

Inflation and Relative Price Risk*

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This paper contributes to the growing literature on the interdependence of the variances of relative prices and the general price level. The analysis concentrates on the concept of risk rather than mere variability. The relationships among sources of aggregate risk, relative price risk and inflation risk are analyzed within the frame of a multimarket model and then estimated with German data.

I. Introduction

Price level stability is the most important goal of monetary policy, according to some, apparently old-fashioned central bank laws.

The virtue of a stable general price level is obvious, provided stability is interpreted to mean constant expectation and zero variance. In such an ideal state changes in absolute market prices are identical to changes in relative prices, hence no biases are introduced into the transmission of information about relative scarcities of goods and services. This ideal state can be preserved even if we permit the general price level to change, provided the resulting rate of inflation will be held constant and provided that the policy is credible. Under those circumstances it would be easy for economic agents to decompose observed changes of absolute market prices into the economy-wide inflation component and market-specific relative price changes. In the absence of progressive taxation a regime of zero or constant inflation promotes efficient exchange and an efficient allocation of resources by avoiding the problem of errors in signal extraction.

The real world is far away from such ideal states, of course. During the forty years since world war II we have experienced worldwide not just inflation but considerable inflation variability. There is no country where economic policies have not proven to be unsteady, moving continuously from inflation to disinflation and back to reflation.

Unsteadiness of policies, most notably of monetary and fiscal policies, has been criticized by non-keynesian economists for a long time to be a potential source of harmful effects. There are two main arguments,

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