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Fiscal and monetary policies likely contributed to the persistent rise in inflation during the post-pandemic period.

We set up a two-sector New Keynesian model with input-output linkages to study the persistently high inflation during the post-COVID-19 period. We include multiple shocks as well as several amplification channels of these shocks in a parsimonious model to quantify the relative importance of each factor. We calibrate the model to match the pre-COVID-19 data and alter parameters governing 1) the fiscal rule, 2) inflation feedback in the monetary policy rule, 3) elasticity of substitution among intermediary inputs in production, and 4) the size of a sectoral demand shift shock to explain the post-COVID-19 data. We obtain estimates of shocks in the model to fit goods inflation data during the post-COVID-19 period and use aggregate inflation to test the model’s ability to explain the recent inflationary episode. Although aggregate demand shocks and a sectoral demand shift shock have played a significant role in the initial inflation surge during 2021, the propagation of these shocks into the persistently high aggregate inflation was also helped by lower inflation feedback in the monetary policy response relative to the pre-COVID-19 period. Compared with other changes in parameters, this alteration of the monetary policy rule best fits the level and persistence of the post-COVID-19 aggregate inflation. While lowering the elasticity of substitution among intermediary inputs can match the level of inflation, it does a poorer job of explaining the persistence of inflation compared with allowing changes in the monetary policy rule.

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