Economics

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Low expectations key to a soft landing

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Motivational speakers often suggest that low expectations are the key to happiness, since they help avoid feeling disappointed with life's outcomes. While there are times where high hopes might be better, keeping expectations low is certainly of benefit for central bankers when it comes to inflation.

As the Fed and the Bank of Canada navigate very troubled waters, we see two alternative routes to a hard landing. They could tighten too much and too fast, and their desired slowdown turns instead into an outright recession. Conversely, by acting too slowly, and giving time for inflation expectations to build, they could leave a recession as the only tool for getting inflation back to earth.

By capping rate increases at 50 bps, central banks should have time to gauge how the economy responds at each step. Still, given lags in data reporting, an overshooting remains a risk.

But with inflation now at multi-decade highs, there's also a chance that inflation expectations soar before the central banks can get CPI numbers into more reasonable territory. There's uncertainty about where these "expectations" come from, and how they actually impact the economy's response to monetary policy. Even if economic theory overstates their importance, they matter to financial market participants because central banks believe they matter, and rate hikes will be less aggressive if the measures of inflation expectations they watch manage to stay well-grounded in the months ahead.

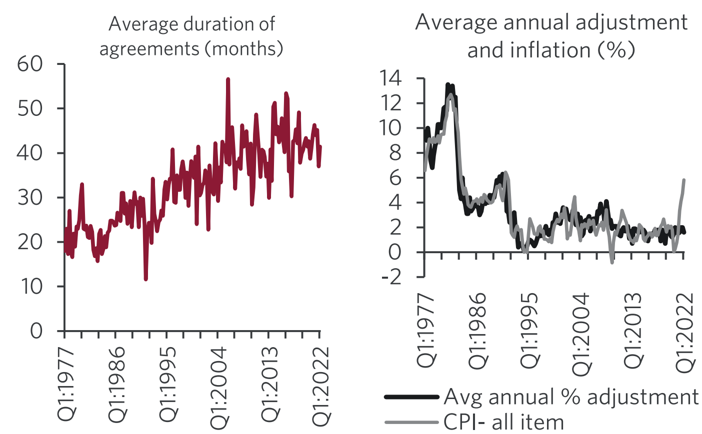
Self-fulfilling prophecies in theory and practice

Why do economists believe that expectations for high inflation can become a self-fulfilling prophecy, or make it more difficult to wrestle inflation down? Some theoretical models stress the impact on wage settings. If firms believe that inflation will remain high, enabling them to pass on outsized wage hikes in their prices, that can influence where competitive labour markets settle, or what unionized workers are able to bargain for. Rising wages then provide the income fuel for consumers to cover year after year gains in prices.

Having locked themselves into those wage rates, firms will effectively lock themselves into the need for higher prices. If rate hikes slow demand and make price hikes unsustainable, the result is a spate of recessionary layoffs when employers find their margins squeezed.

Canadian wage settlement data, tracking unionized workers, seem to align with the link between inflation expectations and wages. In the high inflation period of the late 1970s and early 1980s, inflation expectations climbed sharply. Annual wage adjustments closely followed inflation and contract duration was a relatively short 20 months (Chart 1). As inflation stabilized and expectations became more anchored, contract duration doubled as both workers and firms felt more confident about predicting future price increases.

Chart 1: Canadian wage settlements still tame



Source: Statistics Canada, ESDC

Encouragingly, Canadian wage settlements have not increased with the recent uptick in inflation, suggesting that both workers and employers don't see these price pressures persisting. That's one benchmark to keep an eye on in the months ahead, but so far, so good. More broadly, wages in both the US and Canada have accelerated, but less than prices, and the squeeze on purchasing power will act as one braking force on inflation ahead.

Other models hypothesize that high price expectation beget high prices through their impact on consumer or business purchasing decisions. If buyers expect high prices in the future, they might try to pull forward their purchases to beat the price hikes ahead. That in turn boosts current demand, reinforcing inflationary pressures. It's a pretty theory, but the evidence of a direct impact on prices is not conclusive.[1] There is, however, some evidence of a pull forward in consumption[2] and some have argued that Japan's long deflation morass was fed by consumers expecting falling prices and deferring purchases.

Expectations and the cost of getting inflation down

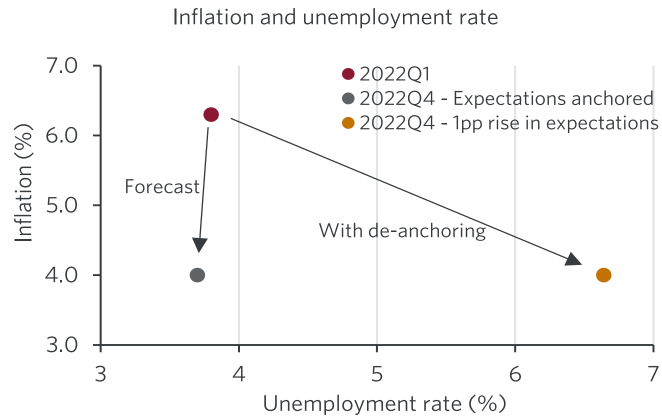
Whether economists have really identified the mechanism through which inflation expectations matter, it seems clearer that low inflation expectations reduce the economic costs when central bankers attempt to bring an inflation outburst to an end. That's a view shared by the US Fed, and Bank of Canada. As BoC Deputy Governor Paul Beaudry said, "history shows that once high inflation is entrenched, bringing it back down without severely hampering the economy is hard. If longer-term inflation expectations move up, a recession is usually needed to bring them back down."

Monetary policy can reduce inflation only by weakening demand and thereby raising unemployment, and historical evidence points to a much tougher trade-off when inflation expectations move higher. In the Fed's current forecast, and our own outlook, forces other than the typical rise in the US unemployment rate will do the heavy lifting in reducing inflation, including an easing in global energy prices and improvements in supply chains. Remember that inflation is much higher now than it was pre-Covid, even though the US unemployment rate is in similar territory.

In our forecast, US inflation goes down to about 4% by the end of 2022, while the unemployment rate stays around its current level (Chart 2). But that soft landing option would go out the window if long term expected inflation were to rise by 1%-point, based on estimates of how the unemployment-inflation tradeoff has historically been impacted by such changes.[3]

[1] Candia, Coibion and Gorodnichenko (2022)
[2] Coibion, Gorodnichenko and Weber (2021)
[3] Hazell, Hereno, Nakamura and Steinsson (2021)

Chart 2: Higher expected inflation would mean u-rate jump needed to quell inflation



Source: CIBC, CBO, University of Michigan, Bureau of Labor Statistics, Hazell et al. (2021)

In that scenario, for the same reduction in inflation, the unemployment rate would need to increase by up to three percentage points to 6.7% if inflation expectations are elevated and sticky. That's just the type of bruising recession that was needed to bring inflation down in the early 1980s, when long term inflation expectations had reached double-digit territory. That said, progress on inflation might require less of a jump in unemployment than this estimate if the start of a recession and softer prices more quickly brings inflation expectations down again.

Groceries, gasoline and faulty memories

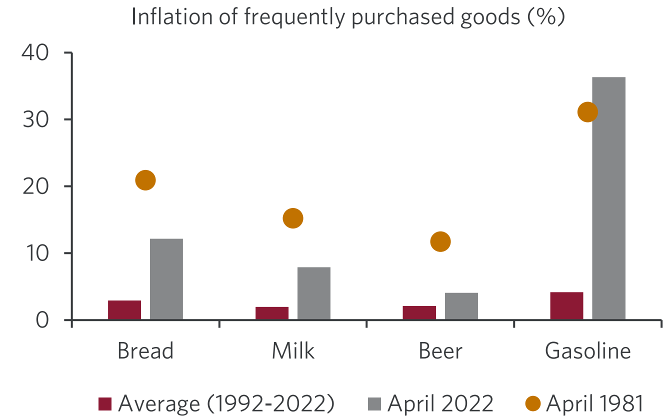
Given those risks, and the degree to which central banks believe in them, financial market participants need to understand where these inflation expectations come from. Overall, three things stand out regarding household and firm expectations: (1) they are systematically higher than expectations of financial markets participants, even when accounting for outliers, (2) they show a fair amount of disagreement, especially when large shocks hit the economy, and (3) they are highly linked to perceived inflation, which is quite different from realized inflation. In comparison, expectations of professional forecasters are much lower, closer to actual inflation, and show very little disagreement. This tells us that sources of information to form expectations vary greatly.

First, consumer expectations seem to be shaped by frequently purchased goods (e.g. food and gas). The implicit weight people put on the prices of different goods does not align with expenditure shares (either their own or those of the CPI basket). Rather, weighting items according to frequency of purchase generates a measure of perceived inflation that aligns much more closely with individual's inflation expectations.[4]

In fact, research finds that when asked about which prices are most important when forming inflation expectations, people

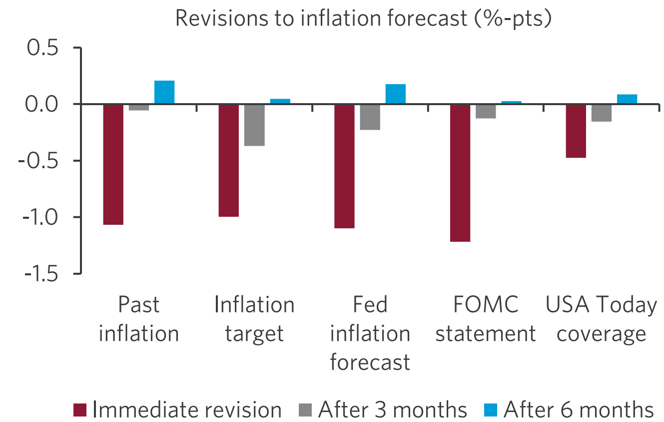
[4] D'Acunto, Malmendier, Ospina and Weber (2021)

Chart 3: Inflation in items impacting expectations



Source: Statistics Canada, CIBC

Chart 4: Respondents' adjustments to inflation forecasts after info provided



Source: Coibion et al (2021)

list things such as bread, milk, beer and gasoline.[5] Although we haven't yet reached 1981 conditions, inflation rates for these goods have escalated relative to their prior decade average (Chart 3). It will be critical to have them at least leveling off soon, which we see as probable in the case of gasoline, but less clear for the others, with milk producers now angling for another price hike.

Moreover, people pay more attention to price increases than price decreases. This means that narrow price pressures in a few key goods can have an outsized effect on expectations, even if the price of other goods is falling. For instance, half of the difference in inflation forecasts between households and professional forecasters can be accounted for by oil prices.[6] We're seeing the first signs of a supply response by OPEC members in the wake of the surge in crude prices tied to the war, but we'll need a more explicit commitment from key players that they will take up more of the quota share that Russia can no longer deliver.

Individuals also have a biased recollection of what prices used to be; while they perceive current prices quite accurately, they think past prices were cheaper than they really were.[7] Therefore, even as inflation slows, people may perceive it as still being high if they underestimate what prices were a year ago.

Business expectations tend to follow the broad trends in households expectations. But firms that face more competitors or sell a wider product range tend to be more knowledgeable about overall inflation dynamics, and therefore behave somewhat more like professional forecasters than households.[8] That's of importance, since employers have to buy into expectations of persistent inflation to be willing to lock in costly wage contracts.

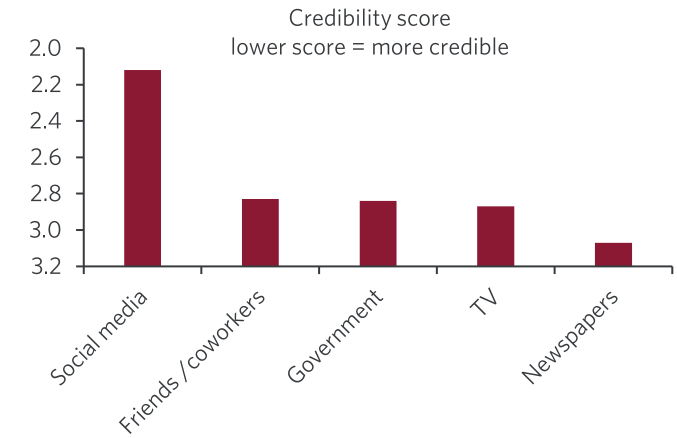
The medium is the message

Obviously, the best way to keep expectations anchored is to keep inflation low. But when that is not immediately possible, can central banks really influence inflation expectations? For all their efforts at communicating to the public, central banks don't seem to get much of a lasting reward in terms of their ability to steer expectations.

Experimental research with survey panels finds that different sources of information can have very different impacts on people's inflation expectations. Survey respondents were provided with either statements from the central bank or other information about inflation to see if that changed their prior reported views on inflation. Informing people about past inflation rates, reminding them of the inflation target, providing them with the Fed inflation forecast and giving them the full FOMC statement all provide a similar learning experience. In each case, people revise down their own one-year ahead inflation expectations by about 1 to 1.5pp (Chart 4). That learning, however, does not last long: three months later there is only a minimal residual impact, and six months later survey respondents had largely reverted to their original forecast.

[5] D'Acunto, Malmendier and Weber (2021)
[6] Coibion and Gorodnichenko (2015)
[7] D'Acunto and Weber (2021)
[8] D'Acunto, Malmendier and Weber (2022)

Chart 5: Respondents see social media as more credible than government or news media

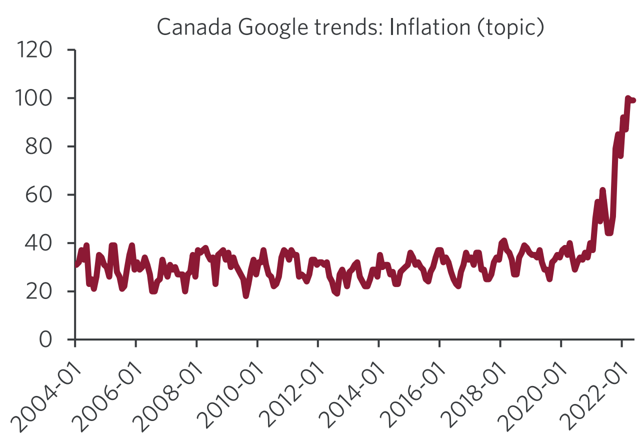


Source: Coibion et al (2021)

If instead of direct information on inflation or access to formal FOMC communication, people are given media coverage of the FOMC announcement, the revisions to their expectations are cut in half. Why? Because, according to the same survey, people don't find newspapers credible (Chart 5). In fact, social media are seen as the most credible source of information, distantly followed by friends and coworkers and then governments.

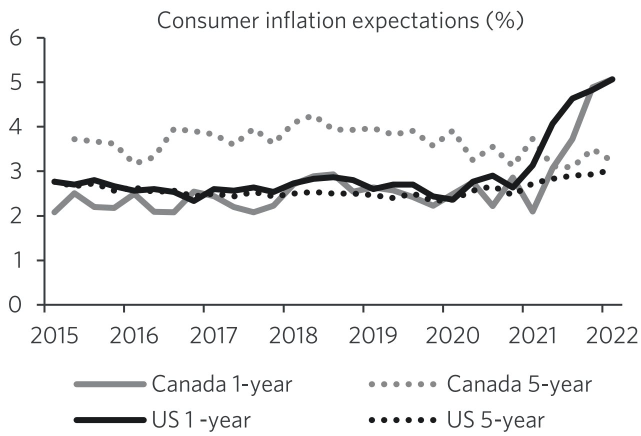
It's hard to know what message people are getting from social media at any point in time, but it's clear that their ears are burning up with online news on inflation. Online searches on the topic are at their highest level ever (Chart 6). Perhaps it's time for Governor Macklem and Fed Chair Powell to amp up their Twitter pages, since it seems like reports on their speeches on the pages of the Wall Street Journal or Globe and Mail won't do the trick.

Chart 6: Canadians searching for inflation info



Source: Google

Chart 7: Long term expected inflation still grounded



Source: Bank of Canada, University of Michigan

Forcing a sprint to the finish

For the time being, long-term inflation expectations seem fairly stable, both in Canada and the US (Chart 7). Consumers expect inflation to persist a little while longer, as shown in their higher 1-year ahead forecast, but they still think this increase is temporary. However, as shown in a recent NY Fed study, there is an increasing divergence of opinion about the future outlook for inflation, and uncertainty has risen.

Given what we now know about how expectations are formed, there is a real risk of de-anchoring. Food and gas prices are elevated and such items are heavily weighted in expectations. A cooling of the housing market would certainly help, but grocery prices will continue to exert their powerful influence when people plan their summer BBQ.

All of this lies behind the recent decisions by both the Fed and the Bank of Canada to complete more of their tightening cycle sooner, by hiking at twice the typical 25 bp pace at each meeting. We still see a mid-2% overnight rate as sufficient to contain growth and curtail domestic inflation pressures in both countries, but we've been moving up the timetable for reaching those yield peaks given the need to get some easing in inflation before expectations are de-anchored, and chances for a soft landing evaporate. Unless we see a cooling in high profile prices for items like gasoline, the odds of a pause, or a shift to quarter point hikes, are now less likely until rates are at the terminal rates we're projecting.

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