Public Abstract

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Title:The Cyclical Behavior of Prices and Inflation

One of the most important theme of macroeconomics is to describe and explain the behavior of key macroeconomic series, such as output, the price level, and inflation. This paper describes the way in which the price level and inflation interact with output over time for the post-World War II United States. The price level is found to be negatively related to output and inflation is found to be positively related to output. In addition, movements in prices forecast movements in output about six months later, and movements in inflation is predicted by movements in output about nine months earlier. To explain the above facts, this paper uses two macroeconomic models including a business cycle model and a dynamic stochastic general equilibrium model in which prices may respond either sluggishly or immediately to changes in outside factors. The former model only explains the negative relationship between prices and output but not the positive relationship between inflation and output. The latter model explains all the observed facts if prices respond sluggishly to outside changes. In contrast, if prices adjust immediately to outside changes, the latter model fails to explain the positive relationship between inflation and output. Better performance of the sluggish-price version indicates that price stickiness can explain the behavior of prices and inflation over time. Thus, a powerful empirical macroeconomic model should include a reasonable degree of price stickiness.