Imperfect Information, Heterogeneous Demand Shocks, and Inflation Dynamics

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Using sector-level survey data for the universe of Japanese firms, we establish the positive co-movement in the firm’s expectations about aggregate and sector-specific demand shocks. We show that a simple model with imperfect information on the current aggregate and sector-specific components of demand explains the positive co-movement of expectations in the data. The model predicts that an increase in the relative volatility of sector-specific demand shocks compared to aggregate demand shocks reduces the sensitivity of inflation to changes in aggregate demand. We test and corroborate the theoretical prediction on Japanese data and find that the observed decrease in the relative volatility of sector-specific demand has played a significant role for the decline in the sensitivity of inflation to movements in aggregate demand from mid-1980s to mid-2000s.