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Independent Thinking

Are inflation expectations slipping their anchor?

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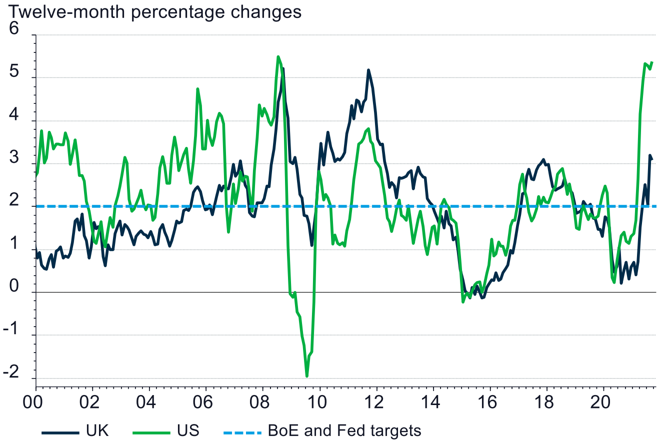
Richard Blows

Western advanced economies are dealing with a period of above-target inflation which central banks expect to be transitory. However, for a while Fathom has been pointing out that households have built up vast savings during the pandemic, which if unleashed would push up aggregate demand and create further upward pressure on inflation. Even if those savings remain unspent, there are still clear upside risks to the inflation outlook. One of those risks is the de-anchoring of inflation expectations.

UK and US consumer prices

Twelve-month percentage changes



Source: Refinitiv Datastream / Fathom Consulting

The majority of measures of household inflation expectations in the US and UK are elevated, with the two series in the chart below being over two standard deviations above their respective averages. Most surveys of expectations among businesses and financial markets have also risen since the start of the year. If households take their higher cost of living expectations into wage negotiations, this is likely to result in rising costs for firms and potentially higher prices for consumers. According to the Employment Cost Index, US firms’ costs of employment rose by around 4% in the year to 2021 Q3.

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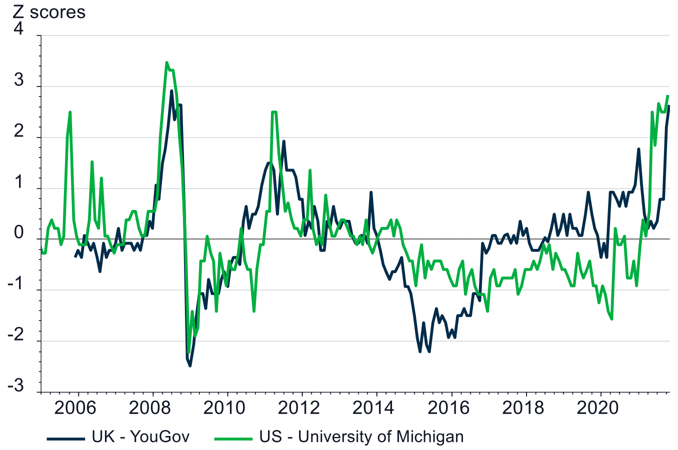
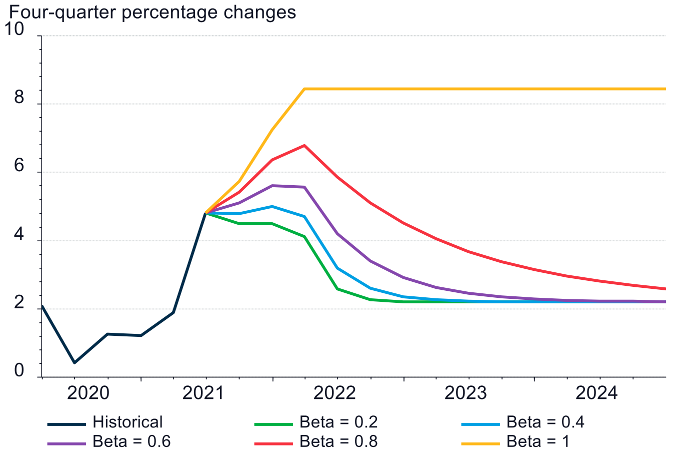
Household consumer price one-year expectations



Source: Refinitiv Datastream / Fathom Consulting

We can also formulate a transition mechanism of how expectations influence outturns of inflation in a model. A New Keynesian Phillips curve, simply stated, equals expected inflation plus surprise inflation. Surprise inflation comes from shocks to things such as oil prices or the exchange rate, as well as unanticipated overshoots in aggregate demand. Expected inflation depends on the beliefs of firms and consumers. If they think inflation is firmly anchored (whether because of highly credible central banks or for other reasons) then inflation will tend to revert quickly to its anchor after any surprises have washed out. But if they do not think that, then expected inflation will be influenced partly by the perceived target and partly by last period's inflation outturn. The degree to which expectations are determined by previous inflation, a level of inflation persistence denoted as 'beta' in the following chart, plays an important role in determining how long spikes in actual inflation can last. If that 'beta' is 1, inflation expectations are de-anchored and the future path for inflation is anybody's guess — it will depend on the pattern of future inflation surprises. But inflation returns to target if 'beta' is less than 1, and the closer 'beta' is to 0, the faster it reaches that stable level.

Simple US inflation projections

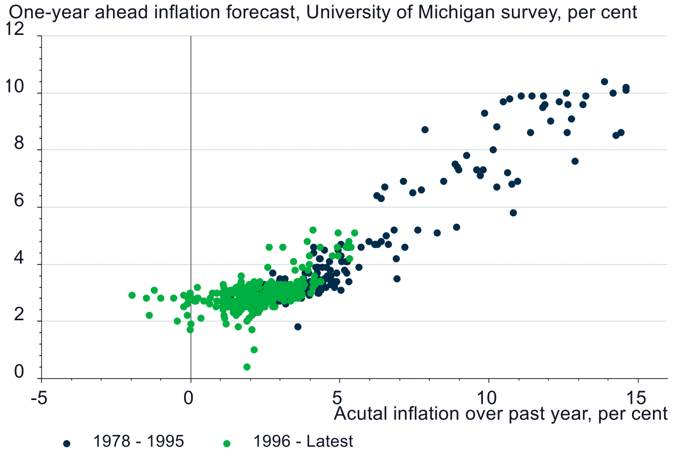


Source: Refinitiv Datastream / Fathom Consulting

The question is, therefore, to what extent do household expectations mirror actual inflation? Measured inflation persistence, the 'beta', had fallen to around zero around the time of the GFC, though has risen slightly since. And expectations appear to broadly track recent inflation, using the US University of Michigan survey measure as an example. The scatter chart below indicates two key aspects to US inflation expectations. Firstly, household expectations tend to remain unphased by inflation between -1% and 3%, broadly expecting year-ahead inflation to return to the Fed's 2% target. However, if inflation rises above 5%, household expectations rise too. While most datapoints since 1996 on the chart are around the flatter segment of the trend, where households tolerate modest outturns of inflation, we cannot reject the possibility that expectations become increasingly de-anchored as inflation rises. We are potentially on the cusp of finding out whether this upward trend holds.

US household inflation expectations

One-year ahead inflation forecast, University of Michigan survey, per cent



Source: Refinitiv Datastream / Fathom Consulting

If this period of above-target inflation keeps expectations elevated, there is the risk that inflation may persist longer than central banks currently expect. In that scenario, central banks would face a dilemma as to whether or not to react by tightening policy. But if expectations fall back, above-target inflation will probably prove to be transitory.

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