Nicolas Groshenny (The University of Adelaide & CAMA)

Cost-Push Shocks, Trend Inflation, and the Great Moderation: An Alternative Interpretation

(co-authored with Qazi Haque and Mark Weder)

Abstract

This paper re-assesses the factors behind the Great Moderation and it makes two contributions, one theoretical and one applied. First, we develop and analyze the dynamics and determinacy properties of a sticky-price model with trend inflation, real wage rigidity and cost-push shocks. Then, we estimate this artificial economy using a Sequential Monte Carlo algorithm while allowing for indeterminacy. To better identify cost-push shocks, our estimation utilizes data on both core and headline inflation. Unlike the literature's preponderant conception, our analysis does not find empirical support for the view that monetary policy provoked equilibrium indeterminacy during the 1970's. The most noticeable change in the Federal Reserve's behavior across the pre- and post-Volcker era is a large increase in the response to output growth. The main cause of the Great Moderation appears to be a reduction in the size of demand shocks.