

Limitations to the role of inflation expectations in monetary policymaking: A markets' perspective

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Long-term inflation expectations, as reflected in surveys and markets, are very important for the general credibility of a central bank committed to price stability. Short-term inflation expectations do not provide a similar signal, as they predominantly reflect the perception of existing inflation.

However, both survey-based measures and markets' pricing of "inflation compensation" over the next five years, or longer, are volatile, opaque and/or prone to revisions. Therefore, any indication from such readings of a possible change in the perception of a central bank's credibility should be taken with a pinch of salt until deviations become relatively widespread among the readings, as well as persistent over an extended period of time of, say, six months or more.

Importantly, therefore, any adjustment to the path of monetary policy, as determined by the research-based outlook for inflation and the economy more broadly, due to changes in individual monthly readings of long-term inflation expectations – or readings over e.g. 2-3 months – would be ill advised.

In particular, during periods when market participants are on high alert with respect to changes in monetary policies because of fear that excessive inflation might trigger a wage-price spiral, as is now the case (or fear of deflation, as was the case ten years ago), central bank communication becomes particularly important. Monetary policymaking is more an art than a science (but like all great arts, based on deep technical skills), which means that the speed of policy adjustments, let alone the direction of policies, should not be guided by individual data points. References in central bank communication to specific data points, particularly volatile ones and those read from the pricing in markets (which come with a fast and potentially disruptive feedback loop) should therefore be done only with the utmost care and clarity of the limitations of their signalling effects.

The limitations of market-based and survey-based inflation expectations

Specifically, market-based inflation expectations suffer from two impediments when it comes to their usefulness as input in policymaking:

First, they are too volatile, given the policy relevant horizon. For example, the 5y/5y – i.e. the market’s pricing of inflation during the five-year period, beginning in five years – had fallen to 1.75% early this year, then it jumped to 2.5% in March, before it dropped back below 2% in July. Surely, any adjustments to the policy path during those six months, on the back of any of the readings of the 5y/5y, would have been misplaced, given the policy relevant horizon of about 6-24 months.

Second, they are far from straightforward to interpret because of the liquidity and risk premia. For example, as illustrated by Isabel Schnabel in her speech on “The globalisation and inflation” on 11 May, the estimate of the inflation risk premia on a 1y/3y Inflation Linked Swap moved from deducting 80 basis points in early 2020 to adding 40 basis points in May of this year. That’s a 120 basis points’ shift in the estimated risk factor alone inside what would have been the policy relevant period for any consideration of policy changes in early 2020.

These impediments suggest that once adjusted for the risk premium, market-based inflation expectations become little more than a weighted average of the forecasts by private-sector professional forecasters, which is less surprising to us commercial economists than it may appear to observers from outside markets. After all, our profession is – precisely – to forecast market prices and on that basis to recommend changes to investors’ asset allocation, including to protect the real value of assets. If the pricing of the key asset classes, including inflation protection assets, on average over time, did not reflect the collective outlook among commercial professional forecasters, wrong as they may turn out to be, chances are that our employment – collectively – would find an early end.

The survey-based inflation expectations are not only volatile, like market-based readings, but prone to changes or revisions, which – in the present environment of elevated, indeed excessive, focus on such readings – causes unnecessary volatility in markets.

For example, on Friday 24 June the University of Michigan (UMich) revised its estimate of consumer 5-10-year inflation expectations for May down to 3.1% (and hence just a sliver above the April number and presumably therefore not a dramatic change) from the preliminary reading of 3.3%. Fed Chair Jay Powell had called the preliminary reading of 3.3% “eye-catching” in his press conference following the Fed’s 75bp rate hike, a characterisation which had led most market participants to conclude that this one number had been a significant reason for the Fed to hike by 75bp instead of the 50bp indicated, and priced in by markets, just a few days before the decision. As a result, the revision of the survey data point caused considerable volatility in markets as confusion about what this revision might mean for future rate decisions spread among market participants.

Whether driven by Fed communication as to the importance for monetary policymaking of this survey-based inflation expectations reading, or not, markets’ intense focus on these readings then caused further confusion in mid-July when the June reading was published. Indeed, the UMich 5-10-year inflation expectations fell to 2.8%, the lowest level since July 2021, which is below its 2001-07 average of 2.9% and only slightly above its 2012-19 average of 2.6% (a period when PCE

inflation was below target in every single year but one). Worse, for the interpretation, however, the headline number hides unprecedented dispersion in responses: The 75th percentile sits at 5.1%, 1.1pp above its 2012-19 average, while the 25th percentile dropped to 0.3%, 1.1pp below its 2012-19 average. Surely, an index with such volatility and sudden dispersion in responses can serve no more than a marginal input in policymaking.

Beyond the general signal of credibility, do inflation expectations matter?

The key reason why inflation expectations may matter for policymakers is the risk that they become self fulfilling. In the present environment of tight labour markets, they may lead to higher wages, triggering a self-fulfilling spiral. In times when inflation expectations approach zero, the risk of deflation becomes real. Yet, while research shows that there is a good correlation between long-term inflation expectations and wage growth, we only have very few episodes during the past decades of significant deviations from the inflation target. In the present high-inflation environment it appears that high wage growth, or the prospect of it, hinges more on past inflation and wage earners' demand for partial compensation for the inflation shock (as the cost of the terms of trade shock gets distributed in society), than on inflation expectations. Consistent with this, much of the higher wage growth appears to have taken the form of one-off bonus payments.

In the US, where massive fiscal support was provided during the pandemic, notably in the form of direct payments to households, and where markets are more flexible (and the worries about the war in Ukraine more distant), there are clear signs of demand-pull effects in the inflation numbers – and labour markets have become very tight, although largely due to a (still partly unexplained) drop in participation. As a result, average hourly earnings growth on a 3-months annualised basis accelerated to more than 6% by the end of last year, but has more recently dropped to about two-thirds of that, and hence to a level only a little above that consistent with the inflation target plus (pre-pandemic) trend labour productivity growth of about 1.5%. (Granted, what underlying productivity growth will be in a post-pandemic world remains uncertain.)

In Europe, there are concerns about upcoming wage negotiations, in particular in Germany, as well as the effect of the indexation of minimum wages in France and other countries. These are important issues to consider for a central bank, and yet, it appears that the unions' wage demands (and certainly the wage growth on the back of indexation) have very little to do with inflation expectations, and everything to do with past inflation and an attempt to recover some of the loss that wage earners have suffered. In several countries, the involvement of the fiscal authorities, including for tax relief for one-off payments, has either taken place or is being considered.

As a result, the ECB can remain confident that the risk of a wage-price spiral is limited, if still the key topic to watch, analyse – and be vigilant about. Importantly,

however, there is little or no evidence that European wage developments are about to be driven by elevated inflation expectations.

Conclusion

Monetary policymaking is complex and much more than a quantifiable science – and more so now than ever. Obviously, it has to be data dependent, but just like policies should not be set on the back of only a few data points, monthly measures of inflation expectations – whether markets-based or survey-based – should not be an important input in setting the direction or details of policy changes. Only if a collection of longer-term inflation expectations data starts to deviate measurably – e.g. by 50bp or more – over an extended period of time – say, six months – should they be used to inform the direction and speed of policy.

Whether formed by the collective wisdom of financial markets (by the price formation reflecting shifting views of traders and investors or by professional forecasters), individual market participants have no greater insight into the future of inflation than, e.g. central banks' research teams. Scottish philosopher, Thomas Carlyle, once opined, "I do not believe in the collective wisdom of individual ignorance". I tend to agree.