Non-technical summary for 'How Do Households Form Inflation and Wage Expectations?'

By Anthony Brassil, Yahdullah Haidari, Jonathan Hambur, Gulnara Nolan and Callum Ryan

What did we set out to do?

Peoples' expectations for future inflation and wages growth play a crucial role in monetary policymaking and the macroeconomy. If people expect prices to be higher in the future, it may affect their decisions about how much to buy today. Similarly, if they expect inflation to be higher over the coming years, they may build higher prices into current employment or sales contracts, particularly if the contract is locked in for a few years – meaning higher expectations can flow into higher actual inflation going forwards. This is why it is so important for central banks to ensure expectations remain anchored around the inflation target.

A better understanding of how people form expectations for future inflation and wages growth can help us to predict how they might react to certain conditions and, in turn, can help inform monetary policy.

We use survey data on Australian households to explore how their short-term expectations are formed, considering questions like:

- Do people base expectations off the recent past or do they look forward, taking cues from other signals about what will happen in the future and looking through short-term price shocks?
- Do people associate higher inflation and wages with a strong economy, as strong demand leads people to bid up prices? Or do they associate them with a weak economy – for example, focusing on the fact that global energy price shocks that push up prices will tend to weaken the economy?

We look at the differences across age, income and housing groups to better understand the aggregate relationships.

What did we learn?

Our research to date has revealed the following findings:

- People appear to associate high inflation with worse economic conditions, but higher wages growth with better conditions.
- The relationship between current wage expectations and inflation expectations is relatively weak.
- Estimated monetary policy shocks have a limited effect on expectations despite affecting actual inflation, while oil price shocks tend to move inflation and real wage expectations in different directions.
- Inflation expectations appear to be based a bit more heavily on past conditions, while wage expectations appear to be based more on future conditions.
- Households appear to have looked through the recent transitory spike in inflation more than we might have expected based on past behaviour, and so expectations have come back down more quickly. This may reflect, in part, the RBA's efforts to communicate the transitory nature of the shock.
- Households' inflation expectations appear to be particularly sensitive to petrol prices, beyond what might be predicted given petrol's share of households' consumption.

Overall, households appear to have a somewhat 'supply-side' view of inflation, where shocks that push up inflation also weaken the economy, but have a more 'demand-side' view of wages. This finding suggests that households may believe there is relatively little trade-off between bringing down inflation and economic activity. But more work is needed to build on these findings.

What was our key takeaway?

While our work is ongoing, these findings indicate that people incorporate quite different signals when forming expectations, both over time and for different prices. Understanding why can help us to better understand the evolution of expectations. It can also help us improve our public education and other communication strategies to make policy more effective.