Inflation expectations: Role, drivers, whose inflation expectations?


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Recent inflation developments in the euro area

Energy, food, goods and services inflation
(annual percentage changes)

Sources: Eurostat and ECB staff calculations.
Note: The HICP food series shown is HICP including alcohol and tobacco. The latest observations are for April 2022.
Consumers inflation expectations three years ahead

Inflation expectations in the ECB Consumer Expectations Survey
(left panel: annual percentage changes; right panel: annual percentage changes; percentages of respondents)

Sources: ECB Consumer Expectations Survey and ECB staff calculations
Notes: Respondents are asked: “By about what percentage do you expect prices in general in the country you currently live in to increase/decrease over the 12-month period between two years from now and three years from now?” “Median” refers to the median across individual respondents. Data are winsorised at the 2nd and 98th percentile. The latest observations are for March 2022.
Do households listen to ECB communication?

Information about the ECB after the Strategy Review announcement
(% of all respondents, by information source)

- Current situation of elevated inflation calls for enhanced communication with the public
  - Majority of HHs did not hear about the ECB after its strategy review announcement in July 2021
  - Main channel: traditional media

- Yet the public is hard to reach!

Source: ECB Consumer Expectations Survey (CES) – September 2021
Note: “In the past two months, have you seen or heard information about the European Central Bank (ECB) from any of the following sources?” Apart from “No info”, all other options are not mutually exclusive, leading to a total sum higher than 100% of the respondents. Weighted estimates.
Can central bank communication enhance credibility?

- Information experiment using the ECB’s Consumer Expectations Survey (Ehrmann, Georgarakos and Kenny, 2022)
- **Control group** received *no information*
- **Four treatment groups** received information about different elements of the ECB’s communication related to its new monetary policy strategy
- Test the **causal effect** of information treatments (relative to the control group) **on credibility**:

  *How likely do you think it is that the ECB will maintain price stability in the euro area economy over the next 3 years? [0%….100%]*
The ECB aims for a 2% inflation target over the medium term as the best way to maintain price stability. The target is symmetric: inflation may sometimes be slightly above it or below. The ECB looks through short-term deviations. **Persistent negative and positive deviations are regarded as equally undesirable.**
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A target of 2% has an important function: it creates space so that monetary policy can have its stabilising effect. In bad times, such as during the pandemic, monetary policy stimulates the economy through low interest rates and so has significant favourable effects on economic growth and employment. This may also imply a transitory period in which inflation is moderately above the target of 2%.
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In addition, the ECB has acknowledged that climate change is an existential challenge for the world, and it is of strategic importance for the ECB’s mandate. As a result, the ECB has decided on a number of measures to account explicitly for the implications of climate change and the carbon transition in its new monetary policy strategy.
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In addition, the ECB has heard the calls of European citizens for a broader coverage of housing costs in the measurement of inflation and it will work towards making this possible.
The effects of communication on ECB credibility

- Communicating the symmetric 2% target improves credibility.
- Adding further explanation about the function of the target has the highest credibility gains.
- Adding reference to environment/housing costs has no additional credibility gains (but no losses either).

Note: Regression estimates and 95% confidence intervals per treatment group.
The effects of communication on ECB credibility by financial literacy

High financial literacy

Results mainly driven by high financial literacy
Low financial literacy: credibility gains more limited; clear need to explain
Conclusions

- Elevated current inflation and the complexity of recent price shocks highlight the importance of a stability-oriented monetary policy strategy that is effectively communicated to the public.

- CES evidence demonstrates how communicating the key elements of the ECB’s new monetary policy strategy can help enhance credibility of the price stability objective:
  - Essential to communicate widely and clearly the central banks symmetric 2% inflation target
  - Providing broader explanations about the role of the target and monetary policy’s “stabilizing effects” raises the credibility benefits further
  - More modest impacts for less financially literate – need to consider more targeted communication strategies that account for such differences. Also, benefits from promoting financial literacy.
Thank you!
References


ECB (2022), Innovation in monetary policy communication, Box 3, ECB Annual Report 2021
