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Inflation and its Persistence

Sarah Lein

University of Basel, CEPR, SFI, Ceslfo, KOF ETHZ

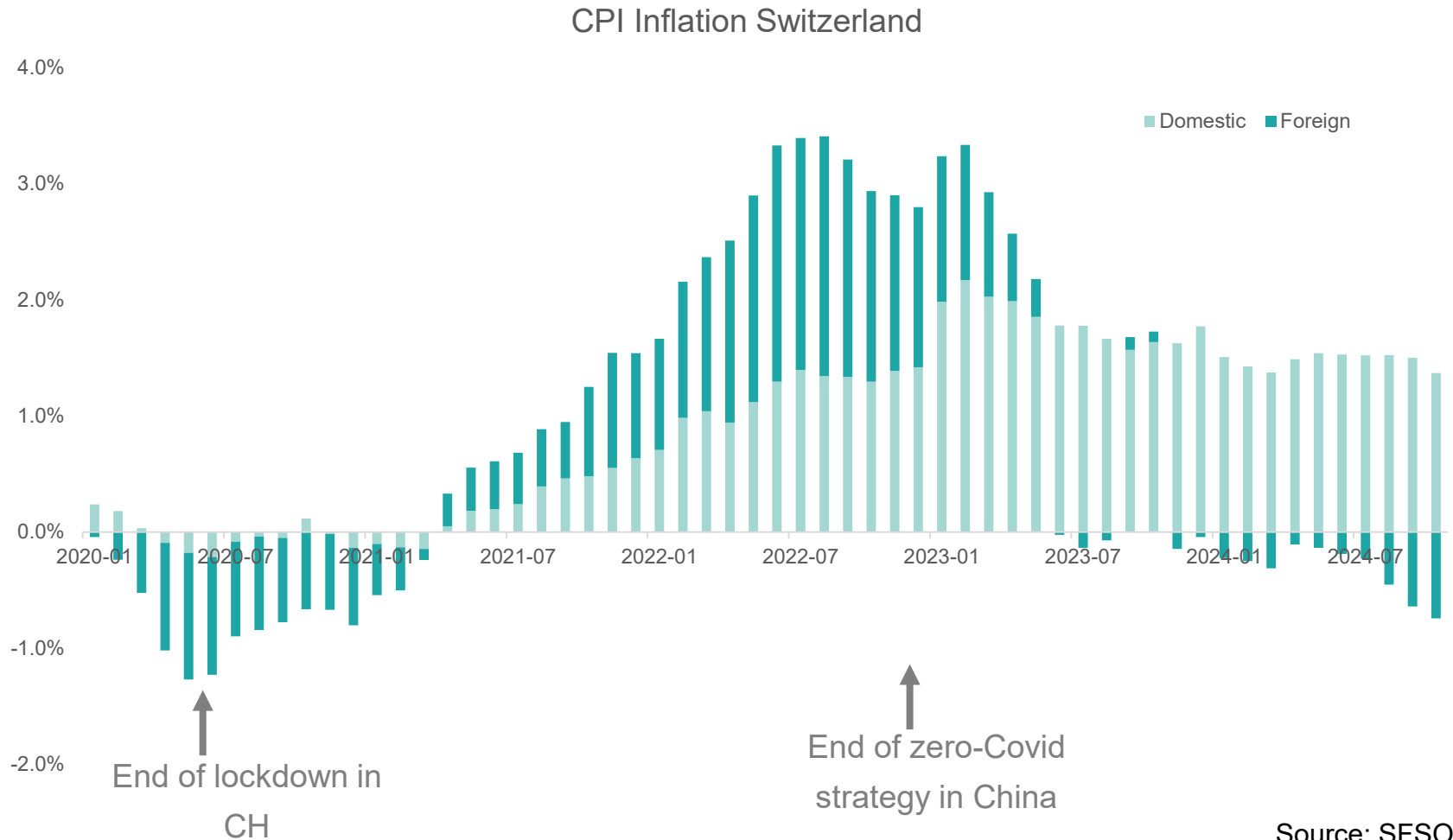
The SNB and its Watchers

November 2024

Inflation surge 2021-22

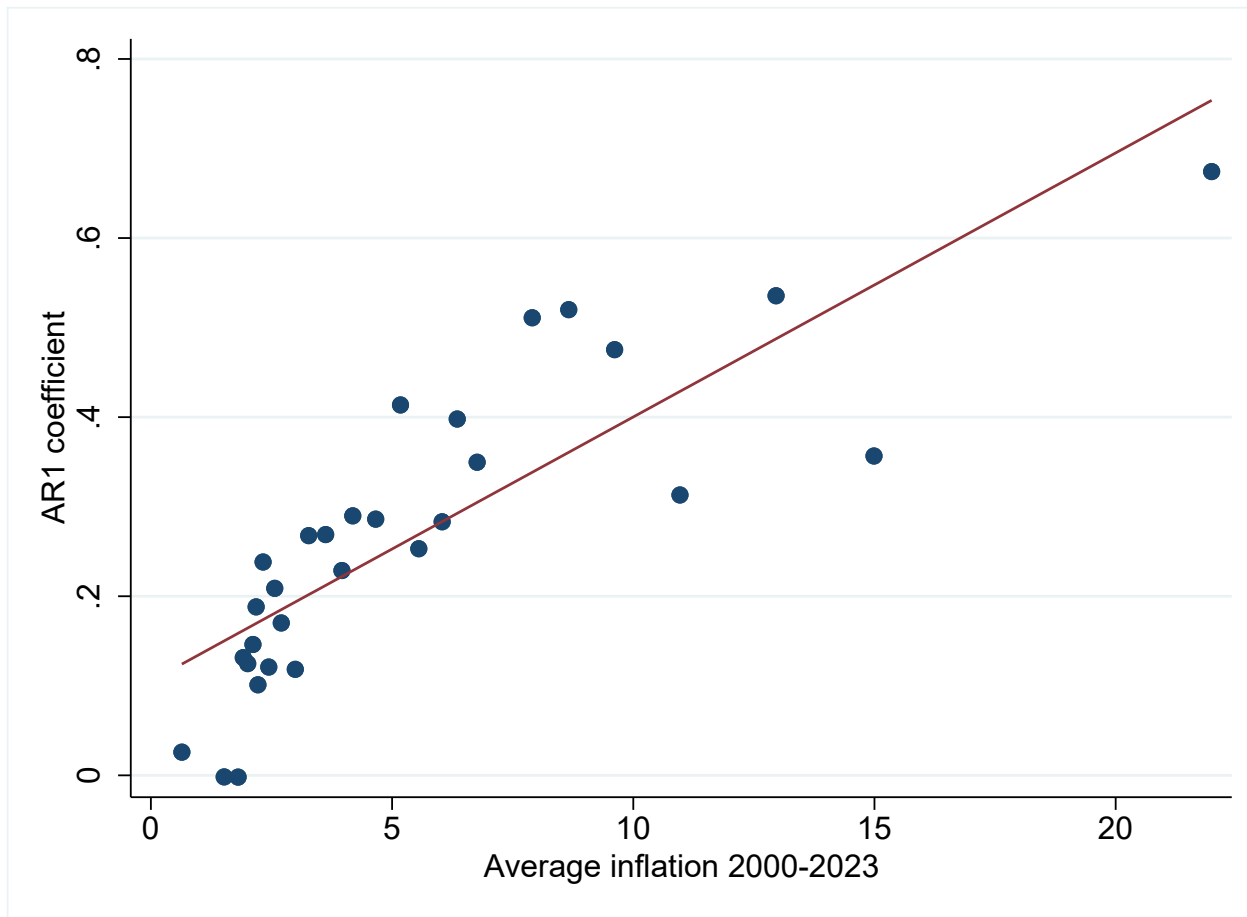
- Initially, many economists viewed the rise in inflation in 2021 as a **transitory** phenomenon
- Yet, as we know today, inflation had been **much more persistent than expected**
- What are the underlying **reasons for this persistence**?
- What **lessons** can we learn from the recent inflationary episode?

Inflation had been more persistent than expected



Source: SFSO

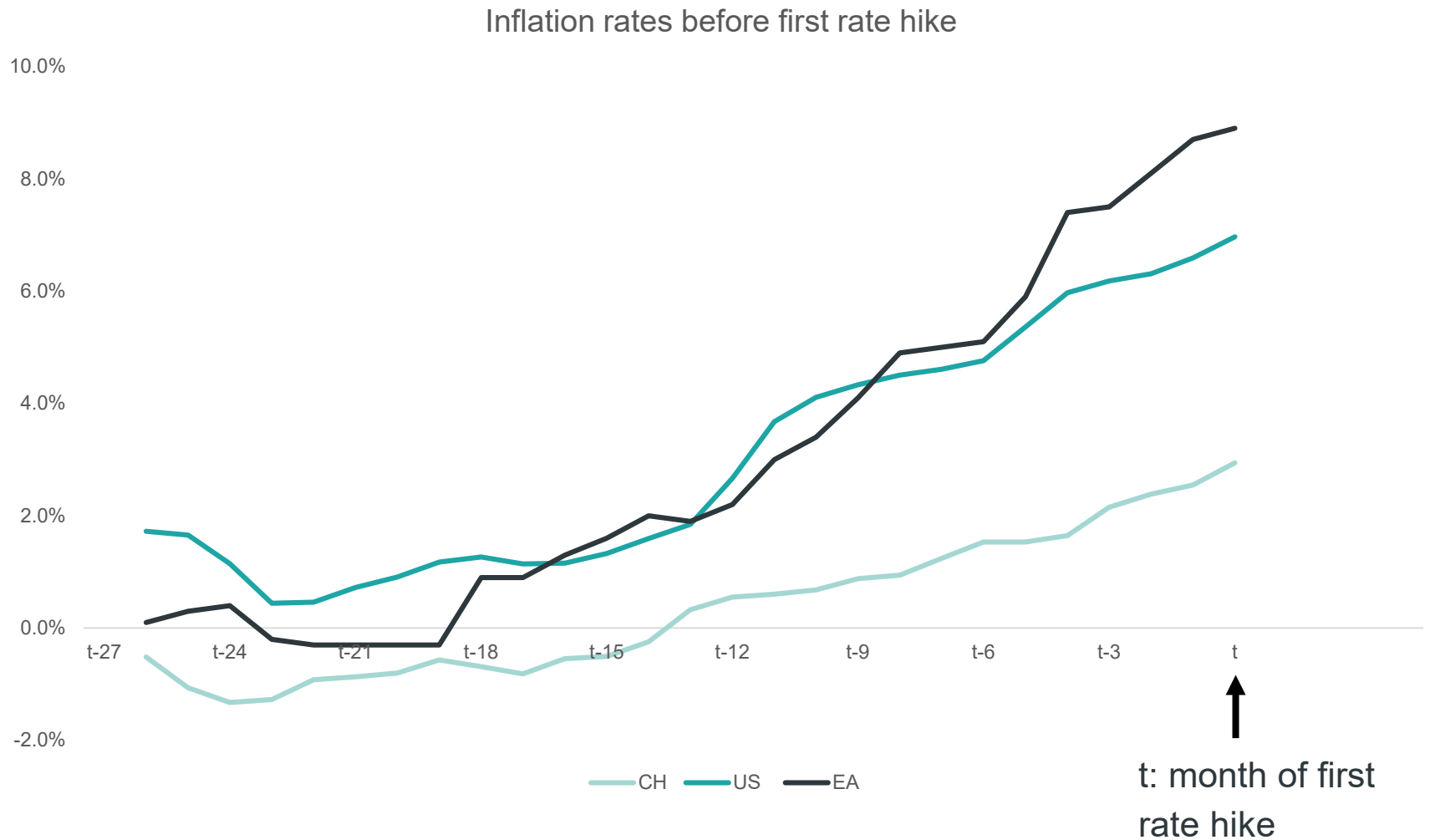
Higher inflation → more persistence



➤ Countries with a high average rate of inflation tend to exhibit greater inflation persistence

Source: IMF and own calculations. To estimate the AR1 coefficient, I run a simple AR(1) model for inflation for each country for the period 2023. The chart is a binscatter for 178 countries with inflation below 30% on average.

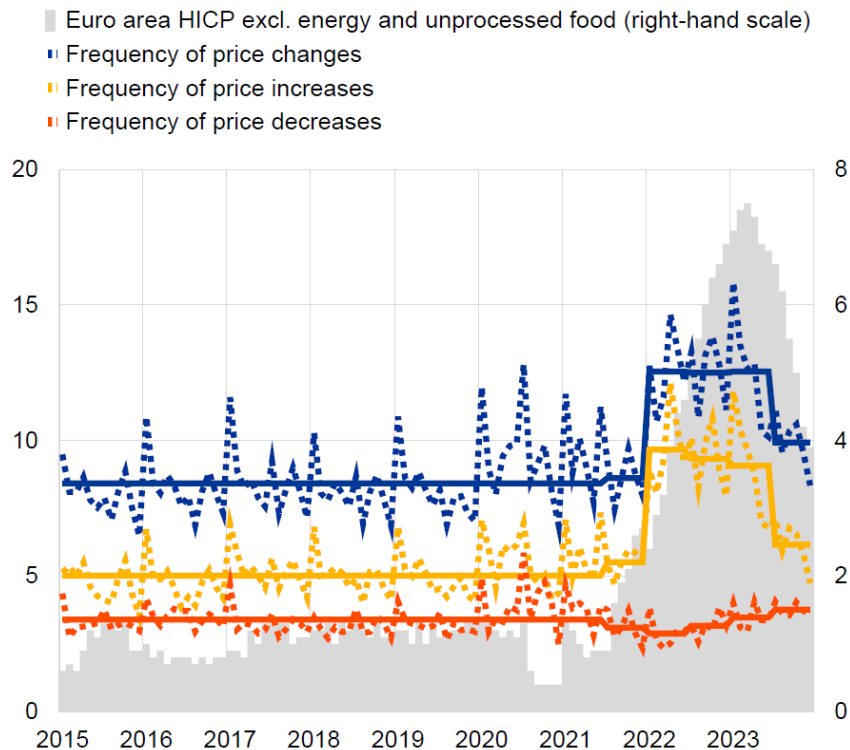
Reasons for persistence I: late policy responses



Reasons for persistence II: nonlinearities

Frequency of consumer price changes

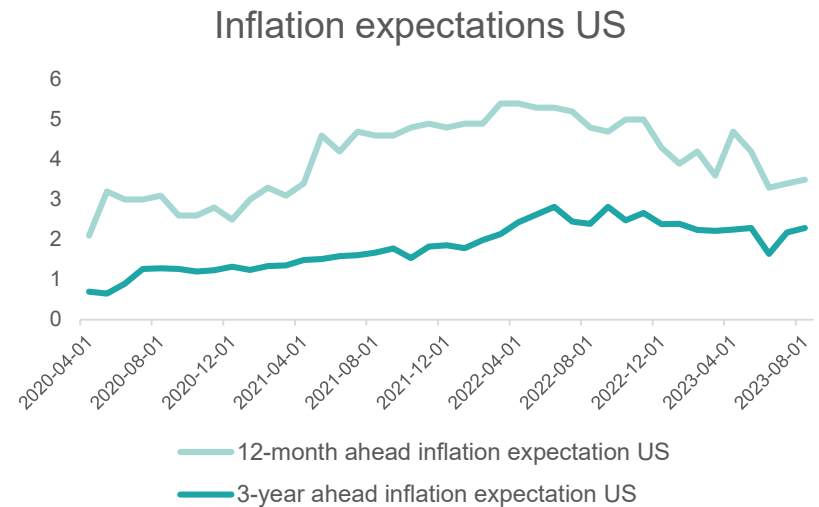
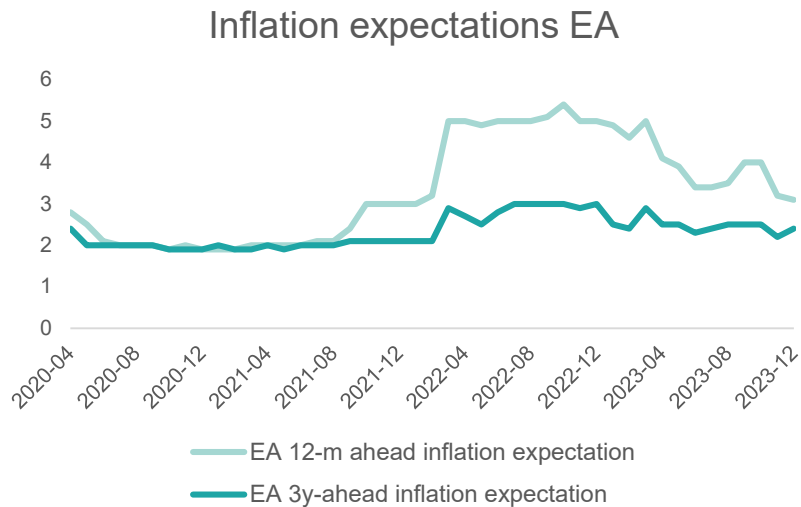
(lhs: percentages; rhs: annual percentage change)



- Prices become more flexible in higher-inflation environments (already at ~ 3-4 percent!)
- Inflation becomes more responsive to shocks, but real effects of monetary shocks are lower

Source: Schnabel, Isabel, Reassessing monetary policy tools in a volatile macroeconomic environment, Nov 2024

Reasons for persistence III: too much focus on long-term inflation expectations



ECB's Schnabel (30 September 2022): «If **long-term inflation expectations** remain anchored, the risks of a wage-price spiral will be limited”

Powell (27 August 2021): “Policymakers and analysts generally believe that, **as long as longer-term inflation expectations remain anchored**, policy can and should look through temporary swings in inflation.”

Sources: ECB, FRED

Reasons for persistence III: too much focus on long-term inflation expectations



- When estimating which horizon of inflation expectations matters for firms' pricing decisions, it's clearly short-term expectations.
- Intuition: prices are typically changed on average at least once per year, that is the relevant horizon.
- Very relevant for actual inflation (since aggregate of all price changes = inflation)
- Also for other contracts: eg. >1/3 of bank credit in CH has maturity <1y.

Source: Abberger, Funk, Lamla, Lein, and Siegrist, 2024 CEPR DP 19595

Reasons for persistence IV: other

- Indexation (for example, rents indexed to inflation and interest rates in CH)
- Fiscal policy responses
- Services prices/wages adjusting to lagged inflation

Lessons

- **Looking through inflation** is not advisable once inflation reaches levels at which it is likely to become persistent.
- Beware of **nonlinearities in high-inflation environments**: they may lead to a much quicker response of inflation (e.g., pass-through of cost shocks or past inflation into prices, compared to normal times).
- More **focus on the near-term**: recent data, near-term inflation expectations.



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Thank you for your attention