

NEW EVIDENCE ON THE SURPRISE SURGE IN INFLATION

Four Mistakes in the Use of Measures of Expected Inflation[†]

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What is expected inflation? The right answer to this question is that there are many expected inflations, by different economic agents, with different information and beliefs. Yet, when people discuss which weights to put in each measure, it is common to argue that the weight should rise with some characteristic, observe that one series is much better in this dimension, and appeal to simplicity to set its weight to 100 percent. Superficially, this seems sensible, or even optimal, given limited attention. But using this argument to focus on one “right” measure of inflation typically leads to the wrong answer to the question at hand.

This paper works through four arguments of this type that are increasingly heard in response to the remarkable progress in the past two decades in measuring expected inflation, using both surveys of expectations and models of prices in financial markets (Weber et al. 2022). This work was partly validated in 2021–2022, as these measures provided valuable early signals that an inflation surge was on the way (Reis 2023), so it is important to correct these mistakes early. This way, measures of expected inflation measures can continue to reliably guide monetary policy.

I. Mistake 1: Focus on Firms’ Expectations Because Firms Set Prices

A common argument states that firms choose prices in the economy. It is their expectations

that matter for how prices are set and, therefore, for what inflation will be. In a modern Phillips curve equation, it is firms’ expectations that appear on the right-hand side of the equation as a key driver of inflation. Therefore, they should be the sole focus of research.

Because, until recently, the only surveys of inflation that spanned a few decades and included a few hundred respondents were those of households, like the Michigan survey in the United States, this argument was used to dismiss them as irrelevant, since households do not choose prices and their expectations do not appear in pricing equations. Looking forward, since the new surveys of firms’ expectations find that managers share with households some of their biases and inefficiencies when making forecasts (Candia, Coibion, and Gorodnichenko 2023), a new version of this argument might dismiss surveys altogether.

In many models of nominal rigidities, there is a partial equilibrium relation in the goods market, derived from monopolistic firms maximizing real profits, given demand, and subject to nominal rigidities:

$$(1) \quad \pi = \pi^f + rmc,$$

where π is inflation, rmc are expected real marginal costs, and π^f are firms’ expectations of inflation, all as log-linear deviations from a steady state. Intuitively, firms want to raise their prices relative to the prices that they expect other firms are setting when the cost of producing an extra good is higher. Keeping fixed expected real marginal costs, then yes, firms’s expectations drive inflation.

However, rmc is not fixed. In fact, say the firm takes as given the nominal prices of the inputs it uses. Then, rmc will equal those input prices minus expected inflation by the firm. Therefore, π^f cancels out from the equation, and the firm’s

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[†]Go to <https://doi.org/10.1257/pandp.20231033> to visit the article page for additional materials and author disclosure statement.

expectations turn out to be irrelevant. Intuitively, if the firm expects higher inflation, it expects that the real cost of hiring inputs is lower, so it can lower its price. This exactly offsets the initial desire to raise prices. Firms care about real profits, but optimal behavior dictates setting a markup over nominal marginal costs, so if these are observed, firm expectations are irrelevant.

Moreover, the input prices depend on other agents' expectations. Assume that firms use capital and labor, with α being the capital share in production, so that real marginal costs are

$$(2) \quad rmc = \alpha(i^l - \pi^f) + (1 - \alpha)(w - \pi),$$

where the firm pays a lending rate i^l to rent capital and pays labor a nominal wage w .

Financial institutions make loans at an interest rate that reflects their expectations. The marginal cost of funds to financial institutions depends on the interbank market rate targeted by the central bank i , and with financial frictions that require using some of the bank's net worth, it also depends on the required return on that net worth. Taking that real return to be constant for simplicity, then

$$(3) \quad i^l = i + \gamma(\pi^m - i),$$

with the parameter $\gamma > 0$ capturing the extent of the financial frictions.

For a given real return on net worth, higher financial markets' expectations of inflation π^m raise the interest rate that is charged to the firm. If markets start expecting higher inflation, they will raise the interest rates they charge on loans, which raises the financial costs of firms, leading them to raise prices. This is a general equilibrium effect from combining the goods market with the loan market.

In turn, the more labor is used and output produced, the more workers must be paid for their rising disutility of working, with an elasticity of θ . If unions and workers have some bargaining power and set wages subject to nominal rigidities, they also have to form some expectations of inflation. In equations, if the workers/unions' expectations of inflation are π^w , then

$$(4) \quad w = \pi^w + \theta y.$$

Now, if workers expect higher inflation, they ask for higher nominal wages. *Ceteris paribus*, this

raises the real marginal costs of firms, and they respond by raising their prices, which causes inflation. Again, it is general equilibrium, now working from the labor market to the goods market, that makes higher inflation expectations elsewhere in the economy drive the increase.

In practice, these two equilibrium channels are important. The expectations of financial markets quickly affect the financial conditions facing all agents, so they have a fast and powerful impact on inflation that monetary policy relies on. In turn, when expectations of wages move away from the central bank's target, they are hard to reanchor and can start wage-price spirals. Arguably, this is the major concern about inflation at the start of 2023.

To conclude, superficially it is firms that set prices, and they respond to their expectations. But they respond as well to the costs they face. Those costs depend on the expectations of inflation of workers and financial markets. In economic equilibrium, choices depend on other's actions, and a priori any of the beliefs could be more or less important for the decisions that are made.

II. Mistake 2: Focus on the Big Players as Their Choices Drive Aggregates

Large firms, unions, or banks have a large weight in the aggregates of production, labor, and credit that are behind inflation outcomes. This is especially so in lending, as private credit in most countries is concentrated on a handful of banks. Another common argument is to put a larger weight on surveys of large firms, especially in the financial sector, because they matter more for quantities. In practice, this leads to focus on the Blue Chip survey in the United States.

An immediate objection to this argument is that market prices reflect the actions of the marginal agent, not the sum over agents. The lending rate i^l is set at the margin where demand and supply for credit meet. The bank that is just indifferent between lending or not may very well be small. In practice, measures of expected inflation from market prices differ systematically from the survey measures of bankers or of dealers in those markets.

Furthermore, consider what determines expected inflation. There are many well-developed models in the literature of how people form their

beliefs. At one extreme, if they have rational expectations and perfect foresight, expected inflation equals actual inflation. At the other extreme, expectations are exogenous animal spirits. A reduced-form way to capture an in-between is to write

$$(5) \quad \pi^f = (1 - \lambda^f)\pi + \lambda^f \hat{\pi}^f$$

for firms where $\hat{\pi}^f$ are the exogenous spirits and λ^f is a parameter between zero and one. The same applies to workers and financial markets, with λ^w and λ^m , respectively.

The closer the λ 's are to zero, the less useful it is to measure expectations through expensive surveys or sophisticated techniques. The measures are just mirrors of what is going on in reality, and researchers are better off measuring outcomes and fundamental shocks. Plausibly, large firms with chief economists will have a small λ^f . Therefore, their $\hat{\pi}^f$ spirits will not be so important on aggregate outcomes. The players may be large, and their choices drive outcomes, but the *autonomous* changes in their expectations that could bring a shock to inflation are small and drive little of the variation that we see in the data.

This can be seen mathematically by combining all the equations presented so far to get the actual Phillips curve for the economy, the structural relation that links real activity to inflation as a result of general equilibrium across markets:

$$(6) \quad \pi = \pi^e + \kappa y + \xi(i - \pi).$$

The coefficients κ and ξ depend on all the other parameters (see the online Appendix). More interestingly, expected inflation π^e is a weighted average of the expectations of firms, markets, and workers:

$$(7) \quad \pi^e = \frac{\alpha\gamma\lambda^m\hat{\pi}^m + (1 - \alpha)(\lambda^f\hat{\pi}^f + \lambda^w\hat{\pi}^w)}{\alpha(1 - \gamma) + \alpha\gamma\lambda^m + (1 - \alpha)(\lambda^w + \lambda^f)}.$$

Each agents' expectation has a larger weight on π^e if their λ 's are larger.

Again, in practice this is not negligible. In both the euro area and the United States, surveys of chief economists in large banks are usually quite close to the central bank's internal forecast. When inflation is close to target, they do not

add much information. When the central bank's model got it wrong in US history—the rise of inflation in the late 1960s, its fall in the early 1980s, and the new rise in 2021–2022—the professional forecasters were just as wrong. Instead, it was household expectations that seemed to provide an autonomous impetus for the dynamics of inflation, and it was their survey measures that contained useful signals (Reis 2021).

III. Mistake 3: Focus on the Measures with Smaller Forecast Errors

Some people do not care about what drives inflation and are only interested in forecasting it. So, they ignore the economic arguments in the previous sections. Rather, they prefer to compare the forecasting performance of different measures of expected inflation and focus on the one that does best according to a criteria like mean squared forecast error. The answer in many countries and in many decades is a survey of professional forecasters. A more brusque version of this “inflation desk” view discards household expectations because, since they are biased and have persistent forecast errors, their forecast errors are large.

Even from a statistical perspective, this argument is weak, for at least four reasons. First, if the goal is forecasting performance alone, the best measure in most advanced economies is the forecast published by the central bank. Since this forecast often includes data from other measures of expected inflation, not much is learned from this forecasting horse race.

Second, as a general principle of forecasting, a combination of different measures usually does better at forecasting than focusing on a single measure.

Third, inflation in most countries has historically gone through different regimes. Surveys of professional forecasts do well within regimes, but not during regime changes. A careful evaluation of forecast performance is tricky because it must consider long-enough samples with some changes in regime.

Fourth, to focus on forecast performance is to confuse concept with measurement. Surveys might be poor, but they can improve through better design. Expectations may be biased, but theories of those biases can de-bias them. A simple direct measure of expected inflation from a survey, like a mean or a median, may seem far

off from reality, but a careful statistical model would combine the survey data moments and link them to the relevant concept.

Turning back to economics, models are mostly used, not for unconditional forecasting, but rather for forecasting what will happen conditional on a shock. To close the model developed so far, start by adding an equation for aggregate demand:

$$(8) \quad y = -\omega(i^l - \pi) + \sigma(\pi^c - \pi).$$

The first term captures the fall in current spending (or rise in savings) when returns are higher. For a fixed interest rate, the second term captures the force that higher consumers' expected inflation π^c leads them to want to spend more today before prices rise.

Close the model with a standard rule for monetary policy: $i = \phi\pi + \phi_y y + \varepsilon$, with policy parameters ϕ and $\phi_y > 0$ and policy shock ε . Focusing on the response of inflation to a shock to consumer expectations (the same could be done with respect to the other agents's expectations) gives

$$(9) \quad \frac{\partial \pi}{\partial \pi^c} = \frac{\sigma}{\rho + \sigma},$$

where ρ is a positive composite parameter (see the online Appendix). The message is clear: shocks to expectations of consumers matter more for outcomes if σ is higher.

In the model, this parameter determines the transmission from expectations to actions. A similar conclusion applies to the other expectation shocks with respect to the parameters that capture how much the actions of their agents respond to their expectations. In general, this transmission is the key parameter to focus and decide how much weight to put on a measure of expected inflation. When it comes to professional forecasters, often they are not the key decision-makers in the firms they work for, so their expectations are removed from choices on investment or pricing. They may well turn out to be the least relevant for inflation outcomes, even if they are statistically accurate.

IV. Mistake 4: Focus on the Expectations That Policy Can Move

When policymakers change a tool of monetary policy or give a speech, financial market

expectations of inflation move within minutes. Household expectations, instead, rarely move at all with policies or communications. In fact, many people, including those running firms, usually cannot state what the goal or mandate of the central bank is or who its head currently is. As a result, asset prices and interest rates are the main transmission channel of monetary policy to the economy. It is then natural for policymakers to focus on financial market expectations and to devote their energy to managing those (Haldane, Macaulay, and McMahan 2021).

Of course, financial market prices often overreact to policies, as well as to noise unrelated to fundamentals. Moreover, market prices reflect both expected inflation and risk premia. Removing the latter is hard and imperfect. A policymaker that responds to every movement in market expectations of inflation may end up propagating shocks to risk attitudes.

In the simple model of this paper, the responsiveness of market expectations π^m to a policy shock ε is captured by λ^m . All else equal, algebra shows that a low λ^m raises $\partial\pi/\partial\varepsilon$. But at the same time, it lowers $\partial y/\partial\varepsilon$. That is, and perhaps unsurprisingly, more responsive expectations make the Phillips curve steeper. Conversely, very sluggish household expectations, captured by a high λ^w or λ^c , make the curve flatter. This changes the trade-offs that policymakers face in stabilizing both inflation and output. The sluggishness of household expectations is not a reason to ignore them, but rather it is what gives the central bank power to affect output. Which measure of expected inflation is more important depends on which macroeconomic variable one focuses on.

Treating the λ 's as fixed parameters is a useful approximation when inflation is stable. But across inflation regimes, economists have long known that the responsiveness of expectations to policy is endogenous to policy and the steepness of the Phillips curve changes. With multiple λ 's across agents, how much each changes across regimes becomes very important. If financial markets were already very responsive to news over two decades of low and stable inflation, then there is little room for change when inflation becomes high and volatile, or to react to policy. Instead, since households were so unresponsive when inflation was low and stable, there is more room for them to start paying more attention. Therefore, because λ^c and λ^w change

by more across regimes than λ^m does, this makes household expectations more important than market ones.

The experience from countries that go through prolonged periods of high and volatile inflation shows that this effect is large. A major task of a central bank in an inflation disaster is to reanchor expectations. This can in part be understood as trying to convince agents to become inattentive again. Households and workers are often those that need more convincing, as opposed to markets, making the latter less important when it comes to measuring expected inflation.

V. Conclusion

The expectations of firms, large banks, professionals, and financial markets are all very important to measure the state of economic expectations. But none of them individually has a strong claim to being more useful than the expectations of households in order to understand inflation outcomes or guide monetary policy. While household expectations are the ones that are more often dismissed, it would be just as mistaken to conclude from this article that one should only focus on household expectations and down-weight the expectations of other agents.

The simple, perhaps obvious, but often forgotten, conclusion is that one needs models to extract as much signal as possible from different measures and to combine them in the better guide. The arguments in this paper noted that those models will take into account which

expectations affect output and input prices, which expectations give a stronger autonomous push to inflation, which expectations are more linked to actions of their agents, and which expectations can be sluggish or fast depending on policy and are therefore prone to being anchored or not.

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