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Exchange Rate Pass Through, Cost Channel to Monetary Policy Transmission, Adaptive Learning, and the Price Puzzle

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Abstract
Using a New Keynesian open economy model, where the supply side effects of the exchange rate pass through as well as the cost channel of monetary policy transmission are taken into account, this paper evaluates the possibility of the price puzzle, which refers to anomalous behavior of inflation to a monetary shock. Unlike the existing studies, we consider the possibility of the price puzzle when agent expectations are based on adaptive learning and three monetary policy alternatives (the optimal monetary policy, money growth targeting, and a Calvo-type policy rule) are available to the central bank. Furthermore, we use two alternative measures of inflation. Calibration of our medium scale model, using plausible parameter values, reveals that irrespective of how the inflation rate is measured and the policy rule used by the central bank, the puzzle fades away when a sufficiently strong exchange rate pass through is present in the economy. We also find that a decrease in inflation is associated with a cost to the society in the form of lower aggregate output but this loss is minimum when the central bank uses the optimal monetary policy.

JEL Classification
E31, E32, E52

KeyWords
Learning, Exchange rate pass through, price puzzle, cost channel, Calvo rule, optimal monetary policy

1. Introduction

Central Banks around the globe tend to use a high interest rate policy to control the rate of inflation. However, a number of empirical studies found that an increase in the US Federal
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