

What effects is EMU having on the euro area and its member countries?
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Session V: Inflation persistence and inflation differentials

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Price-setting and inflation persistence: did EMU matter?

by Angeloni, Aucremanne and Ciccarelli

Discussion by Tony Yates, Bank of England

Summary

- Not really.
- Using micro, and aggregated data on price changes
- Some effect of euro changeover on price-changes
- Some evidence of instability in the reduced form for inflation, and correlations between inflation and expectations

1: No theory of EMU and price-setting

3

- Require either money illusion and/or costs of computing currency conversion (Engel and Rogers – 2004)
- Don't have a tractable general equilibrium model of either of these features to contrast it with a benchmark
- Can't tell how EMU would affect price changes and therefore can't formulate an empirically testable hypothesis

4

- Look for direct evidence of increase in competition:
 - Off model mark-ups, profit share data
 - Structurally estimated mark-up shocks
- Hard to separate effects from other factors: technologies of trade (internet), single market...

5

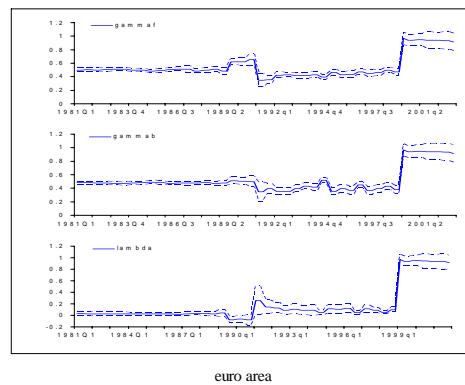
2: Why not assess the contributions to shifts in the time-series properties of inflation directly?

6

- Test for instability...
 - in the structural equation for inflation
 - in the equation for monetary policy
 - in the shocks

7

$$\pi_t = \gamma_b \pi_{t-1} + \gamma_f \pi_{t+1} + \lambda.rmc + u_t$$



Barkbu, Cassino, Gosselin-Lotz and Piscitelli (2005)

8

Changes in monetary policy prior to EMU

- Gerlach (2003)
- Angeloni and Dedola (1999)

9

3: Theories of price-stickiness that underpin inflation persistence confounded by IPN

- Can't have a sharp test of an EMU effect without one.

10

3: Expectations, persistence and EMU

11

- Loose idea that EMU=monetary stability=more “anchored” expectations=less inflation persistence
- Interesting and promising hypothesis that could be sharpened.
- Correlations of survey balances with inflation persistence?
- Bernanke (2004)

12

$$\pi_{t+1} = \varphi\pi_{t-1} + (1 - \varphi)\pi^T$$

	1992-1997		1997-2003	
	φ	π^T	φ	π^T
Consensus				
One year ahead	0.31	3.71*	0.39*	2.40*
Two years ahead	0.63*	5.22*	0.23	2.47*
BASIX				
One year ahead	0.31*	3.51*	0.38*	4.83*
Two years ahead	0.61*	2.83*	0.45*	3.10*

13

- Stability in inflation will impede detecting shifts in the process of expectations formation

14

$$\pi_t = \alpha + \rho\pi_{t-1} + u_t$$

$$\pi_t = \gamma_b\pi_{t-1} + \gamma_f\pi_{t+1} + \lambda.rmc + u_t$$

$$\pi_{t+1} = E_t \pi_{t+1};$$

$$\pi_{t+1} = A(L)\pi_t;$$

$$\pi_{t+1} = \pi^T$$

15

Minor quibbles

- Less rigidity doesn't always mean more price changes
- Distinction between real and nominal rigidities
- Why de-seasonalise?
- Why use Bayesian estimation at all? Use of Bayesian priors more help with structural, not reduced form estimation
- Doesn't make economic sense to assume that parameters of reduced form for inflation follow a random walk
- Quantification of survey information a little suspect

16

Conclusions

- Important question
- We don't currently have the theoretical tools to answer it very well
- Nevertheless, could complement with more direct evidence on what shifts the reduced form
- Sharpen hypotheses about expectations