

Dear referee #2, I thank you for the helpful contributions to fit the paper.

Your main criticism is the claim of lack of clarity regarding

- i) the motivations of the paper and of its main assumption (an assumption that leads to include past inflation in wage setting);
- ii) the methodology.

The main motivation of the paper is, of course, to explain the disinflation puzzle: the new Keynesian Phillips curve does not explain why credible disinflations are costly. This problem is answered by the present paper through its main assumption: that forward-looking agents take into account past inflation in wage readjustments during a credible disinflation because past inflation is a relevant reference when inflation is not low. Driscoll and Holden (2004, hereafter DH) has used this assumption to explain inflation persistence when the unemployment rate is relatively low, and therefore, DH does not explain large disinflation costs. In turn, the present paper argues that DH assumption can generate a higher unemployment rate if the job finding rate, rather than the unemployment rate (used in DH), is used as the measure of workers opportunities outside the firm.

The main empirical motivation for the assumption is found in the literature about inflation persistence: the evidence that past inflation is taken into account in wage and price setting is found in, for example, Fuhrer and Moore (1995), Roberts (2005), and Fuhrer (2006). Meanwhile, the justification to postulate that past inflation is a relevant reference specifically for wage readjustments when inflation is not low is that the inflation rate since the previous readjustment represents the loss in the purchasing power of the wage from that time. Since references are frontiers between what is perceived as losses versus gains, the

reposition of this loss can be seen as a reference for a current wage readjustment.

The methodology used in the present paper is to verify if this assumption is sustained in a calibrated model with rational expectations. The paper proposes that it is sustainable if a relatively low price of reciprocating an unfair wage can generate a large unemployment rate in a disinflation, and it obtains a positive answer. An adequate empirical evidence against alternatives (such as sticky information) would demand a paper specifically dedicated to this (the present paper is already long, and has itself a significant contribution).

The paper develops a new model, different from DH model, and this was done aiming at: i) filling the gap of studying DH assumption with an efficiency wage model,<sup>1</sup> and ii) developing a more detailed to provide a simple calibration to obtain the price of reciprocity. Both models have, however, similar rationales and (with the use of the job finding rate) similar results.

## REFERENCES

Driscoll, J. C., and S. Holden (2004). Fairness and inflation persistence. *Journal of the European Economic Association* 2: 240-251.

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<sup>1</sup> DH states that an efficiency wage model would generate a similar effect to its model, as it does here, but there is no paper showing so.

Fuhrer, J. C. (2006). Intrinsic and inherited inflation persistence."

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Fuhrer, J. C., and G. Moore (1995). Inflation persistence. *Quarterly Journal of Economics* 110: 127-159.

Roberts, J. M. (2005). How well does the new Keynesian sticky-price model fit the data? *The B. E. Journal of Macroeconomics* 5(1): 1-39.