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PRESS RELEASE

Understanding inflation dynamics: Where do we stand?
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The paper "Understanding inflation dynamics: Where do we stand?" surveys the recent literature on inflation dynamics.

There are two reasons why understanding inflation dynamics matters. First, in the presence of price adjustment costs, inflation entails wasteful expenses for firms and generates changes in the distribution of relative prices that do not reflect changes in productivity. Second, inflation affects the real value of nominal assets, including money. In a market economy, the distribution of relative prices and the real value of nominal assets affect the allocation of society's resources to consumption, leisure and investment. Through its effect on real goods prices and asset prices, inflation ultimately determines economic welfare. Public policy that aims at maximizing economic welfare thus needs to understand what drives inflation and how it affects the allocation of resources.

Over the last five to ten years we have seen an enormous research effort aimed at a better understanding of the inflation process, carried out by both the academic and central bank communities. The reason why this area of research has been so productive is that in recent years there has been a fruitful interaction between the modeling of inflation and the search for a larger set of empirical characteristics of inflation.

Whereas during the eighties and nineties central banks had turned away from formal analysis, they are now investing more and more resources in improving the New Keynesian model as well as using it for policy analysis and forecasting purposes. Today, some central banks even publish optimal macroeconomic forecasts based on a version of the New Keynesian model. In optimal forecasts the future interest rate is set at a level that maximizes future economic welfare. This type of analysis is currently becoming an important tool in many other central banks.

However, a number of unresolved issues remain to be dealt with. Even though the microeconomic evidence has substantially narrowed the range of models that can explain the macroeconomic facts, substantial uncertainty remains as to which model is right. In particular, the importance of temporary price markdowns for inflation dynamics and the characteristics of the information set used by price setters for their price adjustment decision, currently remain unresolved issues. More evidence from surveying price setters might improve our understanding of price and inflation dynamics, so that we can converge on one model that matches both the macroeconomic and microeconomic evidence on inflation and prices.

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