

Title: Competition and Phillips curve

Authors: Ippei Fujiwara, Keio University and Australian National University
Kiminori Matsuyama, Northwestern University

Abstract:

It has been well-documented that the Phillips curve continues to flatten, and central banks are wary of the reduced effectiveness of monetary policy to achieve price stability. There has also been a growing concern about higher market concentration, and the adverse effects of the rising profit margins and markups of a few large companies. Are these two events observed in the past two decades merely coincidental? Or, are they related?

To address this issue, this paper extends the canonical New Keynesian model to incorporate endogenous markup with entry and exit, using Homothetic Single Aggregator (hereafter, HSA), a class of homothetic demand systems, which contain CES and Translog as special cases.

We show that under *Marshall's second law of demand* -- the price elasticity of demand goes up with its price -- industrial concentration leads to a rise of the markup and the flattening of the Phillips curve. Furthermore, incomplete pass-through under Marshall's second law generates the dynamic effect of competition. That is, a change in the number of firms through entry directly affects inflation rates in the New Keynesian Phillips curve, which can be interpreted as an endogenous cost-push shock.

Keywords: New Keynesian Phillips curve, market concentration, monopolistic competition, endogenous entry, HSA, variable price elasticity, incomplete pass-through, impulse responses, cyclicity of markups

Updated on 2022-02-25.