Economic Bulletin

Does the Recent Decline in Household Longer-Term Inflation Expectations Signal a Loss of Confidence in the FOMC?

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Over the past five years, the number of households with high inflation expectations has fallen, while the number of households with low inflation expectations has increased. This shift in composition helps to explain the recent decline in household longer-term inflation expectations. It does not suggest a loss of confidence in the FOMC's ability to achieve its price stability mandate, however, as households with low inflation expectations give policymakers higher marks than do households with high inflation expectations.

Household expectations for longer-term inflation, as measured by the University of Michigan Survey, have declined over the last few years. Chart 1 shows the median household expectation for inflation over the next five to 10 years.[1] The decline in household expectations originally coincided with a large drop in oil prices in 2014. However, oil prices have since stabilized, while inflation expectations have remained near historical lows. As a result, some policymakers have flagged deteriorating inflation expectations as a risk to the inflation outlook over the next few years.[2]

Chart 1: Median longer-term inflation expectations

To understand the risk that lower household inflation expectations pose to the inflation outlook, it is helpful to understand why consumer inflation expectations have declined. Using the micro-level data used to construct the Survey median in Chart 1, we can examine individual household forecasts for longer-term inflation over time. The bars in Chart 2 show the percent of household respondents who projected certain longer-term inflation outcomes over a given two-year period.

Chart 2: Household longer-term inflation expectations over time

Over the last several years, the number of households with high inflation expectations has fallen, while the number of households with low inflation expectations has increased. In 2012–13, almost 30 percent of households surveyed expected inflation over the next five to 10 years to be at or above 5 percent. However, that number fell to roughly 20 percent in 2016–17. In addition, the number of households with lower inflation expectations rose by roughly the same amount as the drop in households with higher inflation forecasts. Almost one-quarter of households surveyed over the last two years expect longer-term inflation of about 1 percent.

Given the FOMC's longer-run 2 percent inflation objective, monetary policy makers may find this decline in inflation expectations troubling. Over the last five years, core PCE inflation has remained consistently below 2 percent. If this recent weakness in realized inflation has led some households to mark down their inflation expectations, it could signal lost confidence in the FOMC's ability to meet its price stability mandate.

To explore this possibility, we match respondents' expectations about longer-term inflation with their views about how policymakers have handled the economy. Specifically, we use responses to the question, "as to the economic policy of the government—meaning steps taken to fight inflation and unemployment—would you say the government is doing a good job, only fair, or a poor job?" to ascertain how households perceive recent inflation outcomes. If households with low inflation expectations perceive recent inflation outcomes as inconsistent with the Committee's longer-run inflation objective, then we assume that these households would give policymakers low marks on their handling of the economy. Conversely, if households believe the recent inflation dynamics are consistent with the Committee's objective, then we assume they would give policymakers high marks.

We find that households with lower inflation expectations tend to think the government is doing a better job managing unemployment and inflation than households with high inflation expectations. Chart 3 shows the percent of households that believe the government is doing a "good job" handling inflation and unemployment both across time and sorted by their longer-term inflation expectations.

Chart 3: Household respondents reporting "good" government policy by longer-term inflation expectation

The number of households that believe the government is doing a "good job" has risen over the last several years, likely due to improvements in the labor market. Moreover, households with inflation expectations of 1 percent are more likely to approve of policymakers' handling of the economy than those with inflation expectations significantly above 2 percent. Thus, policymakers may be less concerned with the recent decline in the median household expectation for longer-run inflation, since households with low inflation expectations have not expressed greater dissatisfaction with their handling of the economy.

Endnotes

[1] Specifically, the Survey asks, "by about what percent per year do you expect prices to go up or down, on average, during the next 5 to 10 years?"

[2] For example, Federal Reserve Governor Brainard raised this concern in a recent speech.

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Brent Bundick is a Senior Research and Policy Advisor in the Economic Research Department of the Federal Reserve Bank of Kansas City. He rejoined the Department in 2014 after completing his Ph.D in Economics from Boston College. Prior to graduate school, Brent worked in the Department as a Research Associate and Assistant Economist. He also holds a M.S. in Mathematics and Statistics from the University of Missouri – Kansas City and a B.A. in Economics and Mathematics from the College of William and Mary. Brent's research interests are macroeconomics, monetary policy, and computational economics.

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Andrew Lee Smith is a Senior Vice President and Economist at the Federal Reserve Bank of Kansas City. In this role, Lee has oversight of macroeconomic research and serves as an advisor on monetary policy matters.Lee's research has focused on the effects of expanding and unwinding the Federal Reserve's balance sheet, the impact of forward guidance on financial markets and the economy, and, more generally, how central bank communication can influence expectations and economic conditions.Prior to joining the Bank in 2014, Lee received a Ph.D. in economics from the University of Kansas. He also holds a B.A. in economics and mathematics from Drury University in Springfield, Missouri.

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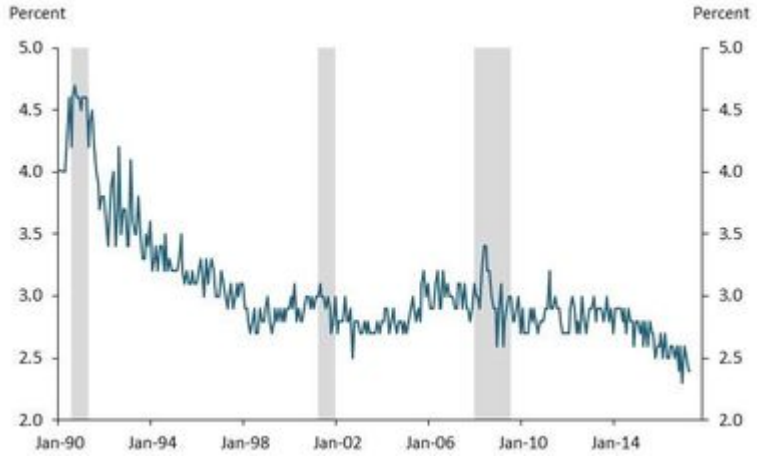
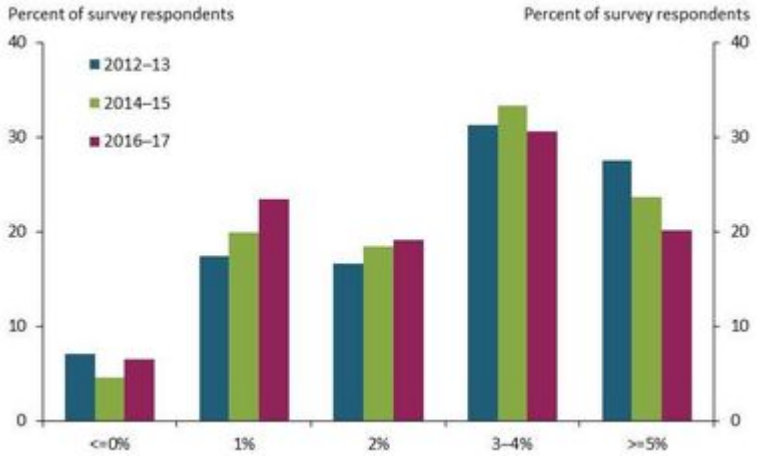
After I graduated from Carleton College in 2016 with a BA in mathematics and economics, I was excited to join the research team at the Federal Reserve Bank of Kansas City. During my time as an RA, I supported José Mustre-del-Río, Andy Glover, Brent Bundick, and Lee Smith. Currently, my main role is to help support the monetary policy briefing process. I also run the Kansas City Fed's Labor Market Conditions Indicators (LMCI) model and collaborate with economists on Bank publications. I really appreciate the variety of work I've gotten to do at the bank and the flexibility given to RAs to explore their interests.

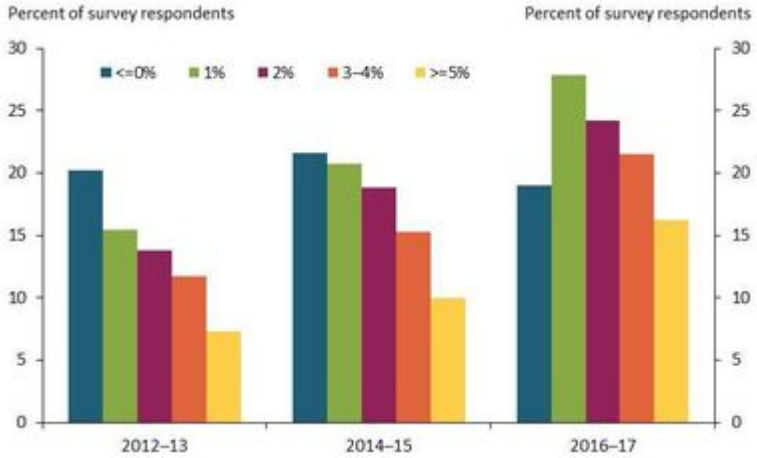
Media



Note: Gray bar denotes National Bureau of Economic Research (NBER)-defined recession.Sources: University of Michigan and NBER (Haver Analytics).



Sources: University of Michigan and authors' calculations.



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