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Nominal anchors and the price puzzle

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Abstract

Looking at the pre-Great Recession period, employing a VAR analysis, we compare the behavior of prices after a monetary policy shock in countries with clearly defined nominal anchors (Australia, Canada, New Zealand, Sweden, Switzerland, United Kingdom and EMU) with their behavior in countries that, at that time, did not possess any such anchor (Japan and United States). While for this last group we find evidence of a price puzzle (i.e. the positive response of prices to a negative monetary policy shock), in the first, once this anchor was set, we do not detect such a perverse dynamic. We argue that in those countries, characterised by clearly defined nominal anchors, the central bank manages to anchor inflation expectations thus ruling out the persistent increase in the price level.

1 Introduction

In VAR analysis, puzzling responses of economic variables (generally prices) to monetary policy shocks are usually thought to be the consequence of a misspecified central bank's policy reaction function (Sims, 1992). The proposals to solve such puzzles deal generally with the addition of (previously omitted) variables in the VAR that help overcome the inadequate description of the central bank's policy function.

This paper intends to further investigate the puzzling responses of prices to monetary policy shocks. Throughout the analysis we consider a VAR in its simplest form containing just three variables: the (log of) real GDP (y), (the log of) the GDP deflator (p) and the policy rate (r). As many others, we think that the omitted variable, whose exclusion could determine the price puzzle, relates to inflation expectations. However, we suspect that the puzzle's severity varies with the extent of inflation expectations' anchoring by the central bank. In particular, we distinguish among three different states: anchored, contained and unmoored expectations. When inflation expectations are firmly anchored we find, in line with previous works, that there is no evidence of any price puzzle, since the central bank manages to keep the inflation process under control.

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