CAN AGGREGATION EXPLAIN
THE PERSISTENCE OF INFLATION?*

Filippo Altissimo (Brevan Howard LLP and CEPR)
Benoît Mojon (Banque de France)
Paolo Zaffaroni (Imperial College London)

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Abstract

An aggregation exercise is proposed that aims at investigating whether the fast
average adjustments of the disaggregate inflation series of the euro area CPI is coher-
ent with the slow adjustment of euro area aggregate inflation. Estimating a dynamic
factor model for 404 inflation sub-indices of the euro area CPI allows to decompose
the dynamics of inflation sub-indices into a part due to a common macroeconomic
shock and to sector specific idiosyncratic shocks. Although idiosyncratic shocks dom-
inate the variance of sectoral prices, one common factor appears to be the main driver
of aggregate dynamics. In addition, the heterogenous propagation of this common
shock across sectoral inflation rates, and in particular its slow propagation to infla-
tion rates of services, generates the persistence of aggregate inflation. We conclude
that the aggregation mechanism explains a significant amount of aggregate inflation
persistence.

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1 Introduction

Recent contributions show that heterogeneity in price stickiness across sectors implies a slower response of aggregate prices to a monetary policy shock than would be the case if prices of all sectors were identically sticky (see Imbs et al., 2005, Carvalho, 2006, Boivin et al., 2006, Clark, 2006, and references therein). In view of this result, it appears legitimate to analyze the role of the aggregation process across heterogenous sectors for the dynamics of the business cycle.

We make a step in this direction by assessing the role of aggregation across heterogenous sectors for the persistence of aggregate inflation. We empirically investigate whether the prediction that persistence of the aggregate is (much) larger than the cross-sectoral average persistence holds true for our data, which gathers inflation rates from 404 sub-indices of the euro area CPI between 1985 and 2005. It turns out that this prediction is not rejected for our data. In particular, we show that the heterogenous responses of sectoral inflation rates to a common shock imply an aggregate inflation response that is indeed much slower than if we impose that all sectors respond similarly to the median/average sector. We therefore argue that the aggregation process can solve the apparent dilemma between the flexibility of sectoral prices \footnote{See Chari et al., 2000, Bils and Klenow, 2004 and Dhyne et al., 2005.} and the persistence of macroeconomic inflation.

Our analysis is based on results on aggregation of time series\footnote{See Robinson, 1978, Granger, 1980, and Zaffaroni, 2004.} and it is built upon an explicit model of the aggregation process that is then estimated and simulated. In the model, each sectoral inflation rate is decomposed into its response to an aggregate shock that affects all sectors and a sector specific shock. Our main findings can be summarized as follows:

1. One common factor accounts for 30 per cent of the overall variance of the 404 series. This share is twice as large if one focuses on business cycle and lower frequencies, i.e. on the persistent components of the series.

2. The propagation mechanism of the common shock is highly heterogenous across sectors.

3. The persistence implied by the aggregation exercise mimics remarkably well the persistence observed in the aggregate inflation. In particular, the cross-sectional distribution of the sectoral parameters implies an autocorrelation function of the aggregate CPI inflation which decays hyperbolically toward zero and displays long memory.
4. The high volatility and low persistence, observed on average at the level of sectoral inflation, is consistent with aggregate smoothness and high persistence.

Such results are important for two distinct reasons: (i) they show the importance of heterogeneity and aggregation in shaping up the dynamic response of macro variables. This is a clear warning against the naïve use of average-median micro parameters in calibrating macro models; (ii) they shed further light on the long standing debate on the persistence of inflation (see Pivetta and Reis, 2007, and reference therein). These results provide support to the view of inflation as a stationary process, albeit with long memory.

The paper is organized as follows. Section 2 illustrates the intuition on the theoretical link between aggregation, heterogeneity and persistence. Section 3 presents the data used in the empirical analysis and addresses the presence of common factors across the price sub-indices. Section 4 introduces the micro model and the estimation methodology. It then discusses the estimation results and their implications for the aggregate persistence. Section 5 concludes.

2 Theoretical link between aggregation, heterogeneity and persistence

To build the intuition on the theoretical link between heterogeneity, aggregation and persistence, we make use of a simple example which summarizes the results of Zaffaroni (2004) (see also Robinson (1978) and Granger (1980)). Let us consider \( n \) units and let the \( i \)th unit be described by a first-order autoregressive model

\[
y_{it} = \alpha_i y_{it-1} + u_t + \epsilon_{it}, \quad i = 1, \ldots, n, \tag{1}
\]

where \( u_t \), the common shock, is an \( i.i.d. \) sequence \( (0, \sigma_u^2) \), and the \( \epsilon_{it} \), the idiosyncratic shock, an \( i.i.d. \) sequence \( (0, \sigma_{\epsilon,i}^2) \) for any \( i, t \). The propagation of the shocks is heterogenous across units and the \( \alpha_i \) are \( i.i.d. \) with probability density function \( f(\alpha) \) over the support \((-1, 1)\).

The aggregate is simply the average of the individual units and by linearity \( Y_{n,t} = n^{-1} \sum_{i=1}^n y_{it} = U_{n,t} + E_{n,t} \), with \( E_{n,t} = n^{-1} \sum_{i=1}^n \epsilon_{it}/(1 - \alpha_i L) \) and \( U_{n,t} = u_t + \hat{\mu}_1 u_{t-1} + \hat{\mu}_2 u_{t-2} + \ldots \). When \( n \) gets large, by the strong law of large numbers, each \( \hat{\mu}_k \) will converge \( a.s. \) to the population moments of the \( \alpha_i \), i.e. \( \mu_k = \int_{-1}^1 \alpha^k f(\alpha) d\alpha \).

The dynamic pattern of the \( \mu_k \) represents the impulse response of the common shocks \( u_t \) on the aggregate. Zaffaroni (2004) shows that the rate of decay of the
\( \mu_k \) (i.e., the persistence of the aggregate shock) only depends on the behavior near unity of \( f(\alpha) \).

To illustrate this result, let us parameterize \( f(\alpha) \) as a Beta\((a, b)\) distribution, with \( a, b > 0 \).\(^3\) The parameter \( b \) governs the mass of the Beta distribution around unity and \( a \) is set equal to \( \left( \frac{\mu - \mu}{1 - \mu} \right) b \) in order to assure that the distribution has mean \( \mu \) for any choice of \( b \). Table 1 reports the behavior of \( \mu_k \) for various choices of \( b \) when \( \mu = 0.8 \) across all columns.

**TABLE 1 ABOUT HERE**

The smaller is \( b \), the larger is the mass of the distribution \( f(\alpha) \) around unity (i.e., the larger is the share of micro units having very high persistence), and therefore the slower would the impulse response converge to zero. In contrast, the last column shows that if all units had the same AR coefficient (equal to \( \mu = 0.8 \)) the impulse response would decay to zero very fast, as \( \mu^k \). Zaffaroni (2004) shows that \( \mu_k \sim ck^{-b} \) as \( k \to \infty \) for some \( c > 0 \). This characterization of the impulse response implies a precise representation of the auto-covariance function (acf) and spectral density of the limit aggregate \( U_t \), the latter being the limit (in mean-square) of \( U_{n,t} \). In particular, Zaffaroni (2004) shows that when \( 1/2 < b < 1 \), then \( \text{var}(U_t) < \infty \), \( \text{cov}(U_t, U_{t+k}) \sim ck^{1-2b} \) as \( k \to \infty \). In other words, when \( 1/2 < b < 1 \) the \( \text{cov}(U_t, U_{t+k}) \) decays toward zero, in agreement with the notion of stationarity, but too slowly to ensure summability, resembling the classical definition\(^4\) of long memory for the \( U_t \) given by:

\[
\text{cov}(U_t, U_{t+k}) \sim ck^{2d-1}, \quad k \to \infty, \tag{2}
\]

with long memory parameter \( 0 < d < 1/2 \). It can be shown that there is a simple mapping between the long memory parameter \( d \) and the tail index \( b \) of the density \( f(\alpha) \), which is:

\[
d = 1 - b. \tag{3}
\]

The above results can be generalized to all distributions whose behavior close to unity can be approximated by \( (1 - \alpha)^{b-1} \). Furthermore, the results can also be extended within a general autoregressive moving average (ARMA) framework where the implication for aggregation depend on the shape of the distribution around unity of the largest autoregressive root of the ARMA process. See Zaffaroni (2004) for more details.

\(^3\)A Beta distribution has density function \( f(x \mid a, b) = B^{-1}(a, b)x^{a-1}(1 - x)^{b-1} \) for \( 0 \leq x \leq 1 \) where \( B(\cdot, \cdot) \) is the Beta function.

\(^4\)When \(-1/2 < d < 0\) in (2), under further regularity conditions, the \( U_t \) is said to display anti-persistence, which is a variation of long memory for which the acf becomes summable. We disregard this case here since not relevant to our empirical application.
To evaluate the following empirical application, we will specifically exploit the theoretical link between the distribution of the micro persistence parameters and the persistence of the aggregate.

3 The data

The data set utilized in our analysis comprises 470 seasonally adjusted and annualized quarter on quarter changes of consumer price sub-indices from France, Germany and Italy. The data runs from 1985 Q1 to 2005 Q1. Long time series of CPI sub-indexes are not readily available in most countries of the euro area. Therefore, we have been obliged to limit our data to France, Germany and Italy. Nevertheless, this has not undermined the representativeness of our exercise given that those three countries together account for roughly 70 per cent of the euro area population and consumption.

Unfortunately, the availability and cross-countries comparability of the data has induced us to work with consumer price data, which are a measure of the cost of goods and services as purchased by final consumers. CPI includes also the margins charged by retailers at the various steps of the distribution process. This implies that such consumer prices do not properly capture price dynamics at the production level nor the cost of intermediate inputs paid by firms.

Concerning the choice of the sample period, we focus on the post 1985 data for two reasons. First, the German data is not available before 1985. Second, we want to avoid that our results on inflation persistence are impaired by possible deterministic breaks over the estimation period. Many empirical studies have showed that the mid-eighties marked a significant break in average inflation in most OECD countries. Among the others, Corvoisier and Mojon (2005) suggests that Italian, French and German time series of inflation all admit a break in the mid-eighties.

We deem the post-1985 sample as appropriate to study the persistence of inflation in the euro area. The three CPI original databases together comprise 470 sub-indices, but 66 of these were not suitable for estimation of ARMA models either because they have too few observations (e.g. some sub-indices are available only since year 2000), or because they correspond to items which prices are set at discrete intervals (e.g. Tobacco or Postal services). We are left with 404 ‘well-behaved’ series each having 81 quarterly observations.
3.1 Sectoral inflation series: descriptive statistics

We now turn to the properties of the sub-sector inflation rates. Table 2 reports descriptive statistics of aggregate inflation and of the distribution of the 404 sectoral inflation rates. Let us emphasize four points.

First, the inflation sectoral averages are quite disperse with fifty per cent of their distribution ranging from 1.8 to 4.2 percent. The mean of aggregate inflation is 2.6 percent. Second, sectoral inflation is noticeably more volatile than aggregate inflation. On average, the standard deviation of the inflation sub-indices is equal to 3.6 per cent, i.e. nearly three times as large the standard deviation of the aggregate. This much higher volatility is a common feature of the inflation rates of sectoral prices as shown in Clark (2006) and Bilke (2005). Third, the persistence of sectoral inflation rates is also clearly smaller than the one of the aggregate inflation series. A first measure of persistence is given by the largest root of an ARMA model fitted on the data. This measure is equal to 0.93 in the case of the aggregate inflation and this is roughly equal to the 75th percentile of the distribution of the same measure on the sector’s data.\footnote{The largest root is the one associated to the best ARMA\((p,q)\) as selected by the Akaike (AIC) criteria with \(0 \leq p, q \leq 4\), estimated using the ARMAX procedure of \texttt{MatLab}.} An alternative measure of persistence is given by the long memory parameter, here denoted \(d_i\) for each sub-indices inflation rate \(\pi_{it}\) (see equation (2)). If the large majority of the sub-indices inflation rates displays long memory, then the aggregation exercise would be trivial. The last column of the table, which reports the statistics relative to the distribution of estimated long memory parameters \(d_i\) based on the parametric Whittle estimator (see Brockwell and Davis, 1987), confirms that only very few sectoral inflation rates exhibit long memory: \(d_i\) is not different from or close to \(-1/2\) for a vast majority of the cross-section. However, as shown below, our estimate of \(d\) for the aggregate inflation rate is 0.18, well above the 75th percentile of the sectoral \(d_i\) parameters \((-0.18\). Finally, we observe sharper differences in persistence across the main sectoral groupings of the CPI (processed food, unprocessed food, energy, non-energy industrial goods - NEIG - and services) than across countries. The gap between the ARMA largest root of the inflation process of unprocessed food prices (0.52) and one of the energy (0.78) is wider than between the root associated to the ARMA processes fitted on the inflation of German, French and Italian prices. Comparing the main groupings of CPI sub-indices across countries, we also find that the sectoral hierarchy at the euro area level applies within each country.

To conclude, we find clear evidence that the inflation rates of the individual sub-indices are way more volatile and much less persistent than the inflation rate of the aggregate CPI
index. Moreover, volatility and persistence are more sector than country specific.

TABLE 2 ABOUT HERE

3.2 Behind the aggregation mechanism: common shock and heterogeneous parameters

This section assesses the two elements that play a crucial role in shaping the effect of cross-section aggregation of time series: the presence of common shocks and of heterogeneity in the propagation mechanism of those shocks. This means that, using the notation of section 2, we are checking whether there is at least one common shock $u_t$ and whether the $\alpha_i$ are different across $i$. The analysis here is carried out using nonparametric methods so that the results do not depend on any parametric assumptions. Following the recent literature on factor model in large cross-sections we estimate the first ten dynamic principal components of the autocovariance structure of the sectoral inflation series. The dynamic principal component analysis provides indications on the number of common shocks explaining the correlation structure in the data (see Forni et al., 2000).

Figure 1 presents the spectrum of the first ten dynamic principal components of the 404 inflation time series.

FIGURE 1 ABOUT HERE

The variance of sectoral inflation is strikingly dominated by one common factor. Figure 1 also shows that this first common factor is the only one for which the spectrum is concentrated on low frequencies. Hence this factor drives the persistence observed in sectoral inflation. The other factors account for a much smaller share of the variance than the first one. They are also more equally relevant at all frequencies, as indicated by their relatively flat patterns in Figure 1.

On the basis of these results, we opt for a factor model of the sectoral inflation series that admits a single common shock, modelling the sectoral inflation time series $\pi_{it}$ as:

$$\pi_{it} = \delta_{hi} + \Psi_i(L)u_t + \xi_{it}, \quad i = 1, \ldots, n, \quad (4)$$


8Dynamic principal components are calculated as the eigenvalue decomposition of the multivariate spectra of the data at each frequency. The autocovariance function up to eight lags has been used in the construction of the multivariate spectral matrix. The data has been standardized to have unit variance before estimating the multivariate spectra.

9The height of the spectrum at frequency zero is a well-known non parametric measure of the persistence of a time series.

10Clark (2006) finds similar results on US inflation data.
where $u_t$ is the common shock, $\xi_{it}$ is a stationary idiosyncratic component, orthogonal to the common component and $\delta_{0i}$ is the constant mean parameter. $\Psi_i(L)$ is a lag polynomial for the $i$th unit which represents the propagation of the common shock through the $\pi_{it}$ process. In the next section we consider parametric specifications of both $\Psi_i(L)$ and $\xi_{it}$.

Model (4) is here to be intended specifically as a reduced form model once all the simultaneous, endogenous, relations are resolved. Indeed, the fact that we are working only with consumer price indexes prevents us from spelling out a complete simultaneous model where all the relations between prices at the various stages of the production process are properly accounted for (i.e., the role of the price of intermediate inputs). Furthermore, our model is designed to be in reduced form because we do not pursue any identification of the nature of the shocks, such as a productivity shock or a monetary policy shock, which would instead require a structural model, coupled with a suitable set of identification conditions.

However, one might still wonder whether our reduced-form approach can shed some evidence on which source of shocks is the dominant one, if any. A simple consequence of a purely monetary shock is its neutrality with respect to relative prices long run dynamics, in line with the definition of pure inflation given by Reis and Watson (2008). For this reason, we look at whether the propagation mechanism of the common shock in the cross-section of price sub-indices is homogenous across items. Still resorting to spectral analysis, we estimate the coherence\(^\text{11}\) between the first principal component and each one of the 404 series, in order to obtain ‘correlation’ at different frequencies.

Figure 2 reports the cross-section distribution of the coherence values at three frequencies: 0 (long run), $\pi/6$ (three years periodicity) and $\pi/2$ (one year periodicity) respectively.

\[ \text{FIGURE 2 ABOUT HERE} \]

The figure supports the presumption that the common shock transmission to sectoral inflation is highly heterogenous. Such evidence plays against the idea that the our common shock can be identified as a monetary policy one. However, we leave the issue of the shock identification to future work.

The following section addresses precisely the issue of how to model and estimate, based on a parametric one-factor linear model, the heterogeneity manifested by Figure 2.

\(^{11}\text{Coherence measures the degree at which two variables are moving together at a given frequency. It is a quantity always between 0 and 1; see Brockwell and Davis (1987) for details.}\)
4 Model: specification and estimation

4.1 The model

The quarterly rate of change of each sectoral price sub-index \( \pi_{it} \) is assumed to behave according to the following parametric specification of (4):

\[
\pi_{it} = \delta_0 + \frac{\Theta^u_i(L)}{\Phi^u_i(L)} u_t + \frac{\Theta^\epsilon_i(L)}{\Phi^\epsilon_i(L)} \epsilon_{it},
\]

meaning that we are considering a particular case of (4) with \( \Psi_i(L) = \Theta^u_i(L)/\Phi^u_i(L) \) and \( \xi_{it} = \Theta^\epsilon_i(L)/\Phi^\epsilon_i(L) \epsilon_{it} \), where as before \( u_t \sim i.i.d. (0, 1) \) is the common shock and now \( \epsilon_{it} \sim i.i.d. (0, \sigma^2_i) \) is the idiosyncratic shock for each \( i = 1, \ldots, n \), also mutually independent from \( u_t \). No distributional assumptions are made. The above polynomials in the lag operator are assumed to satisfy the usual stationarity-invertibility conditions, that is they have all roots outside the unit circle in the complex plane. Also \( \Theta^\epsilon_i(L), \Phi^\epsilon_i(L) \), respectively of finite order \( q^\epsilon_i, p^\epsilon_i \), have no common roots for \( x \in \{ u, \epsilon \} \) ensuring identification. Thus, each \( \pi_{it} \) behaves as a stationary ARMA\((p^\epsilon_i, q^\epsilon_i)\) with a possibly non zero mean \( \delta_0 \), where standard arguments on sum of ARMA processes yield \( q^\epsilon_i \leq \max\{ q^u_i + p^\epsilon_i, q^\epsilon_i + p^u_i \} \) and \( p^\epsilon_i \leq p^u_i + p^\epsilon_i \), equality holding if the two AR polynomials, \( \Phi^\epsilon_i(L) \) and \( \Phi^u_i(L) \), have no roots in common. Note that we allow full heterogeneity of all the parameters characterizing model (5). The aggregation result requires to estimate the cross-sectional distribution of the maximal AR roots of \( \Phi^u_i(L) \) and \( \Phi^\epsilon_i(L) \).

We assume that the \( \epsilon_{i,t} \) are mutually orthogonal across units. This is merely a simplification assumption, not required in fact for the aggregation theory, used in this paper, to be applicable. In fact, a factor model, such as (5), represents a parsimonious way to capture cross-sectional dependence. This enters primarily through the common component, representing a form of pervasive dependence. However, dependence is in principle permitted also through cross-correlated \( \epsilon_{it} \) (i.e., \( \text{cov}(\epsilon_{i,t}, \epsilon_{j,t}) \neq 0 \) for \( i \neq j \)) as long as this form of cross-correlation is sufficiently weak and not pervasive in the cross-section, ensuring that model (5) belongs to the class of approximate factor structure.\(^{12}\) For example, one might consider the case of local correlation arising between the prices of items belonging to the same sector as follows: the \( n \) units are classified into \( m < n \) sectors, with \( \text{cov}(\epsilon_{i,t}, \epsilon_{j,t}) = \rho_l \neq 0 \) for all units belonging to the \( l \)th sector, with \( 1 \leq l \leq m \) and \( \text{cov}(\epsilon_{i,t}, \epsilon_{j,t}) = 0 \) for all \( l \neq r \), any \( i, j \). In this case, the approximate factor structure

\(^{12}\)An approximate factor structure is qualified by the condition that the maximum eigenvalue of the covariance matrix \( \mathbf{E} \epsilon \epsilon' \) remains bounded as \( n \) increases, where \( \epsilon_t = (\epsilon_{1,t}, \ldots, \epsilon_{n,t})' \); see Chamberlain and Rothschild (1983).
condition is still satisfied as long as the number of units belonging to each sector do not increase too fast with $n$. However, we do not endorse these type of parameterizations here. In fact allowing cross-sectional dependence among the $\epsilon_{i,t}$ is not of primarily importance for this paper because, from an econometric perspective, (i) the aggregation mechanism depends solely on the characteristics of the common component (see Zaffaroni (2004)), (ii) our estimation strategy is robust to many forms of cross-sectional dependence among the $\epsilon_{i,t}$ as, for example, an approximate factor structure, and (iii) we are modelling consumer price indexes, which makes difficult to properly account for input/output relations across sectors.

4.2 Estimation strategy

The estimation of model (5) is non standard. First, the large dimensionality (large $n$) rules out the recourse to the conventional Kalman filter approach typically used for univariate or for small multivariate ARMA. Second, the recent techniques for estimation of dynamic factor models, all based on the principal component approach such as Forni et al. (2000) and Stock and Watson (2002), would be inappropriate in our model due to the presence of sector specific AR components $\Phi_u^i(L)$ and $\Phi^\epsilon_i(L)$.

We propose instead the following multi-stage procedure:

(i) For each unit $i$, we estimate the following ARMA($p_i$, $q_i$) implied by (5), namely $\Phi_i(L)\pi_{it} = \hat{\delta}_{0i} + \Xi_i(L)z_{it}$, setting $\hat{\delta}_{0i} = \Phi_i(1)\delta_{0i}$, $\Phi_i(L) = \Phi_u^i(L)\Phi_i^\epsilon(L)$ with MA component $\Xi_i(L)z_{it} = \Theta_u^i(L)\Phi_i^\epsilon(L)\epsilon_{it}$, for some white-noise sequence $z_{it}$ and a polynomial $\Xi_i(L)$ of order $q_i$. Simplification occurs if there are roots in common. Note that here we need not distinguish between the common and the idiosyncratic shock, since this is un-necessary for consistent estimation of the intercept $\hat{\delta}_{0i}$, and of the AR coefficients in $\Phi_i(L)$, which are the goal of this stage.

(ii) We average the estimated MA component $\hat{\Xi}_i(L)\hat{z}_{i,t}$ across $i$ yielding

$$\hat{x}_{t,n} = \sum_{i=1}^{n} w_i \hat{\Xi}_i(L)\hat{z}_{i,t}. \quad (6)$$

where the $w_i$ are the CPI weights. This yields an estimate of its common part, namely the limit of $\left(\sum_{i=1}^{n} w_i \Theta_u^i(L)\Phi_i^\epsilon(L)\right)\epsilon_{it}$, where the approximation improves as $n$ grows since the idiosyncratic part vanishes in mean-square as $n \to \infty$. We then fit a finite order MA to the $\hat{x}_{t,n}$ in order to get, at this stage, an estimate of the common innovation $\hat{u}_t$.

(iii) using the $\hat{u}_t$ as an (artificial) regressor, we finally fit model (5) to each $\pi_{it}$ but with the caution of using it as an ARMAX($p_i$, $q_i$, $q_i$) process (an ARMA process with exogenous
regressors). Note that, in doing so, we are not imposing that the AR roots of the common and idiosyncratic components coincide, a feature admitted by the so-called Box-Jenkins model structure. At this stage we get all parameter estimates.

Steps (ii) and (iii) of the procedure can be iterated in order to improve the estimate of the common shock as well as of the model parameters. Such procedure does not require any distributional assumption but its validity requires that both \( n, T \) to diverge to infinity. Details of the algorithm can be found in Altissimo and Zaffaroni (2004). The described iterative procedure is similar to a recent modification of the EM algorithm for the estimation of factor models in the presence idiosyncratic AR components recently proposed by Stock and Watson (2005).

We set \( 0 \leq p_u^i, p_{\epsilon}^i \leq 2, 0 \leq q_u^i, q_{\epsilon}^i \leq 4 \) implying in stage (i) estimation of ARMA\((p, q)\) with \( 0 \leq p, q \leq 4 \). The order of the models \((q, p)\) in step (i), \( q_i \) in step (ii) and \( p_i^u, p_i^\epsilon, q_i^u, q_i^\epsilon \) in step (iii)) are selected based on the AIC criteria. At each iteration and for each \( i \) this means that we have estimated \( 3^2 \times 5^2 = 225 \) specifications, given the chosen range for \( p_i^u, p_i^\epsilon, q_i^u, q_i^\epsilon \). Our choice on the orders is made solely to contain computational time and to follow the principle of parsimony, since the larger the orders, the larger would be the number of parameters to be estimated. However, in terms of the aggregation mechanism, note that no effect would arise from taking arbitrarily large, yet finite, MA and AR orders.

### 4.3 Results for sectorial inflation rates

This section briefly describes the estimates of up to six thousand parameters (up to 15 parameters for each of the 404 sub-index time series, namely the AR and MA parameters, the mean and the idiosyncratic innovation variance) of the model. First, the estimated common shock \( u_t \) turns out to be white, with a non-significant autocorrelation, corroborating the i.i.d. hypothesis. Second, the idiosyncratic volatility \( \sigma_i \) is substantially larger than the common shock volatility, in fact six times larger. The median of the distribution of the absolute value of the estimated first loading is 0.06, whereas we obtain 0.38 for the standard deviation of the idiosyncratic component. This strikingly confirms that most of the variance of sectoral prices is indeed due to sector specific shocks. Third, we turn to \( \Phi_i^u(L) \), which dominates the dynamic effects of the common shock on sectoral inflation. In Figure 3 (blue dashed line), we show the kernel estimate of the distribution of the signed

\[13\text{We use the armax and bj procedures of MatLab.}\]
modulus of the maximal AR root of such polynomial.\textsuperscript{14}

**FIGURE 3 ABOUT HERE**

It turns out that this distribution is dense near unity with a median of 0.82 and a long tail to the left. Fourth, we compare the dynamics of sectoral inflation rates and main CPI groupings in Table 3. The table reports the number and the relative frequency of series having roots above given thresholds in specific sub-category as well as the total weight of such series in the overall CPI.

**TABLE 3 ABOUT HERE**

Looking at the cross country pattern, highly persistent sub-sectors in Germany account for a much larger share of the overall euro area CPI; this effect is mainly due the high persistence (AR root of 0.96) of German housing expenditure inflation\textsuperscript{15}, which accounts for around 8 per cent of the overall CPI. Furthermore, the Service sector turns out to be the most relevant for the dynamics of aggregate inflation either because it has the largest share of highly persistent series and the highest weight in the consumption basket.

### 4.4 Results for aggregate inflation rate

Given the estimates of the micro parameters, we are now in a position to infer the dynamic properties of the aggregate induced by the behavior of the micro time series, which represent the core results of the paper. We consider three different types of aggregation schemes. First, we reconstruct the aggregate as an exact weighted average of the individual micro time series and in this way we exactly recover the contribution of the common shocks to the aggregate inflation and to aggregate persistence. This exact aggregation result will corroborates the plausibility of one dominant common shock specification. Second, we exploit the theoretical link between the distribution of the largest AR root of sectoral inflation rates and the autocovariance structure of the aggregate, as presented in section 2, to infer the dynamic properties of the latter. We shall call this asymptotic aggregation result, which is the main finding of the paper. Third, we consider a so-called naïve aggregation scheme based on the (wrong) presumption that the aggregate model has the same functional form as the individual models, in our case an ARMA. This exercise will warn against not properly accounting for the aggregation effects.

\textsuperscript{14}We did sign such modulus so that we could distinguish between the effect of a negative root from a positive one and also consider the effect of complex roots.

\textsuperscript{15}The subindex is rent (including imputed rents from owner-occupied houses), which account for around 20 per cent of the German CPI, while it is only 3 per cent of the Italian and French.
Summarizing the results described below in detail, we claim that the analysis of the micro determinants of the aggregate inflation supports the view that aggregate inflation in our sample period can be well described by a stationary long memory process. We will show that starting from very simple ARMA process at micro level we have been able to properly reconstruct the dynamic properties of the aggregate. We will also show that the micro volatility and low persistence can be squared with the aggregate smoothness and persistence.

4.4.1 Exact aggregation

The aggregate inflation data is defined as the weighted average of the sectoral inflation rates.\textsuperscript{16} Therefore using the estimates of the model in (5) it follows:

\[
\Pi_{n,t} = \sum_{i=1}^{n} w_i \pi_{it} = \sum_{i=1}^{n} w_i \delta_{0i} + \hat{u}_t \sum_{i=1}^{n} w_i \frac{\hat{\Theta}_u(L)}{\hat{\Phi}_u(L)} + \sum_{i=1}^{n} w_i \frac{\hat{\Theta}_\epsilon(L)}{\hat{\Phi}_\epsilon(L)} \hat{\epsilon}_{it} = \hat{\delta}_0 + \hat{\Psi}(L) \hat{u}_t + \hat{\xi}_t,
\]

where the \( w_i \) are the CPI weights. Hence, the aggregate inflation is decomposed into two components, one associated with the common shocks, \( \hat{u}_t \), and its propagation mechanism, \( \hat{\Psi}(L) \), and a second associated with the idiosyncratic component \( \hat{\xi}_t \), where \( \hat{\Psi}(L) = \sum_{i=1}^{n} w_i \hat{\Psi}_i(L) \), viz. a weighted average of the propagation mechanisms at micro level. Figure 4 shows the reconstructed aggregate, \( \Pi_{n,t} \), versus its common component, \( \hat{\Psi}(L) \hat{u}_t \). There is a high correlation between the two components, around 0.76, but the former is clearly more volatile. This suggests that the idiosyncratic component \( \hat{\xi}_t \) has not been completely washed out at the aggregate level. However, the effect of the idiosyncratic component has been drastically reduced: the average of the estimated variances of the idiosyncratic components, namely \( \sum_{i=1}^{n} w_i \text{var}(\hat{\xi}_{it}) \), is equal to 0.2, which is four times larger than the estimated variance of the average of the idiosyncratic components, namely \( \text{var}(\hat{\xi}_t) = \text{var}(\sum_{i=1}^{n} w_i \hat{\xi}_{it}) \). Since the idiosyncratic component has little persistence, \( \hat{\Psi}(L) \hat{u}_t \) can be interpreted as a measure of ‘core inflation’, possibly relevant for monitoring and forecasting inflation.

\textsc{Figure 4 about here}

\textsuperscript{16}Statistical offices do not aggregate inflation rates but first they aggregate price indices and then compute the aggregate inflation rate. Here we ignore the possible effect induced by such non-linear transformation since not relevant for the dynamic properties of the aggregate.
4.4.2 Asymptotic aggregation

In this section, we provide a more formal link between micro heterogeneity and aggregate persistence based on the arguments introduced in section 2. However, differently from the simple example discussed there, we first need to take into account that CPI sub-sectors have different weights in the aggregate. To overcome this problem, we implement a relative re-weighting of the 404 maximal AR roots in function of the relative weights of the respective sectors. Precisely, we bootstrap a sample of 10,000 data out of the 404 roots with relative frequency equal to the weighting scheme; hence roots associated to sectors will a larger weight \( w_i \) will be re-sampled more often.

For the bootstrapped sample, the distribution of the roots is estimated in two ways, parametrically and non parametrically. The non parametric estimate resorts on the use of a bounded kernel in order to account for the bounded support of the roots; such non parametric estimate of the density function associated to this simulated sample is plotted in Figure 3 (blue dashed line). Instead, for the parametric case, mirroring the example of section 2, we fitted the Beta distribution to the data:

\[
f(\alpha | \hat{a}, \hat{b}) = B^{-1}(\hat{a}, \hat{b})\alpha^{\hat{a}-1}(1 - \alpha)^{\hat{b}-1},
\]

where the Beta parameter estimates, obtained by maximum likelihood estimation, are respectively \( \hat{a} = 4.7, \hat{b} = 0.87 \) (standard deviations equal to 0.17 and 0.02, respectively). The fitted Beta density is also plotted in Figure 3 (green solid line). The behavior near unity of the two estimated densities, based on the parametric and non parametric estimator respectively, is remarkably similar and in the following we will focus on the estimated Beta.\(^{17}\)

We now have all the ingredients to apply the arguments of section 2. By (3) we immediately get \( \hat{d} = 1 - \hat{b} = 0.13 \) and plugging this value into (2) yields the (estimated) asymptotic behavior for the acf of the common component of the aggregate, \( \Psi(L)u_t \), equal to:

\[
\text{cov}(\Psi(L)u_t, \Psi(L)u_{t+k}) \sim c k^{-0.84} \quad \text{as } k \to \infty.
\]

In other words, it follows that the common component of aggregate inflation has long memory parameter equal to \( \hat{d} = 0.13 \). Therefore, the acf of the common component of aggregate inflation decays toward zero with an hyperbolic decay, and thus is markedly different from the behavior of the sectoral inflation processes.

\(^{17}\)Using simple regression method, we can show that the non-parametric estimate of the root distribution behaves near unity as \( \hat{f}(\alpha) \sim c(1 - \alpha)^{-0.16} \) as \( \alpha \to 1^- \), which is remarkably close to the tail behavior implied by (7) namely \( f(\alpha | \hat{a}, \hat{b}) \sim c(1 - \alpha)^{-0.13} \) as \( \alpha \to 1^- \).
So far we have backed out the aggregate memory from the micro data. One might wonder at what would be the estimate of the memory based directly on the aggregate data. It turns out that the estimate of the memory parameter \( d \) by using only the aggregate \( \Pi_{n,t} \) is equal to 0.18, with standard error of the estimate equals to 0.20, which, given the distribution reported in the last column of Table 2, is reasonably close to 0.13, as recovered from the micro structure. Therefore, the aggregate data presents a long memory behavior that is not present in the micro time series; this long memory characteristic appears to be fully accounted for by aggregation.

### 4.4.3 Naïve aggregation

The above results are framed in term of autocovariance function and they show that the difference in persistence between the micro and macro dynamic is not necessarily inconsistent. The key element there is the aggregate impulse response function \( \Psi(L) \), equal to the limit (in mean square) of \( \sum_{i=1}^{n} w_i \Psi_i(L) \) (cf. equation (4)).

Another way to highlight the effects of aggregation on persistence is to consider the following naïve exercise. We construct an hypothetical average ARMA process (here called in fact naïve), whose roots are the average of the individual roots of the 404 estimated ARMA\( s \). This means that we are considering the following impulse response function:

\[
\Psi_{naive}(L) = \frac{(1 + \theta_1 u L)(1 + \theta_q u L)}{(1 - \phi_1 L)(1 - \phi_p L)}. \tag{9}
\]

Here \( \theta_h^u \), for \( 1 \leq h \leq q \), is the (cross-sectional weighted) average of the \( h \)th root of the MA polynomial \( \Theta^u_i(L) \) corresponding to the common shock \( u_t \) (cf. model (5)). Similarly, \( \phi_k^u \), for \( 1 \leq k \leq p \), is the average of the \( k \)th root of the AR polynomial \( \Phi^u_i(L) \) corresponding to the common shock \( u_t \).

The difference between \( \Psi(L) \) and \( \Psi_{naive}(L) \) arises whenever \( p > 0 \), that is when there is an autoregressive component, since the impulse response is a nonlinear function of the autoregressive parameters. Therefore the coefficients embedded within the impulse response \( \Psi(L) \) decay hyperbolically, a symptom of long memory, whereas the coefficients of the naïve impulse response \( \Psi_{naive}(L) \) decay exponentially. The idea of the exercise is to see the aggregate response to the common shock in case the propagation mechanism is equal across agents versus the case of different propagation mechanisms, i.e. to quantify the

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\(^{18}\)We have used the log periodogram regression estimator of Robinson (1995).

\(^{19}\)Hereafter, we follow the convention of referring to the inverse of the roots as the roots so that, for example, the root of the polynomial \( 1 - \phi L \) will be indicated by \( \phi \) rather than by \( \phi^{-1} \).
effect of heterogeneity and aggregation.\textsuperscript{20}

Figures 5 compares the estimated impulse responses\textsuperscript{21} implied by $\hat{\Psi}^{naive}(L)$ and $\hat{\Psi}(L)$ respectively.

FIGURE 5 ABOUT HERE

The exercise is quite instructive. In the hypothetical case of homogeneity of the micro propagation mechanism, after four years a common shock $u_t$ would be completely absorbed (green dashed line), while in reality, due to the presence of heterogeneity and of some very persistent micro units, around 20 per cent of the shock would not have been absorbed (blue line). In other words, focusing on the naïve model, that uses (9), leads to underestimate the degree of persistence in the data in a quantitatively important way; once and again this results warns against the practice of using average micro behavior in order to calibrate macro phenomena.

5 Conclusions

In this paper, exploiting the heterogeneity in the inflation dynamics across CPI sub-indices within the euro area, we investigate the role played by cross-sectional aggregation in explaining some of the difference observed between micro and macro inflation dynamics. We focus in particular on the link between CPI sub-indices and the aggregate CPI. Our results are able to square the volatility and low persistence observed, on average, at the level of sectoral inflation with the smoothness and persistence of the aggregate. The persistence that we obtain through this aggregation exercise mimics remarkably well the persistence observed in the aggregate inflation. In particular, aggregate inflation turns out to be well described by a stationary long memory process. The persistence of the aggregate inflation is mainly due to the high persistence of some sub-indices mainly concentrated in the service sector, such as housing costs in Germany. Altogether, we show the importance of heterogeneity and aggregation for understanding the persistence of inflation at the macroeconomic level. We leave the design and estimation of stylized models of the business cycle that can be consistent with both heterogeneity at the micro level and the implied persistence at the macro level for future research.

\textsuperscript{20}See also the presentation of similar exercises in the context of micro-founded model, though on hypothetical distribution by Carvalho (2006).

\textsuperscript{21}Here $\hat{\Psi}^{naive}(L)$ is obtained by plugging the sample weighted means $\hat{\theta}^h = \sum_{i=1}^{n} w_i \hat{\theta}_{ih}, 1 \leq h \leq q$, and $\hat{\phi}^k = \sum_{i=1}^{n} w_i \hat{\phi}_{ik}, 1 \leq k \leq p$, into (9).
References


Figure 1: First ten dynamic principal components: variance accounted

Figure 2: Coherence between aggregate and sub-indexes at various frequencies
Figure 3: Distribution of the maximal autoregressive root

Figure 4: Aggregate CPI inflation versus estimated common component
Figure 5: Impulse responses
Table 1: Impulse response function $\mu_k$ for the Beta($a, b$) density with $a = 4b$

<table>
<thead>
<tr>
<th>$k$</th>
<th>$b = 0.2$</th>
<th>$0.7$</th>
<th>$1$</th>
<th>$3$</th>
<th>$0.8^k$</th>
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<tr>
<td>1</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>2</td>
<td>0.72</td>
<td>0.67</td>
<td>0.66</td>
<td>0.65</td>
<td>0.64</td>
</tr>
<tr>
<td>5</td>
<td>0.61</td>
<td>0.48</td>
<td>0.44</td>
<td>0.37</td>
<td>0.33</td>
</tr>
<tr>
<td>10</td>
<td>0.54</td>
<td>0.33</td>
<td>0.28</td>
<td>0.17</td>
<td>0.11</td>
</tr>
<tr>
<td>50</td>
<td>0.39</td>
<td>0.12</td>
<td>0.07</td>
<td>0.01</td>
<td>$1.4 \times 10^{-5}$</td>
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<tr>
<td>200</td>
<td>0.36</td>
<td>0.09</td>
<td>0.05</td>
<td>0.01</td>
<td>$4.1 \times 10^{-20}$</td>
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### Table 2: Descriptive statistics of the 404 sectoral inflation rates
(first two columns annualized q-o-q inflation rates)

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Stand. dev.</th>
<th>Larg. ARMA root</th>
<th>Long mem. d</th>
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<tr>
<td>Aggregate of 404</td>
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<td>1.1</td>
<td>0.93</td>
<td>0.18</td>
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<td>Cross section characteristics</td>
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<tr>
<td>Weighted mean</td>
<td>2.6</td>
<td>3.6</td>
<td>0.78</td>
<td>-0.33</td>
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<tr>
<td>Unweighted mean</td>
<td>2.4</td>
<td>3.5</td>
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<td>-0.36</td>
</tr>
<tr>
<td>Minimum</td>
<td>-11.3</td>
<td>0.7</td>
<td>-0.81</td>
<td>-0.50</td>
</tr>
<tr>
<td>25th percentile</td>
<td>1.8</td>
<td>1.7</td>
<td>0.71</td>
<td>-0.50</td>
</tr>
<tr>
<td>Median</td>
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<td>2.5</td>
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<tr>
<td>75th percentile</td>
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<td>4.0</td>
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<tr>
<td>Maximum</td>
<td>8.1</td>
<td>25.4</td>
<td>1.02</td>
<td>0.32</td>
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<tr>
<td>Mean for selected sub-sets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>1.8</td>
<td>3.0</td>
<td>0.72</td>
<td>-0.34</td>
</tr>
<tr>
<td>Germany</td>
<td>1.5</td>
<td>3.2</td>
<td>0.71</td>
<td>-0.34</td>
</tr>
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<td>Italy</td>
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<td>4.3</td>
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<td>NE Indus. goods</td>
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<td>2.2</td>
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<tr>
<td>Energy</td>
<td>1.9</td>
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<td>0.78</td>
<td>-0.37</td>
</tr>
<tr>
<td>Services</td>
<td>3.3</td>
<td>3.0</td>
<td>0.74</td>
<td>-0.33</td>
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Table 3: Summary statistics of estimated parameters for sectorial inflation rates

<table>
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<tr>
<th></th>
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<th>CPI weight</th>
<th>Largest root &gt; 0.875</th>
<th>Largest root &gt; 0.925</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>#</td>
<td>freq</td>
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<tr>
<td>EA3</td>
<td>404</td>
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</tr>
<tr>
<td>Germany</td>
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<td>0.42</td>
<td>31</td>
<td>0.34</td>
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<tr>
<td>France</td>
<td>147</td>
<td>0.30</td>
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<td>0.38</td>
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<tr>
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<td>56</td>
<td>0.35</td>
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<tr>
<td>Processed food</td>
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<td>0.14</td>
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<tr>
<td>Unprocessed food</td>
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<tr>
<td>Non-energy ind. goods</td>
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<td>0.33</td>
<td>68</td>
<td>0.42</td>
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<tr>
<td>Energy goods</td>
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<td>8</td>
<td>0.50</td>
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<tr>
<td>Services</td>
<td>114</td>
<td>0.39</td>
<td>50</td>
<td>0.44</td>
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