INFLATION EXPECTATIONS – A POLICY TOOL?

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WHY INFLATION EXPECTATIONS?

Key variable for economic decisions: perceived real interest rate

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Mario Draghi (2015): "*When inflation expectations go up with zero nominal rates, real rates go down. When real rates go down, investments and the economic activity improves. That's the reasoning [of QE].*"

STANDARD MECHANISMS

- *Households consume more*: when inflation expectations rise and nominal interest rates are unchanged (ZLB), real interest rates are lower, so households should save less and spend more.

- *Firms invest more and hire more workers*: when inflation expectations rise and nominal interest rates are unchanged (ZLB), real interest rates are lower so user cost of capital and labor are lower, inducing firms to raise their capital and employment.

- *Firms raise their prices*: with sticky prices, inflation lowers firms' relative price over time, so expectation of higher inflation induces them to raise prices more than they would otherwise.

- *Workers raise their wage demands*: with sticky wages, inflation lowers the real wage over time, so expectations of higher inflation induce workers to raise wage demands, which should raise prices further.

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- What are the challenges in using inflation expectations as a policy tool?
  - Measurement of inflation expectations (especially firms)
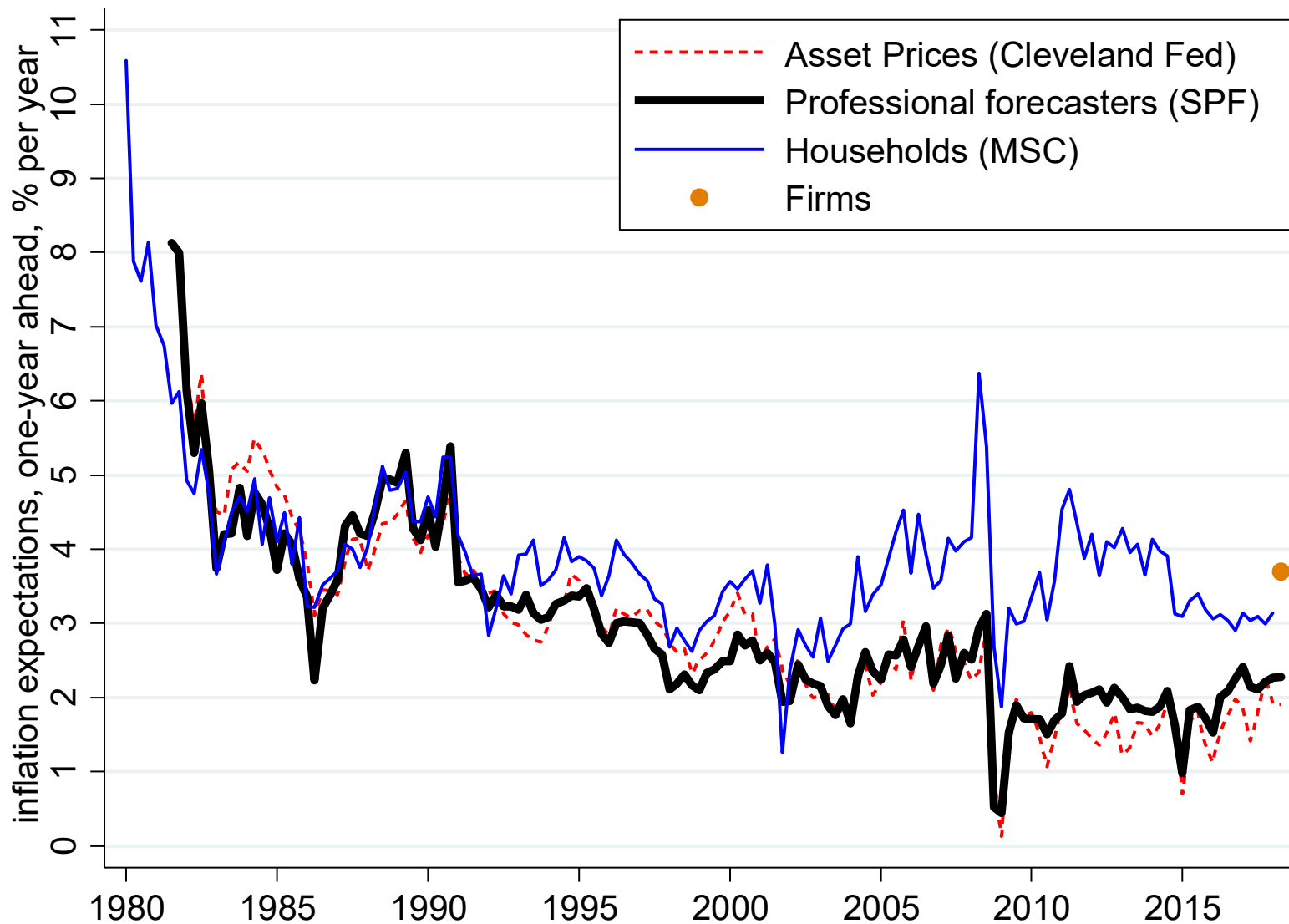 - Breaking through the veil of inattention

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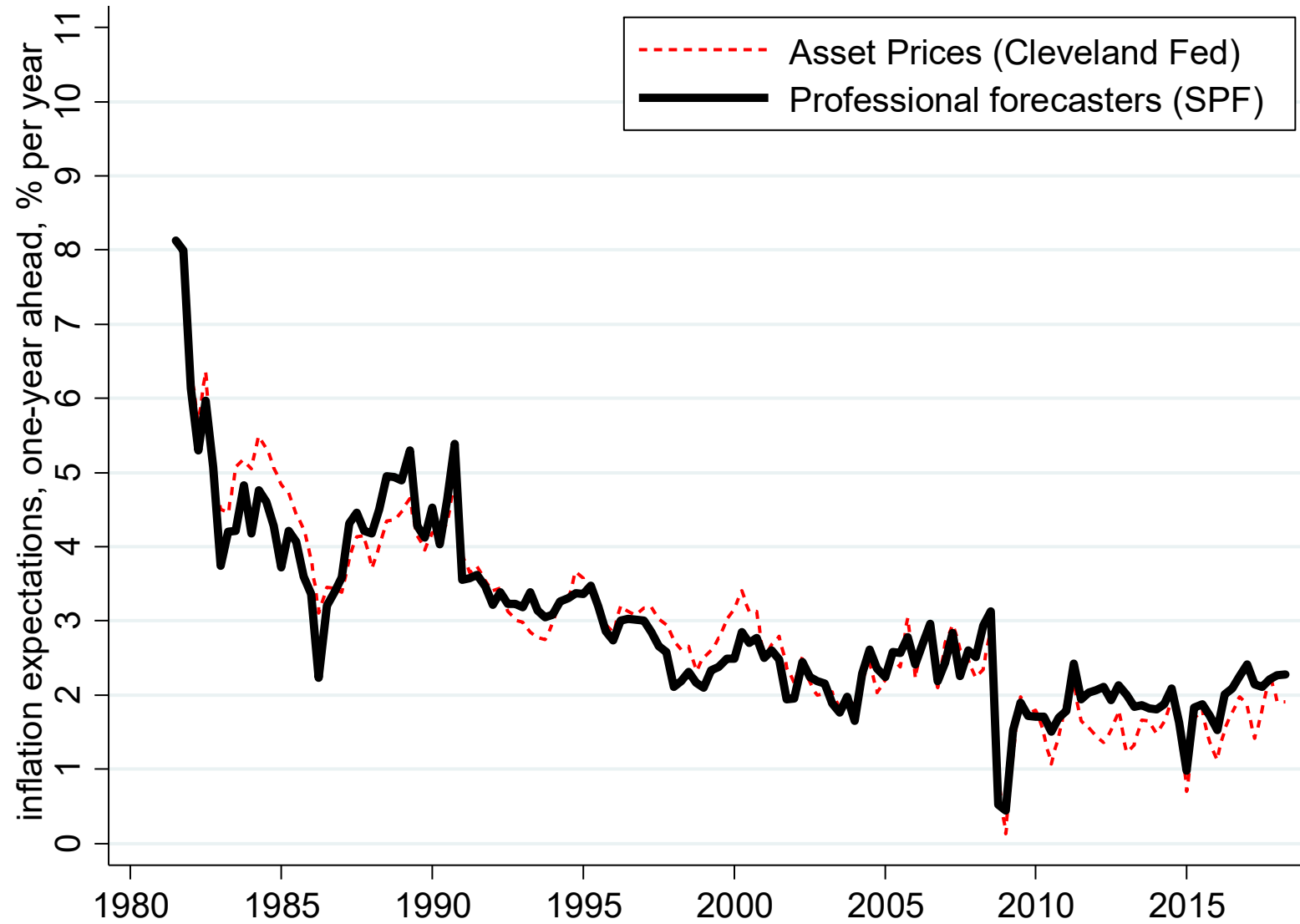
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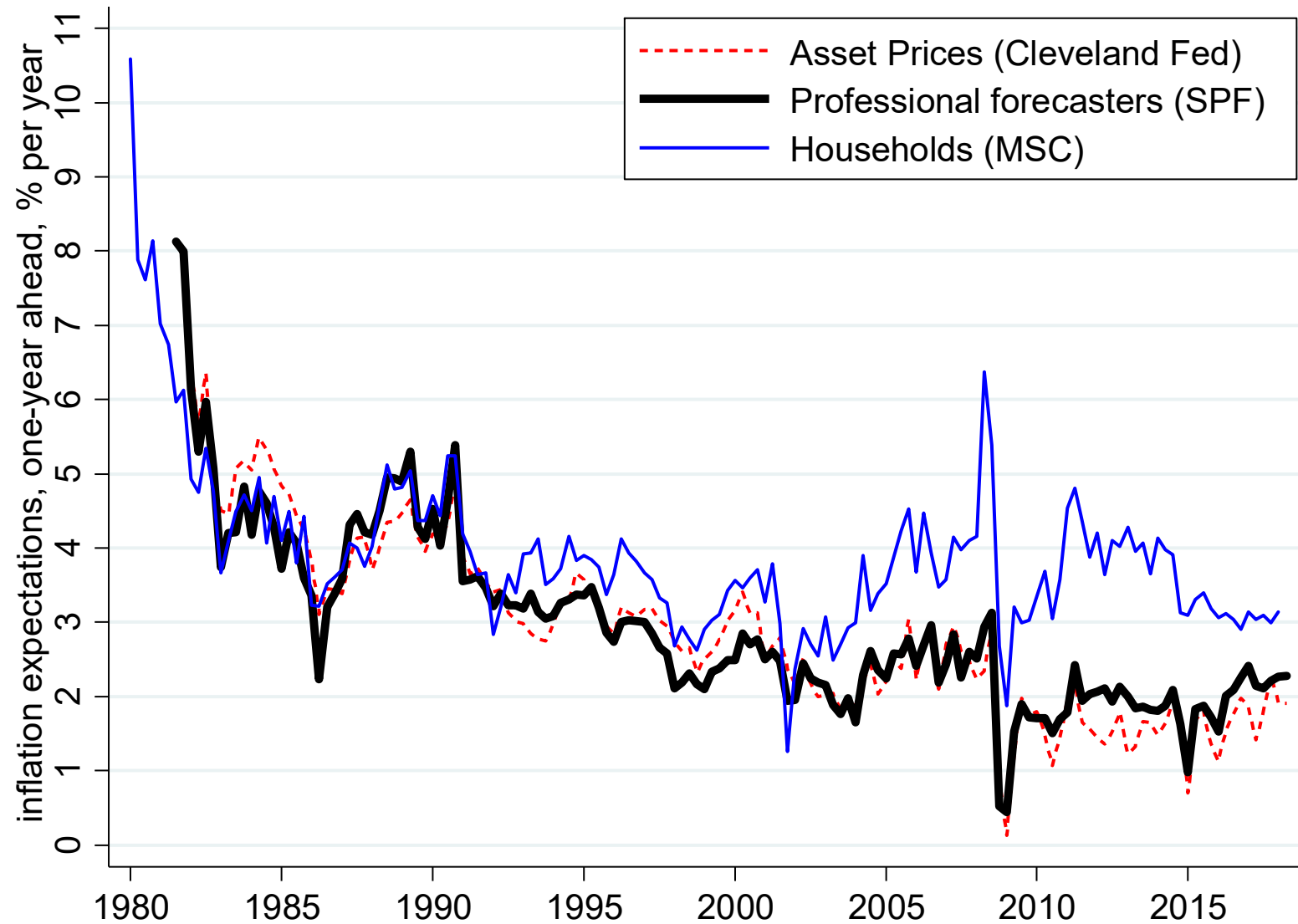
WHOSE INFLATION EXPECTATIONS?

Expectations are not interchangeable across agents

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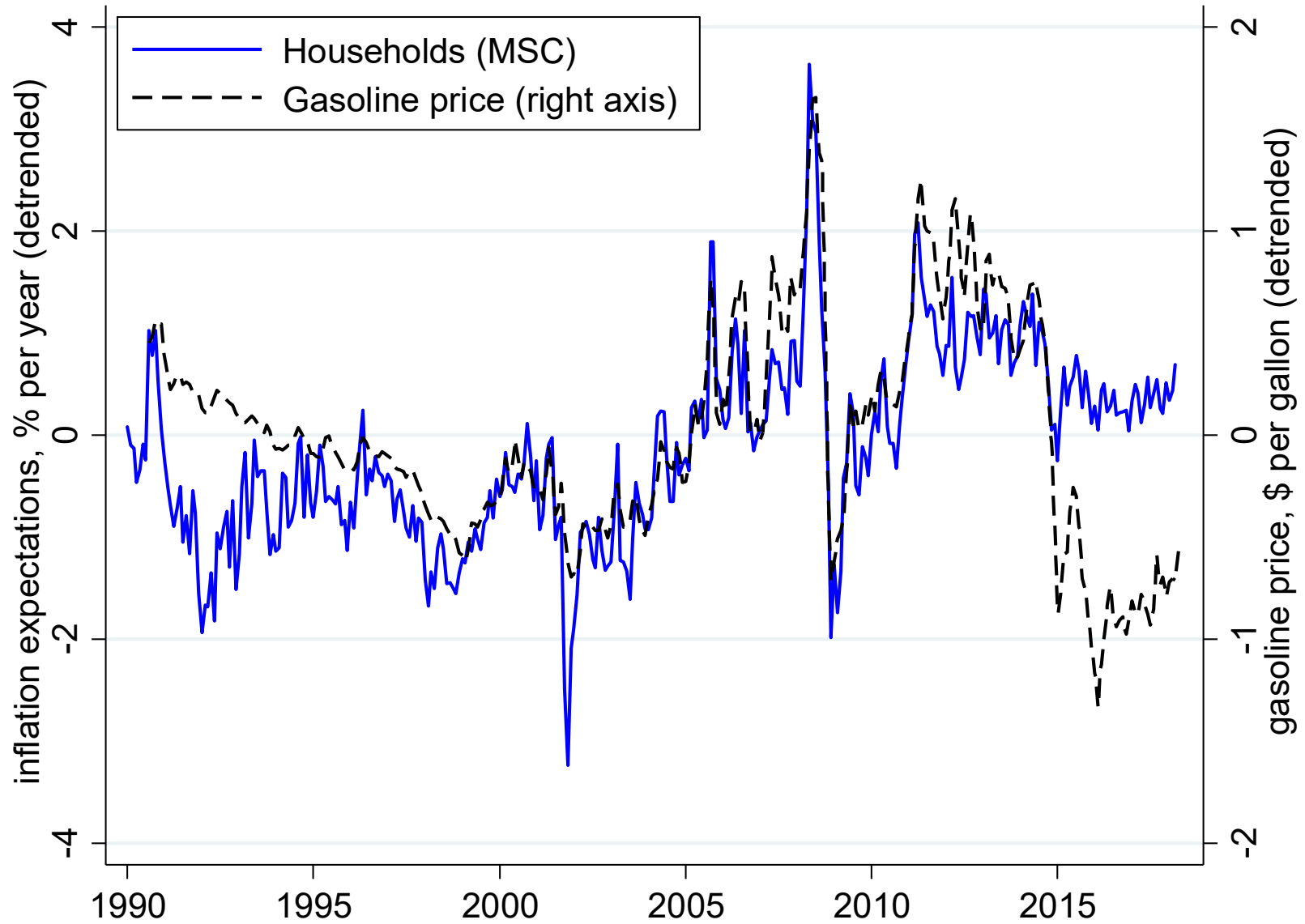
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- Policy

WHAT FORCES INFLUENCE INFLATION EXPECTATIONS?

Predictors of inflation expectations

- Perceptions/experience of inflation (strong)

- Shopping (strong)

- Media (intermediate)

- Policy (weak)

CAN WE MANIPULATE INFLATION EXPECTATIONS?

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Elicit expectations (priors)	→	Informational treatment (inflation target)	→	Elicit expectations (posteriors)
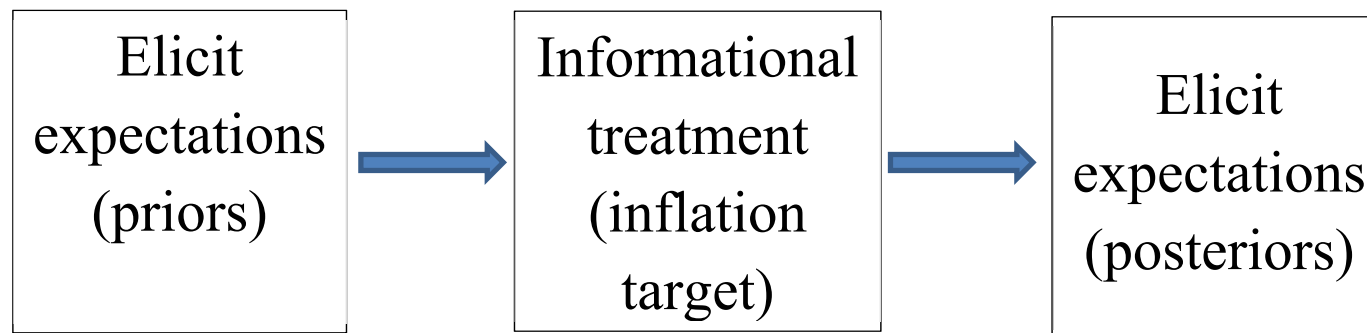
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- Upshot:

    - Households and firms appear to be Bayesian learners

        - Strength of priors
        - Strength of signals } Posterior beliefs

    - Information effects are short-lived (less than 6 months)

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Coibion, Gorodnichenko and Weber (2018)

Dep. var.: Revision of one-year-ahead inflation forecasts of U.S. consumers

Treatment groups (coefficients are relative to control)	
Past inflation	-1.954***
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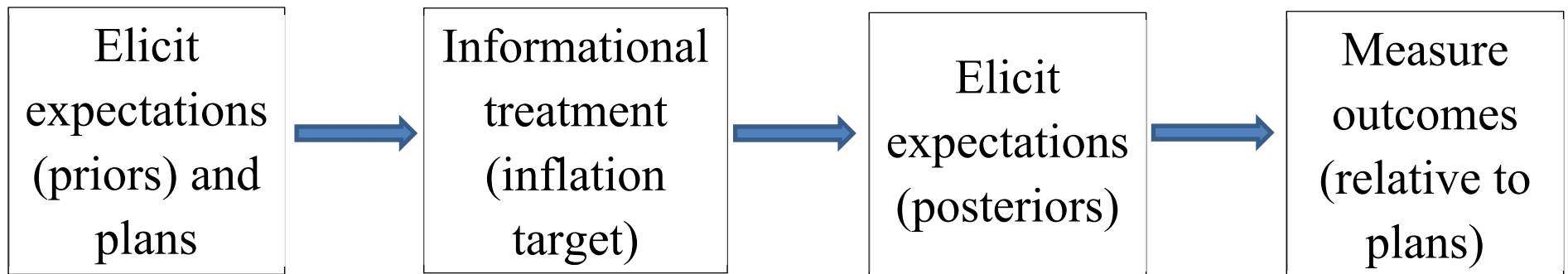
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Elicit expectations (priors) and plans	→	Informational treatment (inflation target)	→	Elicit expectations (posteriors)	→	Measure outcomes (relative to plans)

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  - … but need more research on mechanisms and general equilibrium effects

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- Surveys of firms' inflation expectations are expensive but they are most useful!

- Good surveys: Ukraine and Uruguay

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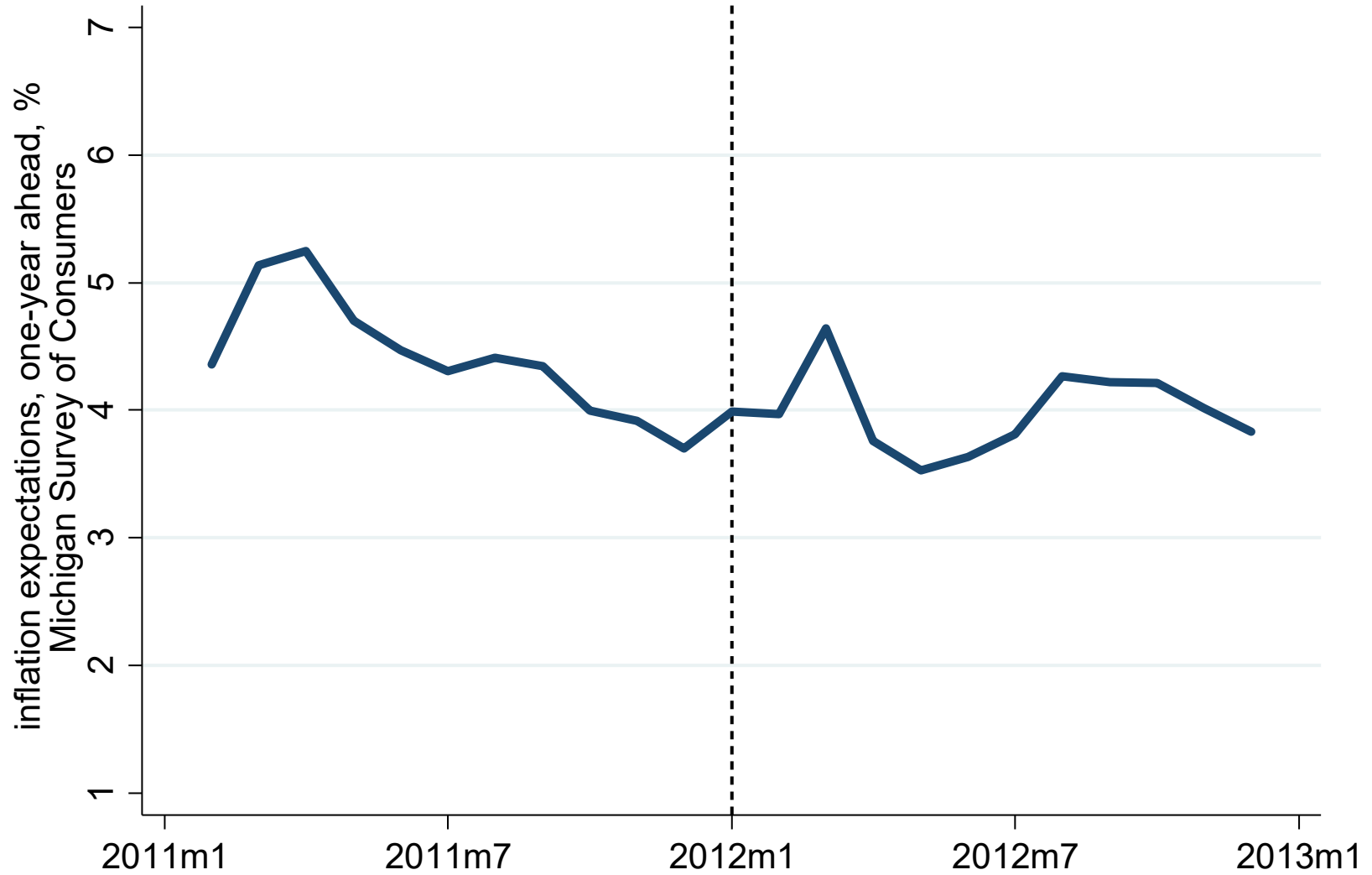- Breaking through the veil of inattention

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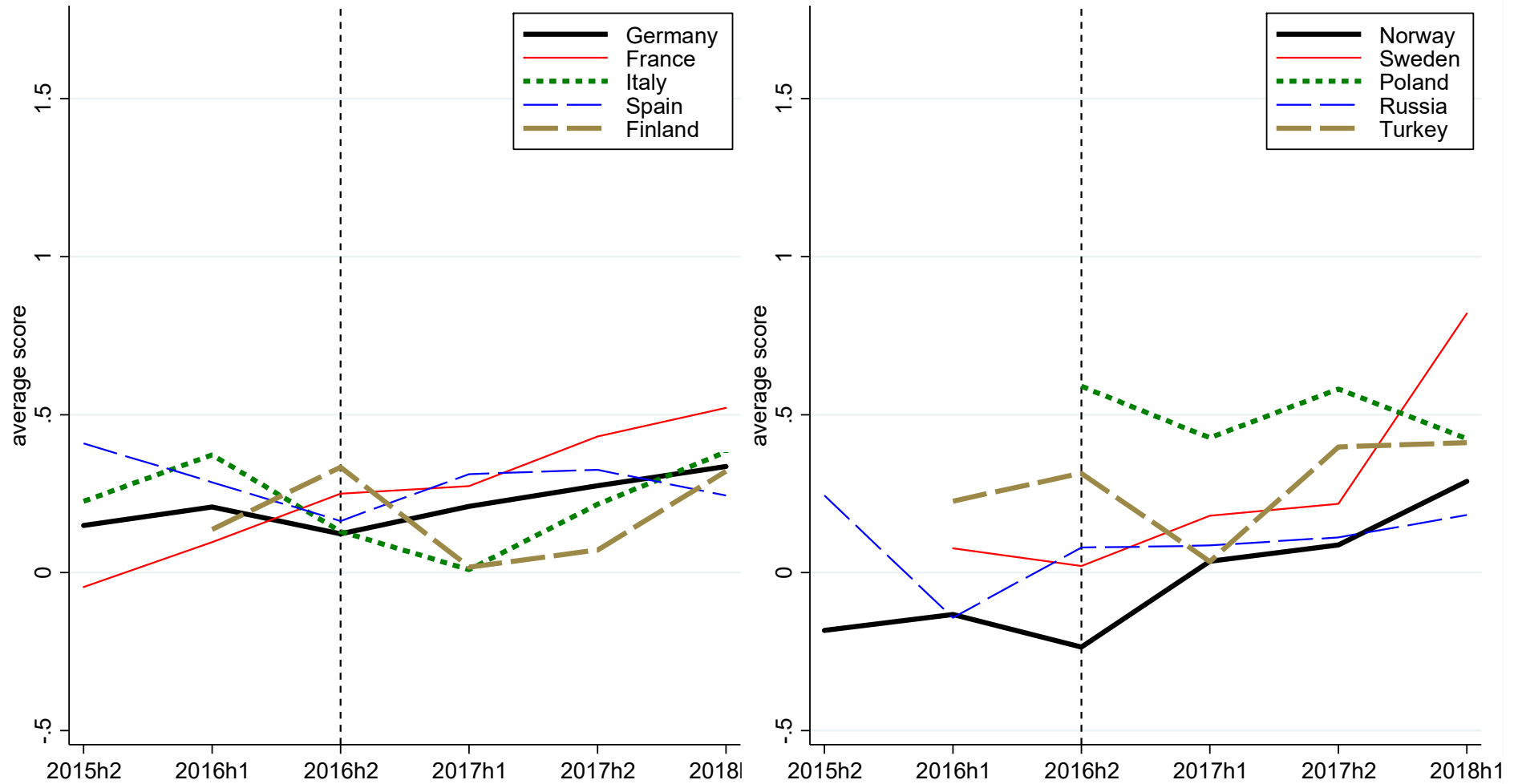## Perceived inflation target in the U.S.
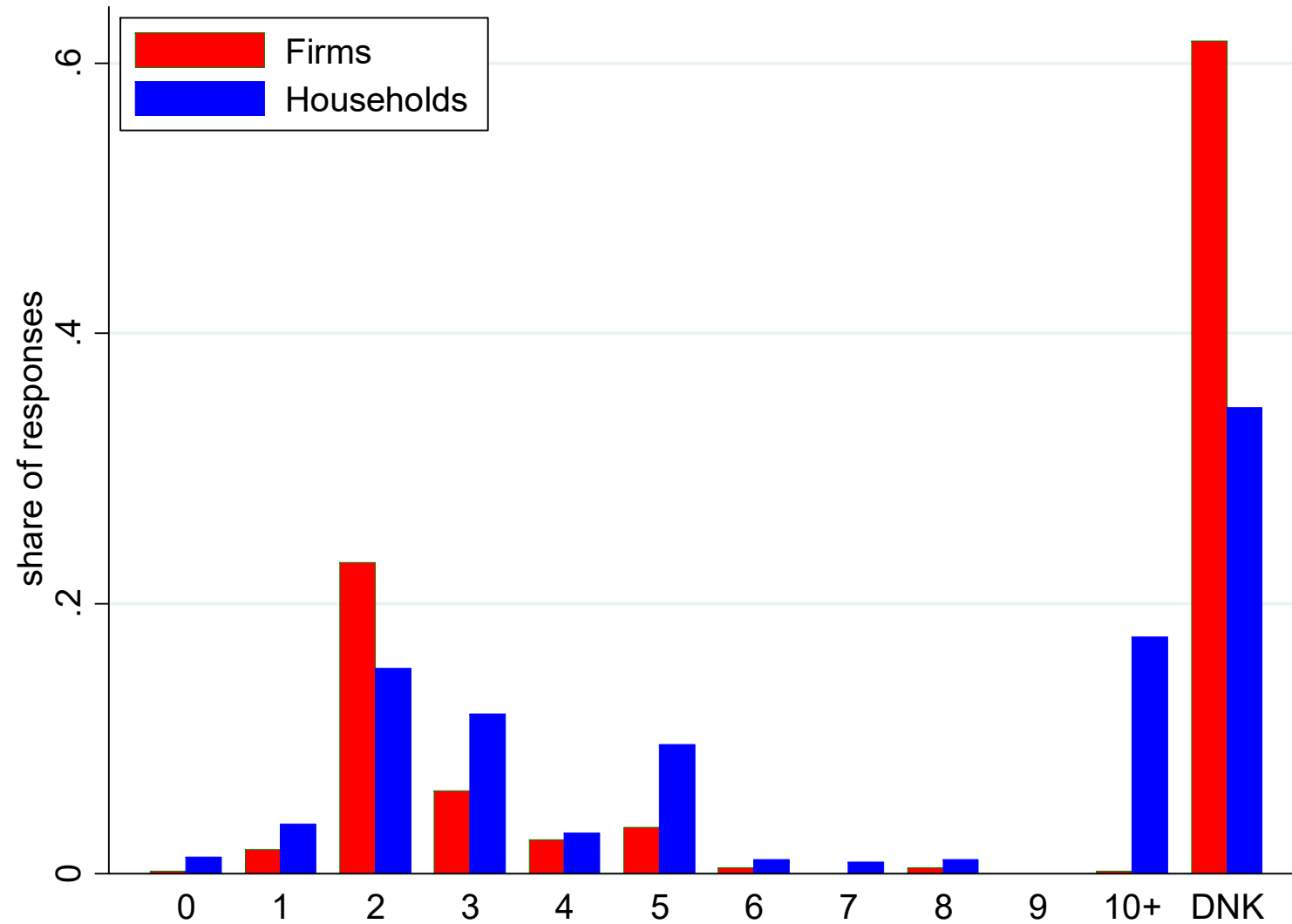
BREAKING THROUGH THE VEIL OF INATTENTION

January 2012: Fed annouces 2% IT

BREAKING THROUGH THE VEIL OF INATTENTION

Employment outlook; ECB announces QE tapering

Source: Deloitte Survey of Chief Financial Officers

BREAKING THROUGH THE VEIL OF INATTENTION

- Communication can work
  - Public campaigns for other policies (healthcare, fiscal) work
  - Information treatment moves expectations

BREAKING THROUGH THE VEIL OF INATTENTION

- Communication can work

- Simple messages are better
  - simple messages/facts are as effective as complex policy statements

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Treatment groups (coefficients are relative to control)	
FOMC inflation forecast	-2.004***
	(0.384)
FOMC statement	-2.272***
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BREAKING THROUGH THE VEIL OF INATTENTION

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- Repeat the message
  - One-time announcements do not have long-lasting effects on expectations of firms and households (information "depreciates" within months)
  - Need information campaigns

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    - But one can have different messages for "North" to slow down and for "South" to accelerate.

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- Target the message to the scenario
  - For example, if inflation is too low, emphasize the inflation target (rather than actual inflation) to raise inflation expectations

CONCLUDING REMARKS

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  - Directly influence prices

  - Target specific areas, industries, or types of consumers

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- Are we ready to use it? Not yet…

  - More research to study how inflation expectations translate into actions

  - More high-quality surveys of firms' inflation expectations

  - New communication strategies to reach consumers and firms