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PRESS RELEASE

Inflation persistence and price-setting in the euro area: results of the Eurosystem Inflation Persistence Network

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This article presents a summary of the work carried out since January 2003 by the Eurosystem Inflation Persistence Network (IPN), a network of researchers from the twelve national central banks of the euro area, the ECB and the academic world. The network conducted a study of inflation persistence and price adjustment mechanisms.

Defining the degree of inflation persistence as the speed at which inflation returns to its long-run equilibrium value following a shock, the macroeconomic analyses conducted by the IPN showed that, under the current monetary policy regime, the degree of inflation persistence in the euro area is relatively moderate, but that its estimates is not very accurate. It also appeared that, under the current monetary policy regime, inflation expectations are the main factor influencing inflation dynamics, whereas past of inflation plays a less significant role. Moreover, the analyses showed that inflation persistence mainly reflects the persistence observed in certain components of the HICP, namely services and non-energy industrial goods.

Thanks to the possibility of accessing to a set of microeconomic data not previously used for research purposes, the IPN was able to supplement the macroeconomic analyses of inflation with a series of microeconomic analyses of the pricing behaviour of firms. The latter were based on quantitative data (consumer and producer price records) or qualitative data (business surveys) and on the results of a specific survey.

These microeconomic analyses revealed that firms in the euro area adjust their prices less frequently than American firms. However, the price adjustment frequency does vary from one sector to another. While prices of petroleum products and unprocessed food are changed very often, prices of non-energy industrial goods and especially services are changed less frequently. The surveys showed that this price rigidity is due mainly to the contractual nature (explicit or not) of business relations and the customers' desire for stable nominal prices. The findings also indicate that price reductions are not rare events, but that firms appear to be slower to pass on negative shocks in their prices. Finally, the microeconomic analyses show that firms do not adjust their prices on particular dates, but rather in response to shocks, and that only one-third of firms use simple rules such as indexation to set their prices.

All these findings have numerous implications for the macroeconomic modelling of inflation. Indeed, they should allow the development of theoretical models based on microeconomic fundamentals compatible with the observed behaviour, in order to provide a better understanding of inflation and the impact of monetary policy.

More generally, the finding that inflation persistence is relatively weak under the current monetary policy regime should not be interpreted in favour of easing monetary policy, particularly in view of the increased role played by expectations in inflation dynamics. Any relaxation of monetary discipline causing inflation expectations to drift could result in an inflation rate which deviates persistently from the price stability target and, since the greater price rigidity in the euro area implies moreover a higher cost in terms of growth if inflation goes out of control, the maintenance of price stability is essential to the preservation of the productive potential of the euro area economy.

Communication
National Bank of Belgium Ltd.
boulevard de Berlaimont 14
BE-1000 BRUSSELS
phone + 32 2 221 46 28
www.nbb.be
VAT BE 203 201 340
TRB 22 300