (102) converge to some finite functions as $\sigma_\epsilon \to 0$.[57] For these, (102) is zero for all outcome variables, whose $E^{Y,s}(\cdot)$ went to zero as $\sigma_\epsilon \to 0$. For the shock to log nominal wages $\sigma_\epsilon \hat{W}_t$, on the other hand, we have $E^{\sigma_\epsilon \hat{W}_t,s}(\cdot) = \sigma_\epsilon^{-1} E^{\hat{W}_t,s}(\cdot)$ scaling with σ_ϵ^{-1} in the limit. For this shock, (102) goes to zero in the limit when the outcomes are price dispersion or menu costs (whose $E^{Y,s}(\cdot)$ scaled with σ_ϵ^2), but to a finite nonzero value when the outcome is log prices (whose $E^{Y,s}(\cdot)$ scaled with σ_ϵ, which is cancelled out by the σ_ϵ^{-1}).

We conclude that, indeed, only one sequence-space Jacobian is nonzero in the limit $\sigma_\epsilon \to 0$: that of log aggregate prices with respect to log nominal wages. Further, canceling the σ_ϵ and σ_ϵ^{-1} factors, the outcome variable is simple linear aggregation of price gaps and has a expectation function of $E^s(\cdot)$; meanwhile, the shock perturbs the loss function $\frac{\mathcal{F}(\hat{x}_{it} - \hat{W}_t; \sigma_\epsilon)}{F''(0)}$, which we have showed converges both in levels and first derivative to $\frac{1}{2}(\hat{x} - \hat{W})^2$—a quadratic function whose derivative with respect to $\hat{W}$ is unitary and also leads to an expectation function of $E^s(\cdot)$. At this point, the Jacobian (102) in the limit becomes identical (using symmetry and rearranging) to pass-through matrix of log marginal costs to log prices in the canonical model, as desired.

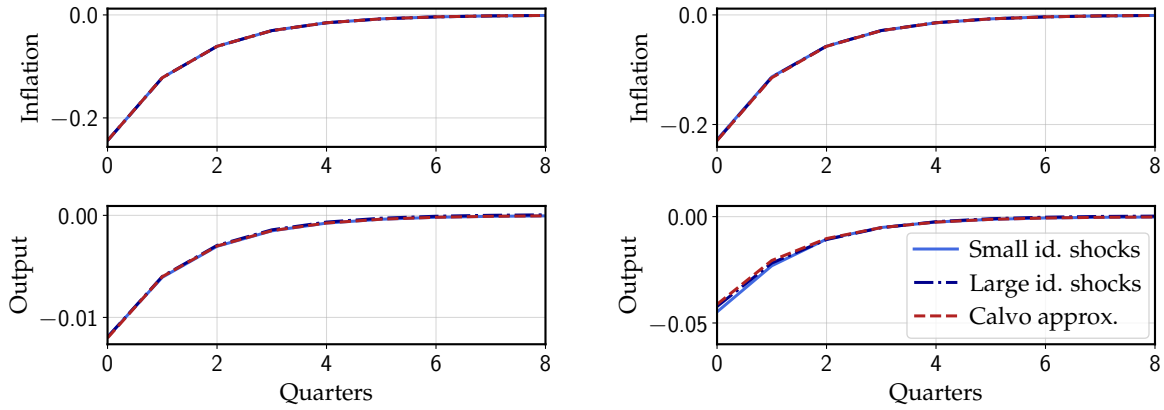
E.3.3 Step 3: Simplifying the system in the limit

Given the results in the previous subsection, the log-linearized system can be written as

$$\hat{\mathbf{P}} = \Psi\left(\hat{\mathbf{w}} + \hat{\mathbf{P}}\right)$$

$$\hat{\mathbf{w}} = (\sigma + \varphi)\hat{\mathbf{Y}}$$

[57] It turns out that these are zero due to the symmetry of the solution as $\sigma_\epsilon \to 0$, but we do not need this for our result.



(a) Golosov-Lucas. (b) Nakamura-Steinsson.

Figure E.1: Impulse responses with large idiosyncratic shocks.

Note: both pricing models are calibrated to match the same moments as in section 2.5.

$$\hat{\boldsymbol{\pi}} = (\mathbf{I} - \mathbf{L})\,\hat{\mathbf{P}}$$

$$\hat{i}_t = \phi \hat{\pi}_t + \hat{v}_t$$

$$\hat{Y}_t = \hat{Y}_{t+1} - \frac{1}{\sigma}(\hat{i}_t - \hat{\pi}_{t+1})$$

where we note that with $\sigma_\epsilon \to 0$, the steady state price dispersion is $\Delta_{ss} = 1$ and steady state menu cost labor demand is $\Xi_{ss} = 0$. We can solve out the first equation for the price level in terms of the real wage

$$\hat{\mathbf{P}} = \Psi\,(\mathbf{I} - \Psi)^{-1}\,\hat{\mathbf{w}}$$

Combining this with the expressions for the real wage and inflation, we find

$$\hat{\boldsymbol{\pi}} = (\varphi + \sigma)\,(\mathbf{I} - \mathbf{L})\,\Psi\,(\mathbf{I} - \Psi)^{-1}\,\hat{\mathbf{Y}} = (\varphi + \sigma)\,\mathbf{K} \cdot \hat{\mathbf{Y}}$$

where $\mathbf{K}$ is exactly the Generalized Phillips curve of the canonical model from section 2. Together with the Taylor rule and the Euler equation, this is the three equation system in proposition 4.

E.4 Impulse responses with large vs small σ_ϵ

Figure E.1 evaluates how well the $\sigma_\epsilon \to 0$ limit described in Proposition 4 approximates the original nonlinear model with $\sigma_\epsilon > 0$. The dashed-dark blue line labelled "large idiosyncratic shocks" shows the linear impulse response in the model with large idiosyncratic shocks, whose solution is described in section E.1. The solid-light blue line labelled "small idiosyncratic shocks" shows the approximation to that impulse response in the $\sigma_\epsilon \to 0$ limit described in proposition 4. The dashed red line shows the effects in the best-fitting Calvo model to this latter model. We calibrate the model with large idiosyncratic shocks to hit the same targets as in our calibration from section 2.5. The effects from non-zero price dispersion and aggregate menu costs, as well as the

nonlinearities in the objective function and price aggregation, are not important quantitatively.

E.5 Proof of proposition 5

In the model with strategic complementarities, firm i now produces gross output Q_{it} of variety i from hours N_{it} and intermediate X_{it} using the production function

$$Q_{it} = \frac{A_{it}}{\chi^{\chi}(1-\chi)^{1-\chi}} N_{it}^{\chi} X_{it}^{1-\chi}$$

where X_{it} is produced using the same aggregate as consumption, and has therefore the same price $P_t = \left(\int_0^1 (A_{it}P_{it})^{1-\zeta} di\right)^{\frac{1}{1-\zeta}}$.

Firm i's static profits at date t excluding menu costs are then

$$\Pi_{it} = \frac{P_{it}}{P_t} Q_{it} - \frac{MC_{it}}{P_t} \cdot Q_{it}$$

where $MC_{it} \cdot Q_{it}$ is the nominal cost for firm i of producing gross output Q_{it} at date t, with the marginal (and unit) cost MC_{it} given by

$$MC_{it} = \frac{1}{A_{it}} \underbrace{W_t^{\chi} P_t^{1-\chi}}_{\equiv MC_t}$$

where MC_t is the aggregate component of marginal cost. Factor demands are given by

$$\begin{aligned} N_{it} &= \chi \frac{1}{A_{it}} \frac{MC_t}{W_t} Q_{it} \\ X_{it} &= (1-\chi) \frac{1}{A_{it}} \frac{MC_t}{P_t} Q_{it} \\ X_{jit} &= A_{jt}^{1-\zeta} \left(\frac{P_{jt}}{P_t}\right)^{-\zeta} X_{it} \end{aligned}$$

where X_{jit} denotes firm i's demand for firm j's input at time t. Aggregating across intermediate and final good demand, total demand for firm i's output is given by

$$Q_{it} = A_{it}^{1-\zeta} \left(\frac{P_{it}}{P_t}\right)^{-\zeta} \left(\underbrace{C_t + \int X_{jt} di}_{\equiv Q_t} \right)$$

where Q_t is total gross output.

Hence, the static profits of firm i, excluding menu costs, are given by

$$\Pi_{it} = \left(\frac{P_{it}}{P_t} - \frac{1}{A_{it}} \frac{MC_t}{P_t}\right) \cdot Q_{it} = \left(\frac{P_{it}}{P_t} - \frac{1}{A_{it}} \frac{MC_t}{P_t}\right) \cdot A_{it}^{1-\zeta} \left(\frac{P_{it}}{P_t}\right)^{-\zeta} Q_t$$

and its statically optimal price is

$$\overline{P_{it}} = \frac{\zeta}{\zeta - 1} \frac{MC_t}{A_{it}} \equiv P_{it}^* \cdot MC_t$$

As in section 5.1, we can rewrite Π_{it} using $\overline{P_{it}}$ as

$$\begin{aligned} \Pi_{it} &= \left(\frac{\zeta}{\zeta - 1} \frac{MC_t}{P_t} \right)^{1-\zeta} Q_t \cdot \left(\left(\frac{P_{it}}{\overline{P_{it}}} \right)^{1-\zeta} - \frac{\zeta - 1}{\zeta} \left(\frac{P_{it}}{\overline{P_{it}}} \right)^{-\zeta} \right) \\ &= \left(\frac{\zeta}{\zeta - 1} \frac{MC_t}{P_t} \right)^{1-\zeta} Q_t \cdot F\left(\log \left(\frac{P_{it}}{\overline{P_{it}}} \right) \right) \\ &= \left(\frac{\zeta}{\zeta - 1} \frac{MC_t}{P_t} \right)^{1-\zeta} Q_t \cdot F\left(x_{it} - \log MC_t \right) \end{aligned}$$

where we have again defined the idiosyncratic price gap as

$$x_{it} \equiv \log P_{it} - \log P_{it}^* = \log P_{it} - \log \overline{P_{it}} + \log MC_t$$

Assuming that the menu cost is still stated in units of labor, and continuing to write $Y_t = C_t$ for GDP, the complete dynamic problem of the firm is therefore now

$$\min_{\{x_{it}\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t C_t^{-\sigma} \left[\left(\frac{\zeta}{\zeta - 1} \frac{MC_t}{P_t} \right)^{1-\zeta} Q_t \cdot F\left(x_{it} - \log MC_t \right) + \sigma_\epsilon^2 \xi_{it} \frac{W_t}{P_t} 1_{\{x_{it} \neq x_{it-1} - \sigma_\epsilon \epsilon_{it}\}} \right]$$

with the aggregate amount of labor required for menu costs still given by (46), and labor market clearing now given by

$$N_t = \chi \frac{MC_t}{W_t} \Delta_t Q_t + \Xi_t \tag{106}$$

with the same equations for Ξ_t and Δ_t as in section 5.1.

Equilibrium is characterized by the same unknown sequences $\{w_t, W_t, P_t, Y_t, N_t, \Delta_t, \Xi_t, i_t, \pi_t\}$ as before, plus the 4 unknown sequences $\{Q_t, MC_t, mc_t, X_t\}$. These unknown some the same 9 equations (97b)–(97g), except that (97b) is replaced by a new set of functions

$$P_t = \mathcal{P}_t\left(\{MC_s, mc_s, Y_s, Q_s\} \right), \quad \Delta_t = \mathcal{D}_t\left(\{MC_s, mc_s, Y_s, Q_s\} \right), \quad \Xi_t = \mathcal{X}_t\left(\{MC_s, mc_s, Y_s, Q_s\} \right)$$

and that (97c) is replaced by (106), as well as the 4 additional equations:

$$\begin{aligned} MC_t &= W_t^{\chi} P_t^{1-\chi} \\ Q_t &= Y_t + X_t \\ X_t &= (1-\chi)\,\frac{MC_t}{P_t}\Delta_t Q_t \\ mc_t &= \frac{MC_t}{P_t} \end{aligned}$$

The proof proceeds as in section E.3. In the limit with $\sigma_\epsilon \to 0$, these new equations log-linearize as

$$\begin{aligned} \hat{mc}_t &= \hat{MC}_t - \hat{P}_t = \chi\left(\hat{W}_t - \hat{P}_t\right) = \chi\hat{w}_t \\ \hat{Q}_t &= \chi\hat{Y}_t + (1-\chi)\,\hat{X}_t \\ \hat{X}_t &= \hat{mc}_t + \hat{Q}_t \\ \hat{N}_t &= \hat{mc}_t - \widehat{w_t} + \hat{Q}_t \\ \varphi\hat{N}_t &= \hat{w}_t - \sigma\hat{Y}_t \end{aligned}$$

It can be verified that these equations simplify to

$$\begin{aligned} \hat{N}_t &= \hat{Y}_t \\ \hat{Q}_t &= \hat{Y}_t + (1-\chi)\,\hat{w}_t \\ \hat{X}_t &= \hat{Y}_t + \widehat{w_t} \\ \hat{w}_t &= (\sigma+\varphi)\,\hat{Y}_t \qquad (107) \\ \hat{mc}_t &= \chi\hat{w}_t \qquad (108) \end{aligned}$$

Hence, the relationship between real wages and output is (107) is the same as before, but movement in real marginal cost is scaled down by χ per (108). The equations characterizing equilibrium are therefore now

$$\hat{\mathbf{P}} = \Psi\left(\hat{\mathbf{mc}} + \hat{\mathbf{P}}\right)$$

$$\hat{\mathbf{mc}} = \chi(\sigma+\varphi)\hat{\mathbf{Y}}$$

$$\hat{\boldsymbol{\pi}} = (\mathbf{I}-\mathbf{L})\,\hat{\mathbf{P}}$$

$$\hat{i}_t = \phi\hat{\pi}_t + \hat{v}_t$$

$$\hat{Y}_t = \hat{Y}_{t+1} - \frac{1}{\sigma}(\hat{i}_t - \hat{\pi}_{t+1})$$

This delivers proposition 5.

F Appendix to Section 6

F.1 Proof of proposition 6

We now assume that the menu cost ξ_{it} is drawn from an arbitrary distribution with differentiable c.d.f $\mathcal{H}(\cdot)$. In period t, a firm with price gap x adjusts its price with probability

$$\Lambda_t(x) = P\left(\xi_{it} \leq V_t(x) - V_t(x_t^*)\right) = \mathcal{H}\left(V_t(x) - V_t(x_t^*)\right). \tag{109}$$

Now expected price gaps evolve according to

$$E^{t+1}(x) = \int_{-\infty}^{\infty} \left(1 - \Lambda(x')\right) f(x' - x) E^t(x') dx'$$

and the steady state adjustment frequency is given by

$$\text{freq} = \int_{-\infty}^{\infty} \Lambda(x) g(x) dx,$$

where $g(x)$ is the steady state distribution of price gaps.

We first characterize the extensive margin price level response dP_t^e generated by a change in adjustment probabilities $\{d\Lambda_s(x)\}_{s=0}^{\infty}$. Similarly to the first part of equation (20), we have

$$dP_t^e = -\sum_{s=0}^{t} \int_{-\infty}^{\infty} \left[d\Lambda_{t-s}(x) g(x) E^s(x)\right] dx. \tag{110}$$

Intuitively, a perturbation in adjustment probabilities $d\Lambda_{t-s}(x)$ generates an additional mass of price changes $d\Lambda_{t-s}(x)g(x)$, which then changes the price level at date t by $-d\Lambda_{t-s}(x)g(x)E^s(x)$. The intensive margin response dP_t^i is still given by the second part of equation (20)

The next step is to characterize the responses of optimal policies $\Lambda_t(x)$ and x_t^* to aggregate marginal cost shocks. First, notice that the reset point dynamics is still given by (25). Now differentiate (109) with respect to x and evaluate it at steady state to obtain

$$\Lambda'(x) = -h\left(V(0) - V(x)\right) V'(x),$$

where $h = \mathcal{H}'$. By totally differentiating (109), also around steady state, one gets

$$\begin{aligned} d\Lambda_t(x) &= h\left(V(0) - V(x)\right)\left(V'(0)dx_t^* + dV_t(0) - dV_t(x)\right) \\ &= -\Lambda'(x)\frac{dV_t(0) - dV_t(x)}{V'(x)}, \end{aligned}$$

where the second line uses $V'(0) = 0$. One can still obtain $V'(x) = \sum_{u=0}^{\infty} \beta^u E^u(x)$ and $dV_t(x)$ from

equation 23. Using the definition $\Phi_t^e(x) = E^t(x)/\overline{x}$, we have

$$-\frac{d\Lambda_t(x)}{\Lambda'(x)} = \frac{\sum_{s=t}^{\infty} \beta^{s-t} \Phi_{t-s}^e(x) d\log MC_s}{\sum_{s=t}^{\infty} \beta^{s-t} \Phi_{t-s}^e(x)}. \tag{111}$$

This implies that $-d\Lambda_t(x)/\Lambda'(x)$ responds to future marginal costs according to weights $\beta^t \Phi_t^e(x)$, just like the reset point of a TD model in (8).

Now rewrite (110) as

$$dP_t^e = \sum_{s=0}^{t} \int_{-\infty}^{\infty} \left[\Lambda'(x) g(x) \left(\sum_{\tau=0}^{\infty} E^\tau(x) \right) \frac{\sum_{s=0}^{t} \Phi_s^e(x) \left(-\frac{d\Lambda_{t-s}(x)}{\Lambda'(x)} \right)}{\sum_{\tau=0}^{\infty} \Phi_\tau^e(x)} \right] dx.$$

This shows that dP^e responds to changes in past policies $-d\Lambda_t(x)/\Lambda'(x)$ with weights $\Phi_t^e(x)$, as the price level of a TD model responds to changes in past pricing decisions in (9). It follows from this that the extensive margin dynamics of the price level is equivalent to the sum of a continuum of TD models, one for each point x, with survival function $\Phi_t^e(x)$ and weight $\Lambda'(x)g(x)\left(\sum_{\tau=0}^{\infty} E^\tau(x)\right)$. Proposition 6 then follows from $d\hat{P}_t = dP_t^e + dP_t^i$.

F.2 Details on the measurement

Here we describe the dataset used in section 6, as well as the numerical procedure for recovering the adjustment hazards $\Lambda(x)$. We use data from Bonomo et al. (2022). A law enacted in 2014 requires large food retailers in Israel to post online information on the prices of all their products on a daily basis, which the Bank of Israel then collects. The only empirical object we use is the price-change distribution in figure 13, which is computed using data on the top 5% stores in terms of number of observations, totaling 506.1 million daily observations. The size of each price change is standardized by the within-store standard deviation of price changes in order to filter out store heterogeneity. This does not affect the pass-through matrix, which is scale-invariant.

In order to recover the adjustment hazards $\Lambda(x)$ from the data, we first need to specify a functional form for it. We postulate

$$\log\left(\frac{\Lambda(x)}{1-\Lambda(x)}\right) = p(x) - s\phi_\sigma(x). \tag{112}$$

In the expression above, $p(x)$ is a polynomial of degree 2, $\phi_\sigma(\cdot)$ is the p.d.f. of a normal distribution with standard deviation σ, and s is a scaling factor. The scaled normal p.d.f. generates the drop in adjustment hazards close to $x = 0$, visible in figure 13, necessary for matching the price-change distribution. Given $\Lambda(x)$, one can compute the stationary distribution of price gaps $f(x)$, which can then be used to compute the resulting distribution of price changes. We then choose the coefficients of $p(x)$, along with the parameters s and σ, in order to minimize the sum of squared errors between empirical and model-implied price-change distributions. Having computed $\Lambda(x)$ and $f(x)$, we then follow the steps outlined in section F.1 to compute the pass-through matrix.