

Slides for
**“The Role of Inflation Expectations in Monetary Policymaking:
A Practitioner’s Perspective”**

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**European Central Bank Forum on Central Banking:
Challenges for Monetary Policy in a Rapidly Changing World**
Sintra, Portugal

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*** The views expressed here are my own and not necessarily those of the
Federal Reserve System or my colleagues on the Federal Open Market Committee.**

Inflation expectations in theory

- Inflation = f (resource gap, lagged inflation, inflation expectations)
- Fed's statement on longer-run goals and monetary policy strategy:
 - *"The Committee judges that longer-term inflation expectations that are well anchored at 2 percent foster price stability and moderate long-term interest rates and enhance the Committee's ability to promote maximum employment in the face of significant economic disturbances."*
- "Well anchored": Insensitive to data and consistent with 2 percent inflation
- Policy communications: goals and commitment
- Policy actions to maintain credibility of commitment

Inflation expectations in practice

- Inflation expectations are not directly observable
- Multiple measures: households, businesses, professional forecasters, financial markets
 - Not all aligned
 - Whose expectations matter?
 - Less info about businesses even though they are price-setters
- Expectations vary within groups
 - Demographics: Women, older people, more educated tend to have higher inflation expectations
 - Salient prices: gasoline, food
- Direction of causality?
- Difficult to assess whether inflation expectations are becoming unanchored and how credible the public finds the central bank's commitment to achieving its policy goals

Figure 1: Measures of longer-term inflation expectations in the U.S. are rising

Atlanta Fed Business Infl Exp, over next 5-10 years

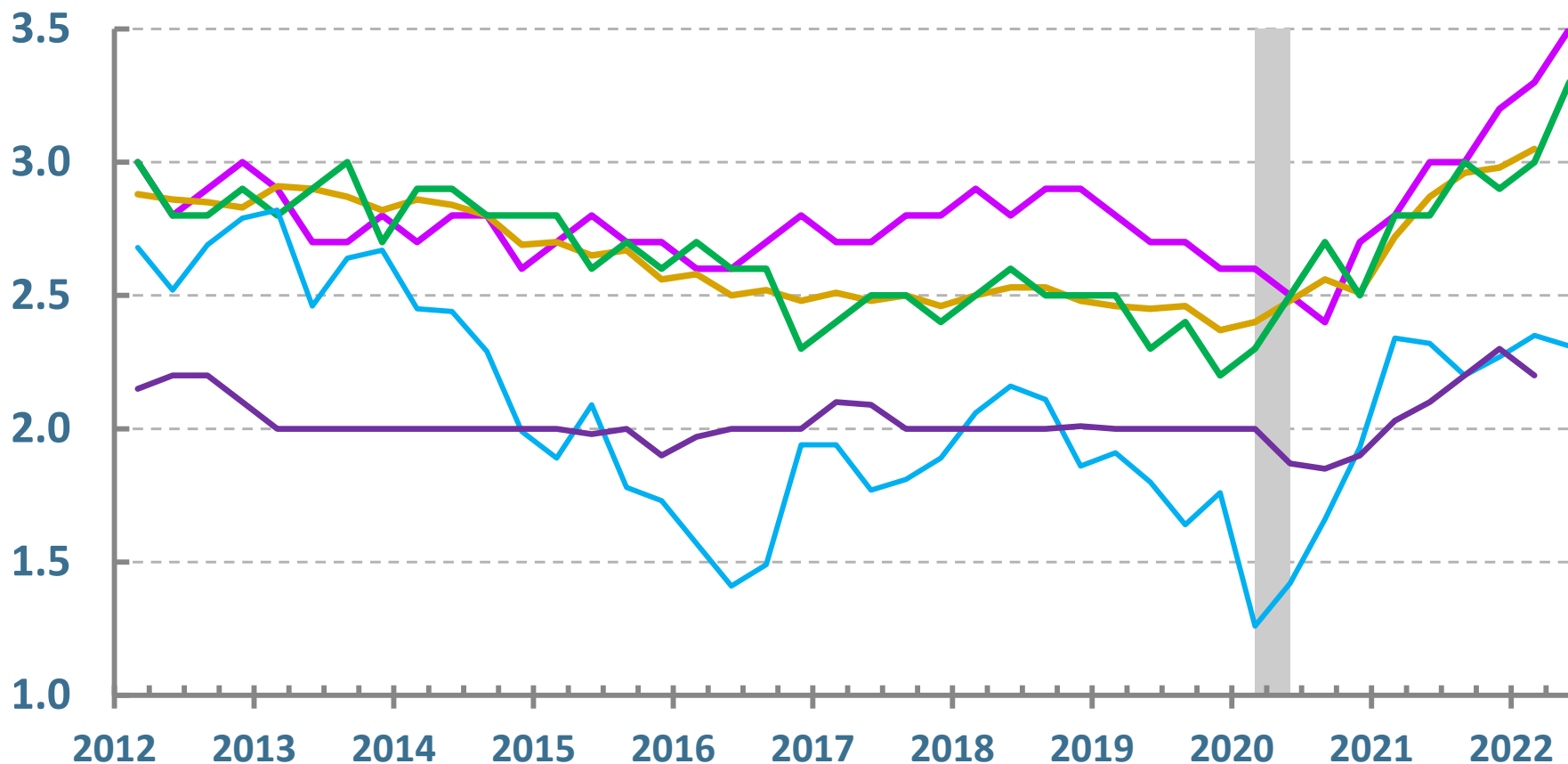
U Michigan Consumer Infl Exp, over next 5-10 years

BOG Common Infl Exp, scaled by U Mich, over next 5-10 years

Infl Comp: 5 yr/5 yr forward

SPF, 10-year PCE infl

Percent



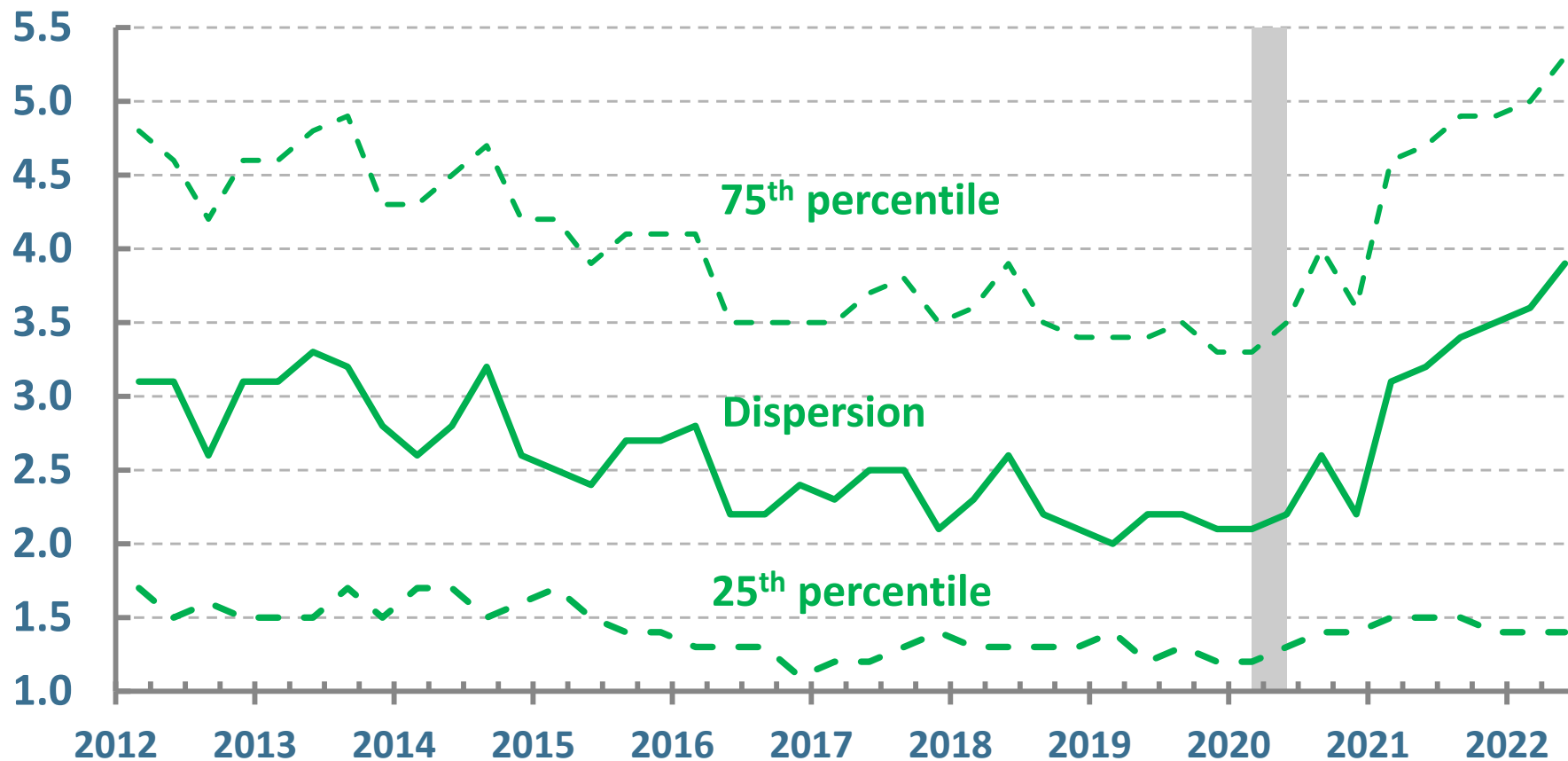
Source: Federal Reserve Board, Federal Reserve Bank of Atlanta, Federal Reserve Bank of Philadelphia, University of Michigan, via Haver Analytics

Quarterly data (end of qtr for U Mich and Infl Comp): Last obs. 2022Q1 for CIEI, end of 2022Q2 for U Mich and Infl Comp, 2022Q2 others

Figure 2: Dispersion in longer-term inflation expectations of households is rising

University of Michigan Consumer Survey of Expected Inflation over next 5 to 10 years

Percent



Source: University of Michigan
Last month of each quarter: Last obs. June 2022

Policymaking given the gap between theory and practice

- Inflation is unacceptably high and longer-term inflation expectations are rising
- Risk-management perspective:
 - Which is more costly: (1) assuming inflation expectations are well anchored when they are not, or (2) assuming inflation expectations are becoming unanchored when they are not?
 - Model simulations => (1) is worse
 - In (1): Policy too loose, inflation rises further, inflation expectations rise, reinforcing upward move in inflation
 - In (2): Policy too tight, inflation falls and could move below goal, but only temporarily because inflation expectations are well anchored at goal
- Cannot be complacent when longer-term inflation expectations are rising

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