

Domestic inflation dynamics in the face of changes in international commodity prices, inflation expectations, and the exchange rate (by Gerson Cornejo, David Florián and Alan Ledesma)

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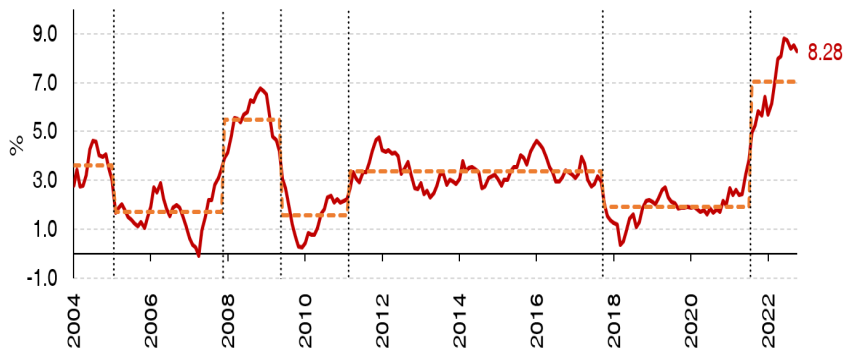
A brief summary

- This paper studies the dynamics of domestic inflation and its quantitative response to changes in commodity prices, the exchange rate, and inflation expectations.
- To this end, the paper uses a Bayesian approach with block exogeneity for a small open economy., where structural shocks are identified using sign and zero restrictions.
- The paper finds that non-metal commodity price shocks are persistent and inflationary, particularly international food prices.
- In contrast, international metal price shocks trigger a lower and less persistent inflation.
- In addition, the paper also finds significant and relatively persistent responses to exchange rate shocks.

Comments/questions

- 1 **Structural breaks.** Inflation has risen considerably in Peru and all around the world. The dynamics of the last period of high inflation is of particular interest of policymakers.

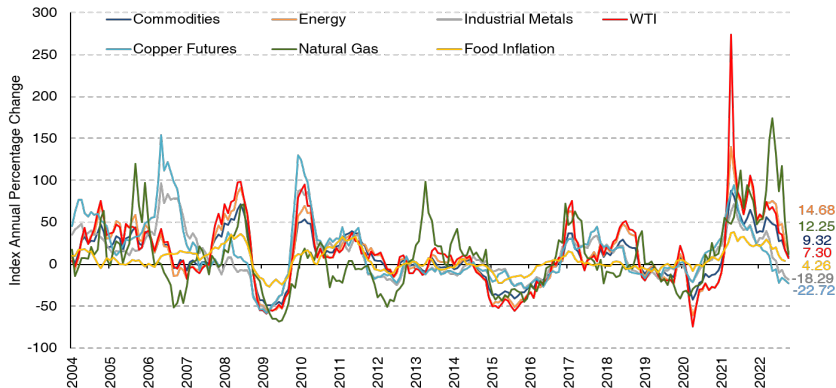
Figure 1: Peru inflation, structural Breaks



Comments/questions

Commodity price indices have risen significantly.

Figure 2: Commodity price indices (percentage change)



Comments/questions

But core inflation has also risen.

Figure 3: Headline and core inflation



Comments/questions

② **Other drivers.** Some important variables to consider during the last period of high inflation.

- ▶ Policy variables: in some countries, there was an excess of fiscal stimulus together with monetary accommodation.
- ▶ Supply-chain disruptions and bottlenecks caused by the pandemic. [Benigno et al. \(2022\)](#) propose a novel indicator to capture pressures that arise at the global supply chain level.
- ▶ Economic activity:
 - ★ Rebound in demand.
 - ★ Consumption shift towards goods.
 - ★ Labor supply shock. Reduction in the participation rate. Does labor informality play a role? [Alberola and Urrutia \(2020\)](#) argues that informality mitigates inflation volatility for most type of shocks but makes monetary policy less effective.

③ External variables.

- ▶ Raising in the US policy rate. The era of negative real yields in the US may be coming to an end. Episodes of extreme capital outflows (“sudden stops”) could become more frequent.
- ▶ US financial conditions have tightened: dollar appreciation and sharp rise in mortgage rates. Increase of 10-year US Treasury yields.
- ▶ Global liquidity and commodity prices possibly explain about two-thirds of inflation variability in LAC5.

④ **Historical decomposition of inflation.** In the absence of policy and real activity variables, the contribution of each variable in the historical decomposition of inflation will be biased.

- ⑤ **Compare with other LAC5 countries.** The block exogeneity is the same for other Latin American countries. The paper may include countries such as Brazil, Chile, Colombia and Mexico.

- ⑥ **Robustness: Local projections (LP).** LP is a natural alternative to estimate impulse responses from VARs.
 - ▶ VAR-based structural identification—including short-run, long-run, or sign restrictions—can equivalently be performed using LPs ([Plagborg-Møller and Wolf, 2021](#)).

 - ▶ Forecast error variance decompositions can be done following the approach of [Gorodnichenko and Lee \(2019\)](#).

7 Long term inflation. Discussion in AEs that are also relevant in EMEs on inflation dynamics.

- ▶ Inflation as a Fiscal Limit. The risk of embarking on persistently high inflation seems to be rooted in the worrying combination of the large public debt and the weakening perception of credibility on the fiscal framework ([Bianchi and Melosi, 2022](#)).
- ▶ Deglobalization. Globalization made it easier for major central banks to pursue and maintain low inflation. Deglobalization risks having the opposite effect, monetary policy may need to be tightened more than would otherwise be the case ([Forbes, 2019](#)).
- ▶ Bifurcation (“near-shoring” instead of “off-shoring”).
- ▶ Redundancy in productive processes (“just-in-case” instead of “just-in-time”).

7 **Long term inflation.** Discussion in AEs that are also relevant in EMEs on inflation dynamics.

- ▶ Demographics. A larger share of young and old in the population is associated with higher inflation ([Juselius and Takáts, 2018](#)).
- ▶ Inequality. Cross-country evidence that inflation and income inequality are positively related ([Albanesi, 2007](#)).
- ▶ Environmental deterioration and public policy. For instance:
 - ★ Frequency of extreme climatic events that have a significant impact on the prices of certain goods (climateflation).
 - ★ Higher taxation of fossil fuels may lead to an increase in prices.

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