What Do Long Data Tell Us About the Permanent Component of Inflation?

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In the aftermath of the COVID-19 pandemic, the United States, like other advanced economies, experienced inflation at levels not seen for the past 40 years. This paper addresses a key question raised by this development. Namely, to what extent the recent spike in U.S. inflation is driven by a change in its permanent component.

To this end, we use a semi-structural model of output, inflation, and short-term interest rates to identify the permanent component of inflation. When we estimate the model on data for the period 1900 to 2022, it predicts a modest increase in the permanent component of inflation between 2019 and 2022 of 1.3 percentage points. By contrast, when we estimate the model using postwar data (1955 to 2022), the permanent component of inflation is predicted to have increased between 2019 and 2022 by 5.0 percentage points.

Our interpretation of this result is that the postwar data, dominated by the great inflation of the 1970s, which was slow in building up, leaves not much choice to the model but to interpret the post-COVID-19 inflation as also driven by low-frequency factors. By contrast, the pre-war era is rich in large and short-lived inflationary spikes, including the one around the Spanish flu pandemic of 1918. Since a key characteristic of the COVID-19 inflation was its speed and size, the model estimated on long data naturally associates it more with the prewar inflation spikes than with the great inflation of the 1970s.

We believe that this result is important

for three reasons. First, most modern applied models of inflation dynamics are estimated on postwar data. The economic consequences of the COVID-19 crisis, however, are not like anything we saw after World War II. As a consequence, it is conceivable that postwar data may contain little information useful for understanding economic outcomes of unusual events like the recent pandemic. Second, having a clear idea of the extent to which a given deviation of inflation from its intended target is driven by its permanent component is important for policymaking, as it informs the timing, size, and communication of the corresponding policy response. Third, it is becoming increasingly plausible that climate change will open an era of larger economic fluctuations. Until enough data has accumulated under such new regime, the volatile pre-war period may offer useful information for understanding and forecasting business cycles to come.

The remainder of this paper proceeds in three sections. Section I presents the model and briefly discusses data and estimation. A more detailed presentation of these issues can be found in Schmitt-Grohé and Uribe (2022) from which this paper draws heavily. Section II presents the main result of the paper, namely, the behavior of the permanent component of inflation around the COVID-19 pandemic and how it depends on whether the model is estimated on data starting at the beginning of the twentieth century or only after World War II. Section III concludes.

I. The Empirical Model

The model structure is based on Schmitt-Grohé and Uribe (2022), which in turn builds on Uribe (2022). Here we briefly outline its key components. A difference

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with related state space models (e.g., Stock and Watson, 2016) is twofold: First, the present model allows for innovations in permanent shocks to affect the cyclical component of endogenous variables, as is the case in optimizing DSGE models. Second, the present model allows for persistence in both the permanent components and the transitory components of output, inflation, and the real interest rate. The log of real output per capita, y_t , the inflation rate, π_t , and the nominal interest rate, i_t are assumed to be nonstationary. Output is assumed to be cointegrated with a nonstationary productivity shock, X_t , and with a nonstationary natural rate shock, X_t^r . Inflation is assumed to be cointegrated with a nonstationary inflation-target shock, X_t^m , and the nominal interest rate is assumed to be cointegrated with the nonstationary inflation-target shock and the natural rate shock. Accordingly, the cyclical components of output, inflation, and the nominal interest rate, denoted \hat{y}_t , $\hat{\pi}_t$ and i_t , are given by

and

$$\hat{i}_t = i_t - X_t^m - X_t^r,$$

 $\hat{y}_t = y_t - X_t - \delta X_t^r,$

 $\hat{\pi}_t = \pi_t - X_t^m,$

where δ is an estimated parameter.

The focus of the present paper is the behavior of the latent variable X_t^m representing the permanent component of inflation.

The law of motion of the cyclical components is assumed to take the form

$$\begin{bmatrix} \hat{y}_t \\ \hat{\pi}_t \\ \hat{i}_t \end{bmatrix} = B \begin{bmatrix} \hat{y}_{t-1} \\ \hat{\pi}_{t-1} \\ \hat{i}_{t-1} \end{bmatrix} + C \begin{bmatrix} \Delta X_t^m \\ z_t^m \\ \Delta X_t \\ z_t \\ \Delta X_t^r \end{bmatrix},$$

where z_t^m and z_t represent a stationary monetary shock and a stationary real shock, respectively. The matrices B and C are estimated.

The exogenous shocks follow univariate

AR(1) processes,

$$\begin{pmatrix} 1 \\ \Delta X_{t+1}^m \\ z_{t+1}^m \\ \Delta X_{t+1} \\ z_{t+1} \\ \Delta X_{t+1}^r \end{pmatrix} = \rho \begin{bmatrix} \Delta X_t^m \\ z_t^m \\ \Delta X_t \\ z_t \\ \Delta X_t^r \end{bmatrix} + \Psi \begin{bmatrix} \epsilon_{t+1}^{X^m} \\ \epsilon_{t+1}^{Z^m} \\ \epsilon_{t+1}^{Z^m} \\ \epsilon_{t+1}^{X^r} \\ \epsilon_{t+1}^{X^r} \end{bmatrix},$$

where ρ and Ψ are estimated diagonal matrices and ϵ_t^s , for $s = X^m, z^m, X, z, X^r$, are i.i.d. disturbances distributed N(0, 1). All variables of the model are unobservable.

The model is estimated using data on output growth, Δy_t , the change in consumer price inflation, $\Delta \pi_t$, and the change in the short-term nominal interest rate, Δi_t . The following identities serve as observation equations:

$$\Delta y_t = \hat{y}_t - \hat{y}_{t-1} + \Delta X_t + \delta \Delta X_t^r + \mu_t^y,$$
$$\Delta \pi_t = \hat{\pi}_t - \hat{\pi}_{t-1} + \Delta X_t^m + \mu_t^\pi,$$

and

$$\Delta i_t = \hat{i}_t - \hat{i}_{t-1} + \Delta X_t^m + \Delta X_t^r + \mu_t^i$$

where μ_t^s , for $s = y, \pi, i$, are normally distributed mean-zero i.i.d. measurement errors whose variances are estimated.

The model is estimated on annual U.S. data spanning the period 1900 to 2022. The data source for the period 1900 to 2017 is Jordá et al. (2017). For the period 2018 to 2022, we use data sources as listed in the documentation for the Jordá et al. database. Specifically, the data source for real GDP per capita is the U.S. Bureau of Economic Analysis (2018–2022), the data source for the CPI index is the Bureau of Labor Statistics (2018–2022), and the data source for the short-term nominal interest rate is Officer (2023). Details on the identification scheme, priors, and the estimation technique can be found in Schmitt-Grohé and Uribe (2022).

II. The Permanent Component of Inflation

Figure 1 plots the estimated path of the permanent component of inflation, X_t^m , over the period 1900 to 2022, as predicted by the model. The path of X_t^m was obtained by setting the vector of estimated parameters equal to its posterior mean and then applying two-sided smoothing using the Kalman filter. This technique yields X_t^m up to a constant. In the figure, we arbitrarily pick this constant to ensure that the mean of X_t^m over the estimation sample matches that of actual inflation. For comparison, the figure also plots the actual inflation rate.

Observed inflation displays distinct characteristics in the pre- and postwar periods. In the pre-war period, inflation is highly volatile and spikes in inflation and deflation are typically short lived. As a result, the model interprets these episodes as mostly transitory, that is, not primarily driven by movements in the permanent component of inflation, X_t^m . A case in point is the observed inflation spike around the 1918 influenza pandemic. Between 1915 and 1918 inflation increased from 1 percent to 17 percent and then fell quickly to -11 percent by 1921. At the same time, X_t^m was relatively little changed; it increased by 2.2 percentage points between 1915 and 1918 and then fell by 2.6 percentage points between 1918 and 1921.

Figure 1 further shows that the dynamics of inflation and its trend component are quite different in the postwar pre-COVID-19 era. This period is dominated by the great inflation of the 1970s. Contrary to what happened during the pre-war period, this inflation episode was slow in building up. Inflation began to increase from a level of 2 percent in the mid 1960s to a peak of 10 percent in 1980. The figure shows that inflation accelerated for about 15 years. The return of inflation to the levels observed in the mid 1960s took another six years. To a large extent, the model accounts for the great inflation of the 1970s with a significant movement in the permanent component of inflation, X_t^m . Between 1960 and 1980 the model estimates that X_t^m rose 5.3 percentage points.

A key characteristic of the post-COVID-19 inflation hike is its speed. From 2019, the year before the onset of the pandemic, to 2022, the annual rate of inflation rose by 6 percentage points. The model interprets this sudden spike in inflation as being more akin to those observed in the pre-war period than to the great inflation of the 1970s. Specifically, of the 6 percentage-point increase in inflation observed between 2019 and 2022, X_t^m accounts for only 1.3 percentage points. Thus, according to the model the post-COVID-19 inflation burst was not predominantly driven by an increase in the permanent component of inflation.

How important is the inclusion of pre-war data in arriving at this conclusion? This question is relevant because most of the existing literature on the joint behavior of inflation, output, and the nominal interest uses data that starts only after World War II. We therefore next examine the predictions of the model when estimated on postwar data. Specifically, we reestimate the model on a sample starting in 1955. In keeping with much of the related literature, we start the postwar sample a few years after the actual end of World War II. Figure 2 displays the inferred path of the permanent component of inflation, X_t^m , and actual inflation. As in the estimate using data since 1900, the inflation of the 1970s is interpreted by the model as having a large permanent component. The key difference of this estimate relative to the one obtained when the model is estimated over the sample beginning in 1900 is that now almost all of the COVID-19 inflation spike is attributed to the permanent component of inflation X_t^m . Specifically, between 2019 and 2022 the permanent component of inflation increases by 5 percentage points, which is more than eighty percent of the total observed inflation increase. So according to the model estimated on postwar data, the inflation burst associated with COVID-19 was to a large extend driven by the permanent component of inflation.

A natural concern is that the result that the COVID-19 inflation is not driven primarily by its permanent component when estimated on the long sample could be due to inflation and output being measured with less accuracy prior to 1955 than thereafter. To address this concern, we re-estimate the model allowing for



Figure 1. Inflation and Its Permanent Component: Sample 1900 to 2022

Note: The permanent component of inflation, X_t^m , is computed by two-sided smoothing using the Kalman filter. It is normalized by adding a constant to match the sample mean of inflation.



Figure 2. Inflation and Its Permanent Component: Sample 1955 to $2022\,$

Note: The permanent component of inflation, X_t^m , is computed by two-sided smoothing using the Kalman filter. It is normalized by adding a constant to match the sample mean of inflation.

heteroskedasticity in measurement errors. Specifically, we find that if in the estimation using data from 1900 to 2022 measurement errors are allowed to explain a fraction of the variance of the data twice as large pre-1955 than post-1955, then of the 6 percentage-point actual increase in inflation between 2019 and 2022, the model attributes 2.2 percentage points to the permanent component X_t^m . While this is larger than the 1.3 percentage points obtained under the assumption of no heteroskedasticity, it is still less than half of the 5 percentage points attributed to X_t^m when the model is estimated on the 1955–2022 sample. This suggests that our finding is robust to allowing for larger measurement errors in the pre-postwar period.

Which of the two interpretations of the COVID-19 inflation hike makes more economic sense? Neither the model nor the data can answer this question. We believe, however, that the more compelling view is the one that emerges from the estimation including the pre-war data. The reason is that the economic developments triggered by the COVID-19 pandemic are of a nature not seen since the end of World War II. So it is conceivable that postwar data does not have that much to say about such event. By contrast, the pre-1955 period was littered with economic crises that came with large swings in the rate of inflation, including a pandemic similar to the COVID-19 one. It seems therefore reasonable that data from that early period may provide useful information for understanding the economic predicament in which the economy found itself in the aftermath of the global health crisis caused by the COVID-19 pandemic.

III. Conclusion

Modern business cycle analysis is a story told with postwar data. Before the COVID-19 pandemic this approach made sense. The volatile pre-war data seemed out of touch with the unprecedented stability witnessed in the postwar period and in particular since the Great Moderation. This paper suggests that the COVID-19 pandemic has called this approach into question and has given renewed value to the information contained in pre-war macroeconomic indicators. It is now the postwar data that seem out of touch with current developments.

The analysis conducted in this paper serves as a proof of concept. Seen from the perspective of a model estimated on postwar data, the post-COVID-19 inflation spur is interpreted to be caused by a large increase in the permanent component of inflation. The reason is that the model was given little chance to conclude otherwise; the only other major prior inflation increase during this sample period turned out to be a protracted one, which naturally is ascribed to the permanent component not just by the present model but also by the majority of existing models of U.S. inflation. However, once the sample is expanded to include the sudden, large, and short-lived swings in inflation observed in the first half of the 20th century, the same model attributes a major fraction of the post COVID-19 inflation to its transitory component.

Looking ahead, recent studies point in the direction that climate change will raise economic volatility around the globe. Thus, until sufficient data accumulates under this seemingly emerging new regime, long historical time series data could be a valuable input to business cycle analysis.

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