LONG-RUN INFLATION EXPECTATIONS
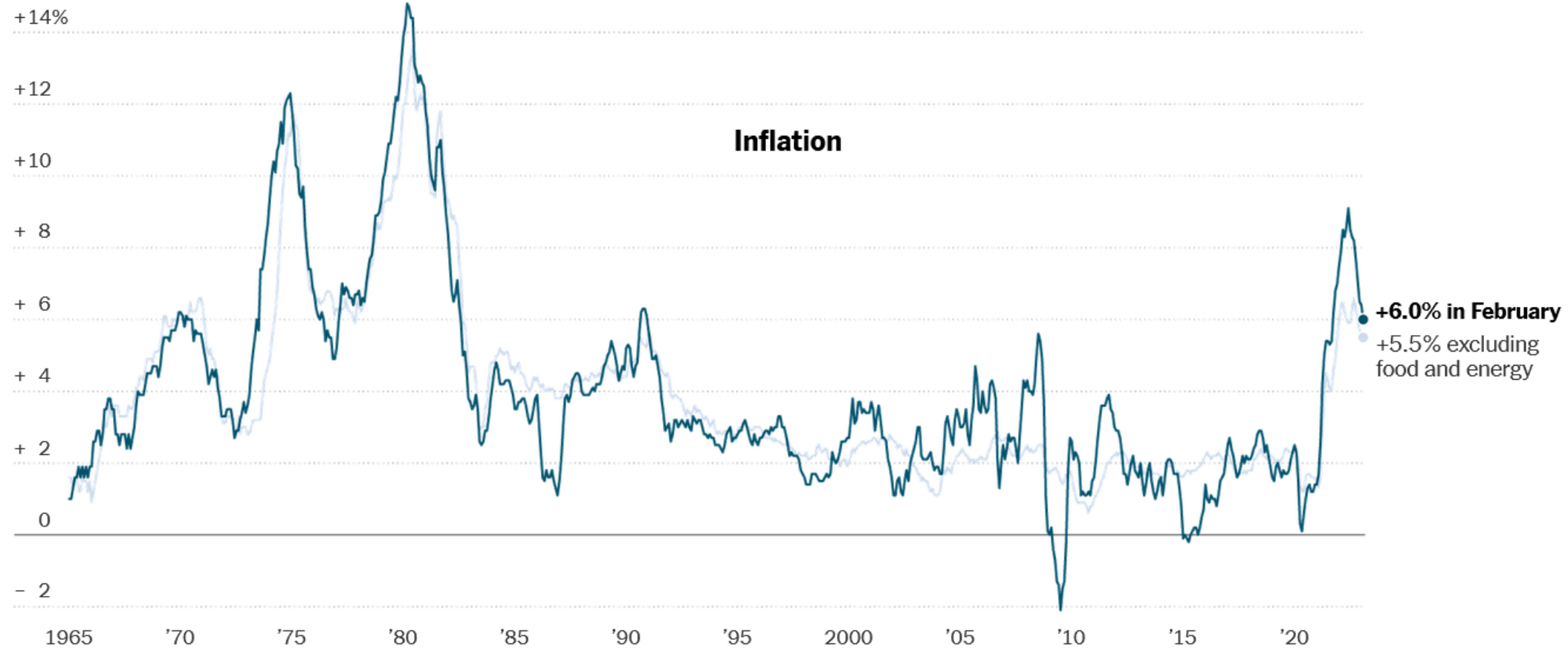
By Jonas Fisher, Leonardo Melosi and Sebastian Rast

Discussion by Yuriy Gorodnichenko
UC Berkeley and

Inflation in February
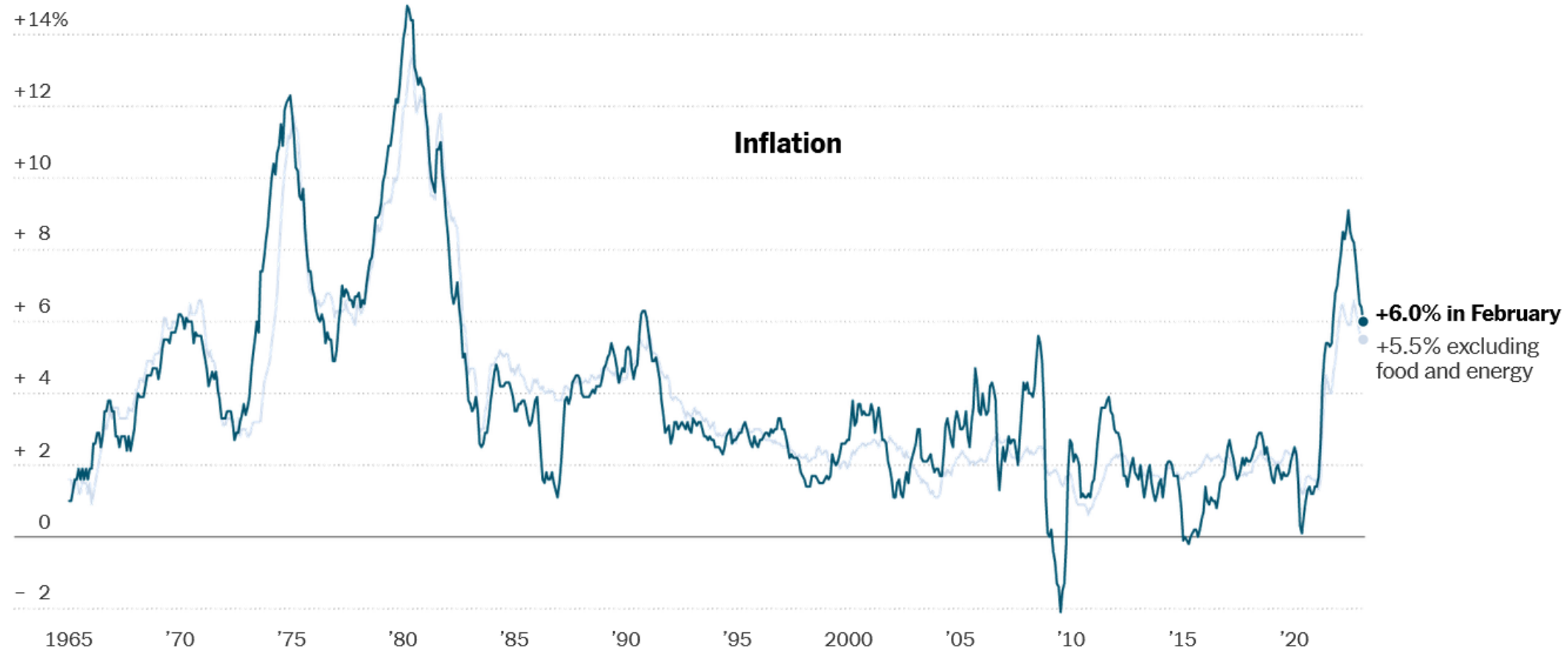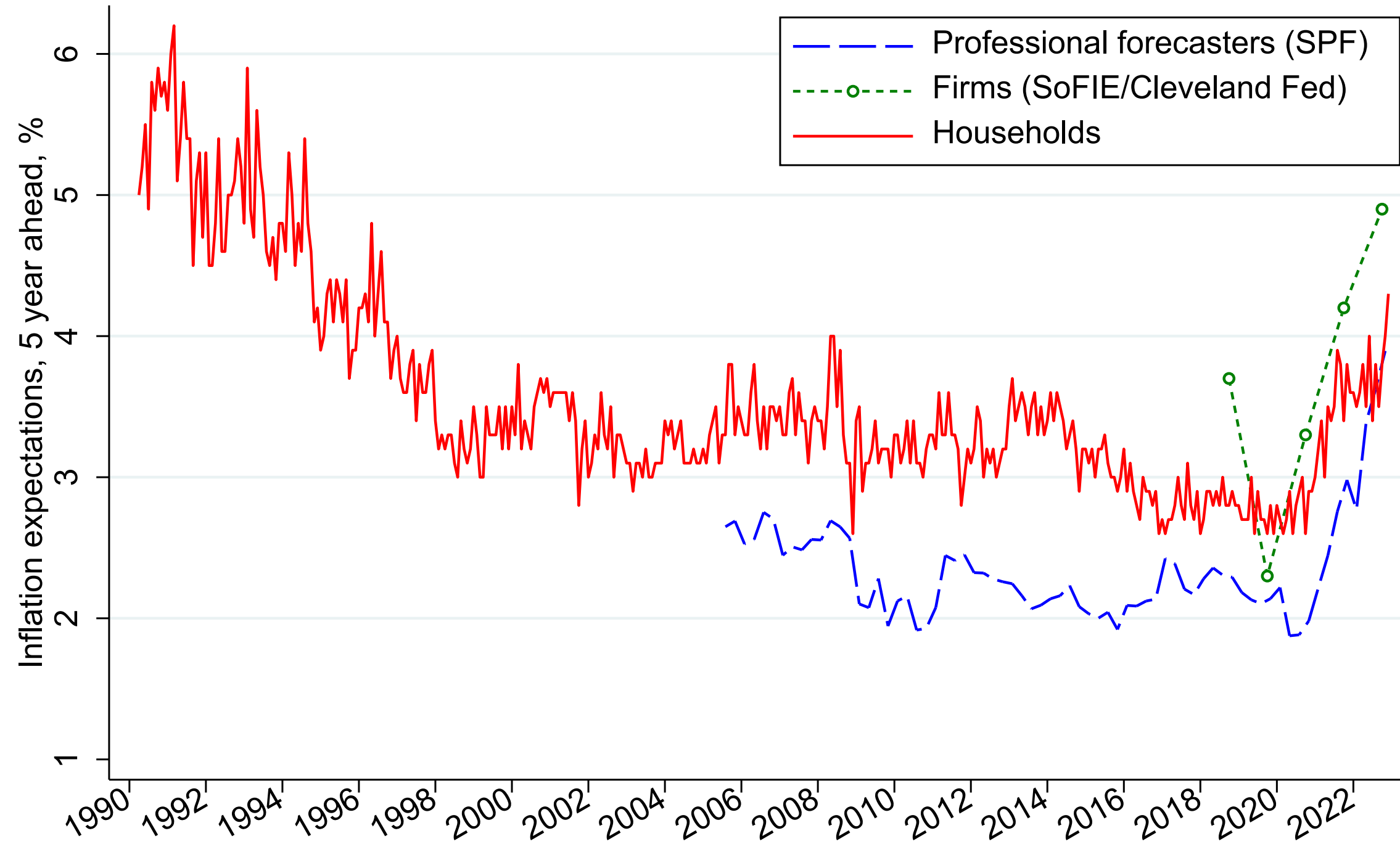
March 14, 2023

Give this article

Inflation

+14%

+12

+10

+ 8

+ 6

+ 4

+ 2

0

− 2

+6.0% in February

+5.5% excluding food and energy

1965 '70 '75 '80 '85 '90 '95 2000 '05 '10 '15 '20
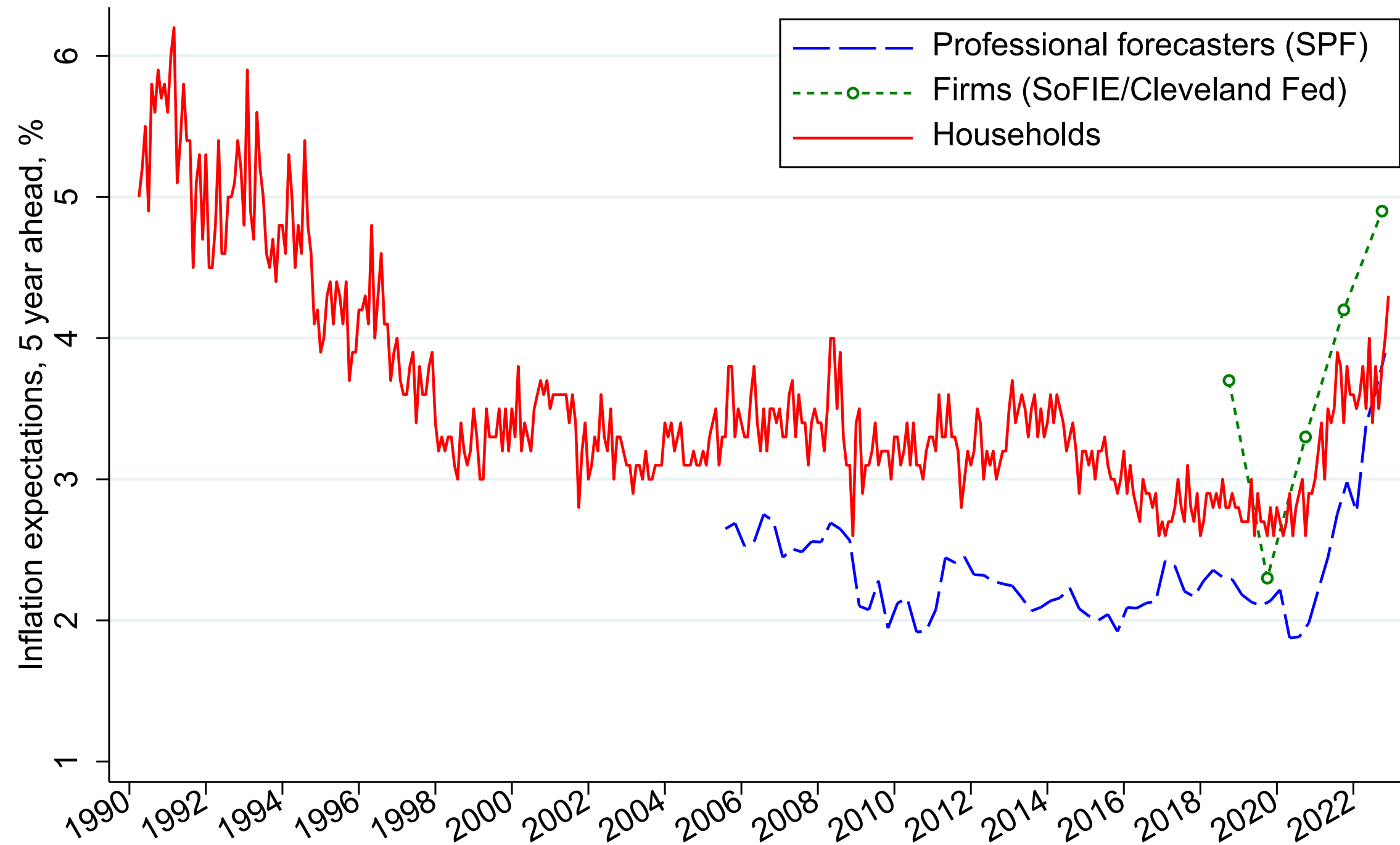
Jerome Powell (March 22, 2023): "Despite elevated inflation, longer-term inflation expectations appear to remain well anchored."

LONG-TERM INFLATION EXPECTATIONS

Inflation expectations, 5 year ahead, %

Legend:
- Professional forecasters (SPF)
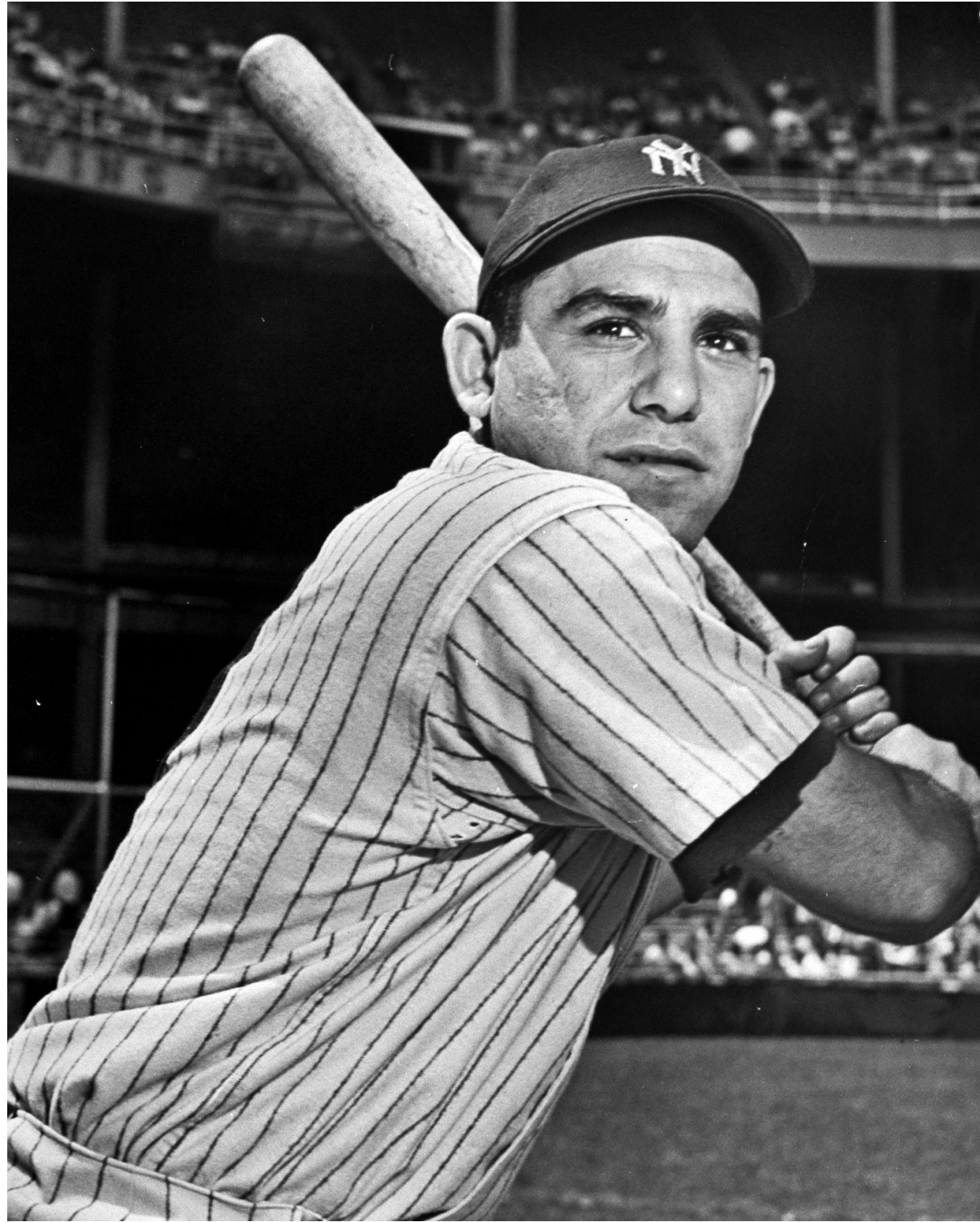- Firms (SoFIE/Cleveland Fed)
- Households

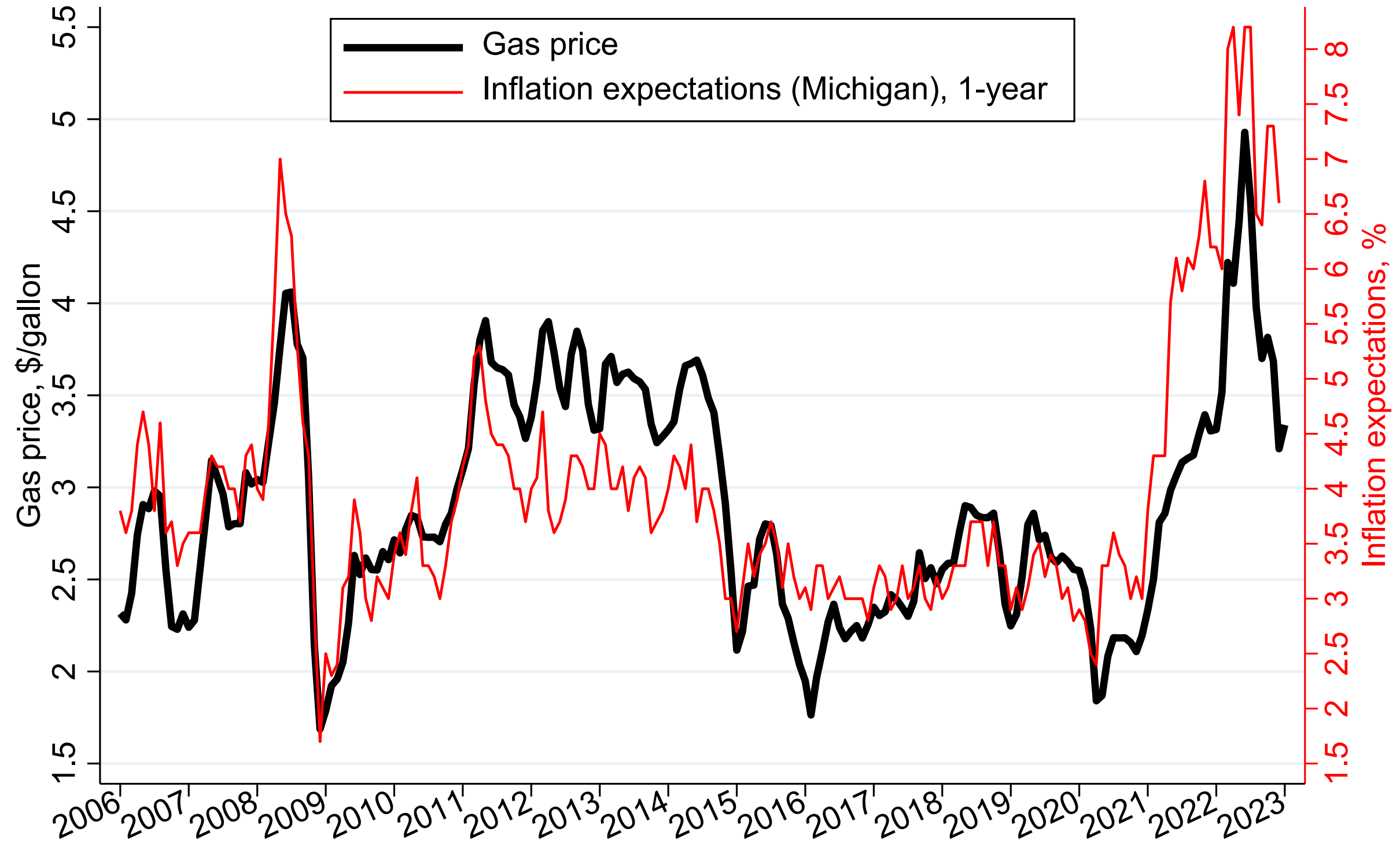# LONG-TERM INFLATION EXPECTATIONS

This paper: a statistical model of long-term inflation

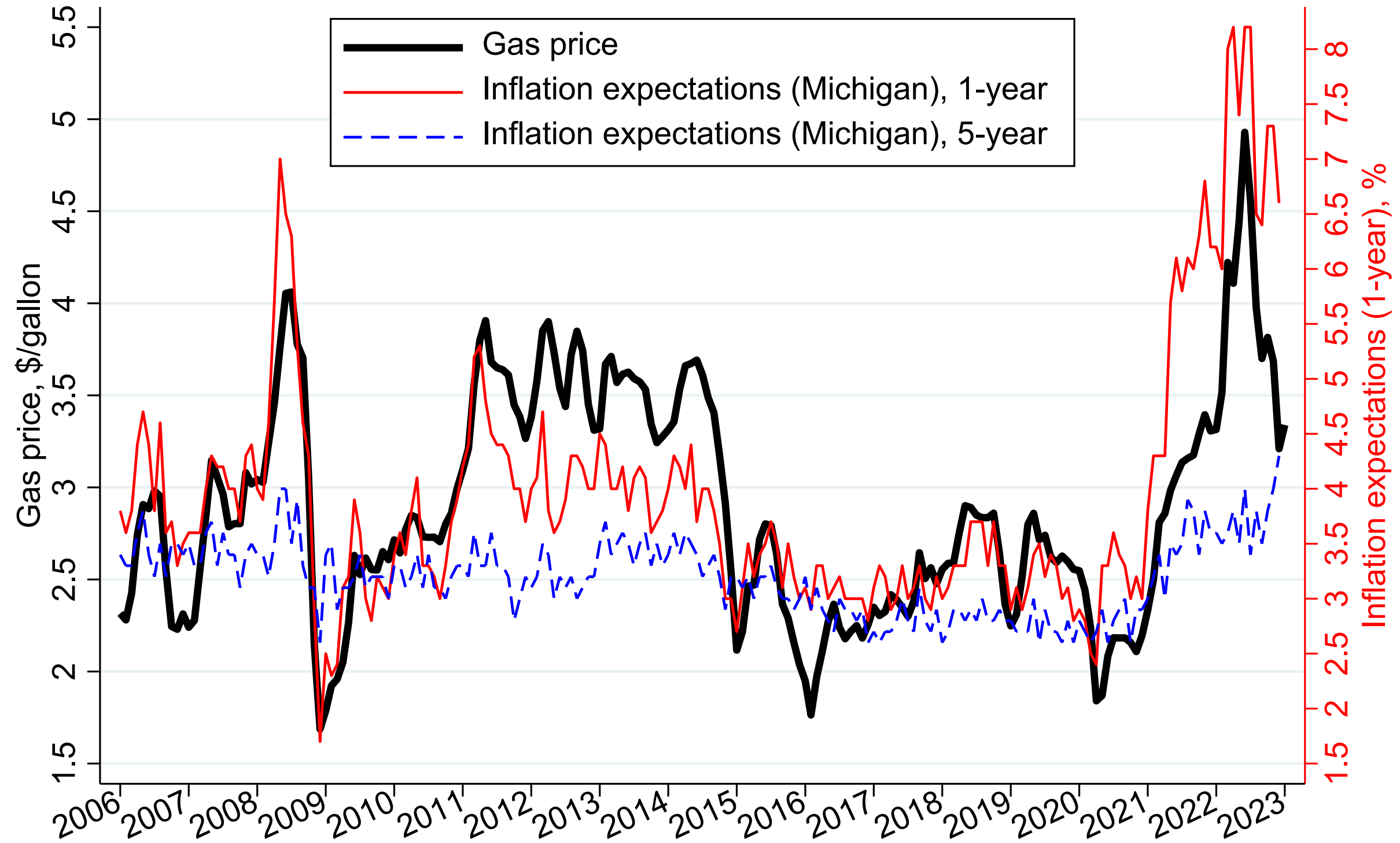# CHALLENGES OF FORECASTING

Yogi Berra: "It's tough to make predictions, especially about the future."

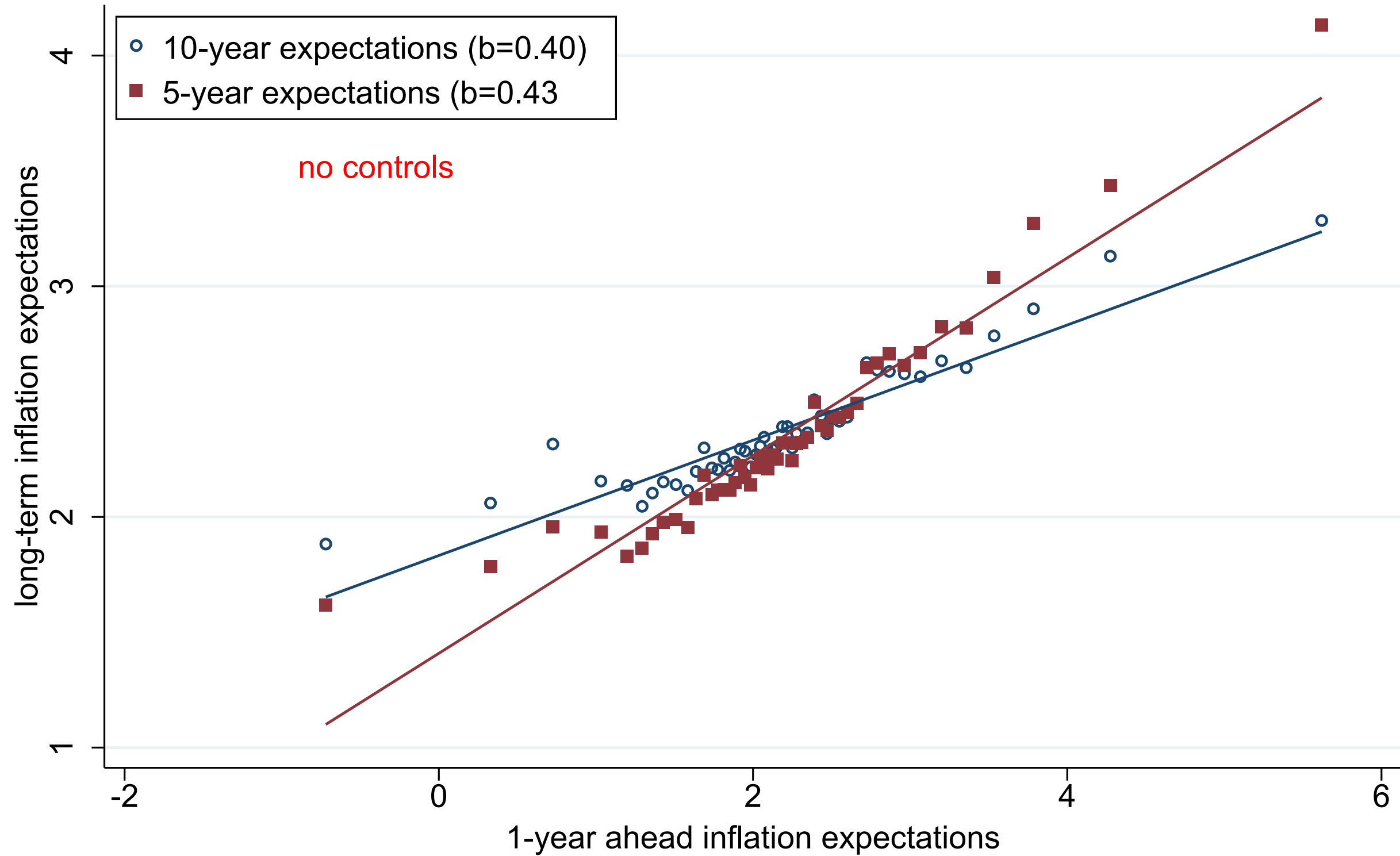COMMENT #1: FUNDAMENTALS

COMMENT #1: FUNDAMENTALS

COMMENT #2: WHAT IS ANCHORED EXPECTATIONS?

- Beliefs are close to the inflation target

- Beliefs are not dispersed (little disagreement)

- Confidence in forecasts (small uncertainty)

- Small forecast revisions

- No comovement in long- and short-run expectations

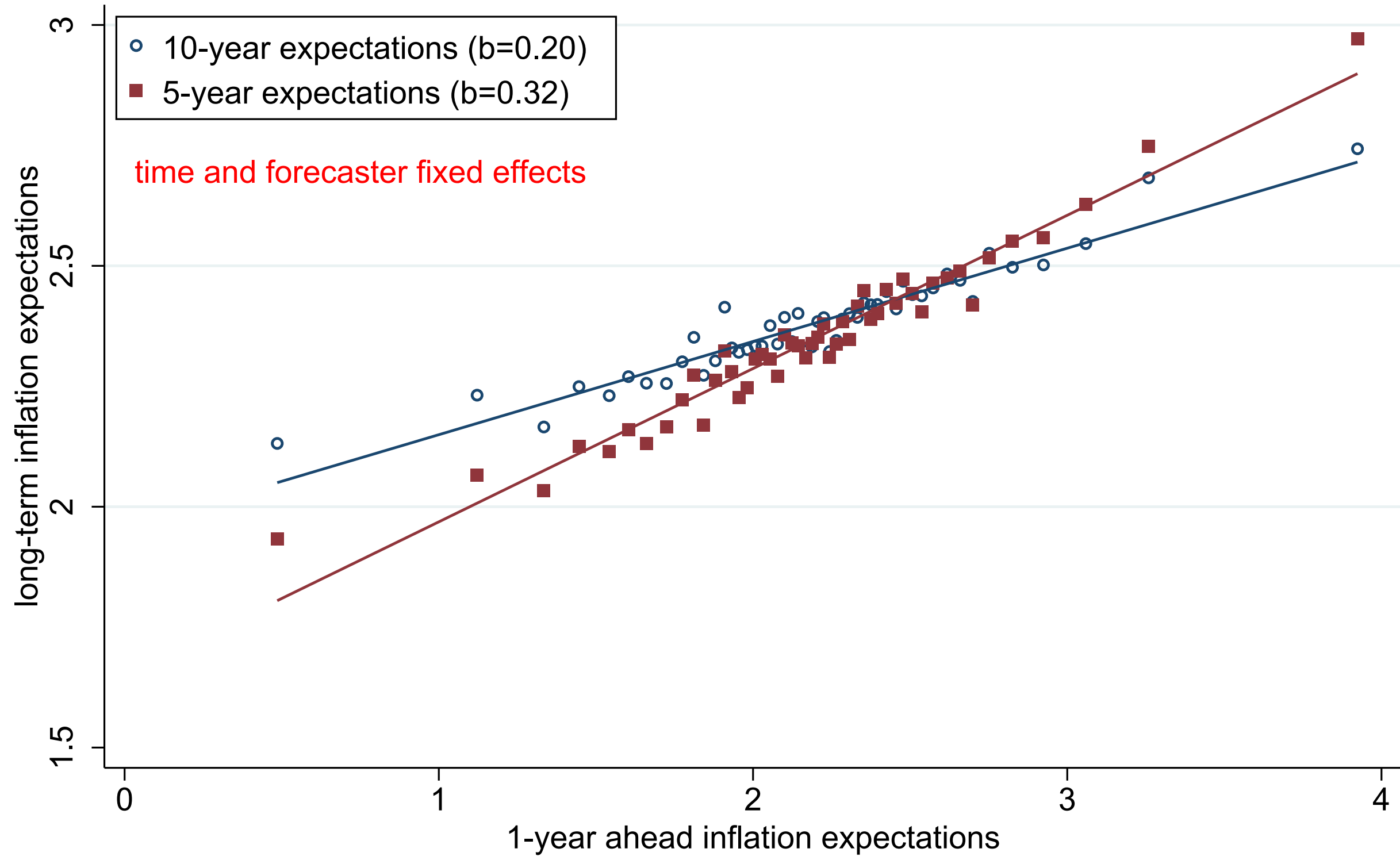# COMMENT #2: WHAT IS ANCHORED EXPECTATIONS?

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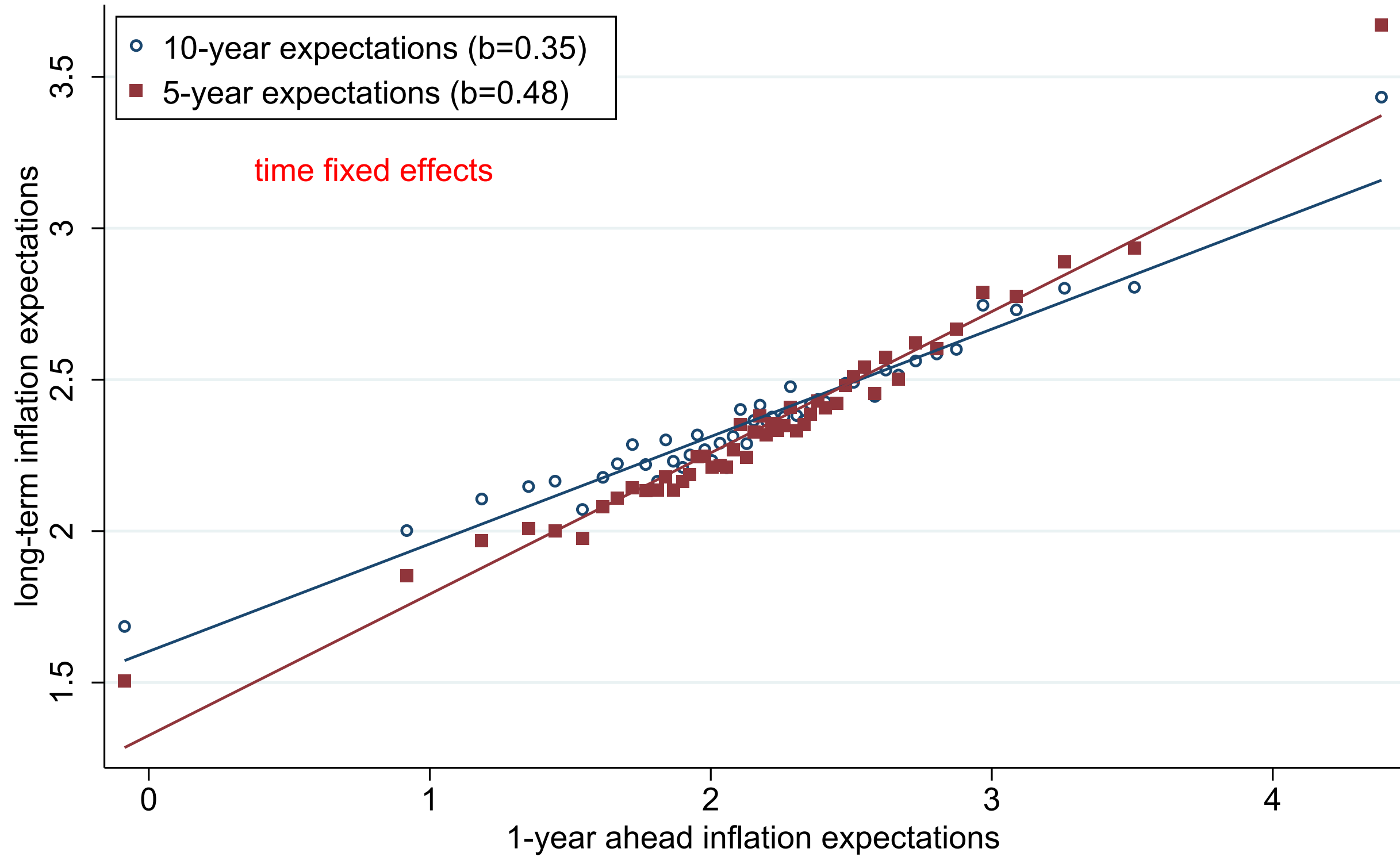
COMMENT #2: WHAT IS ANCHORED EXPECTATIONS?

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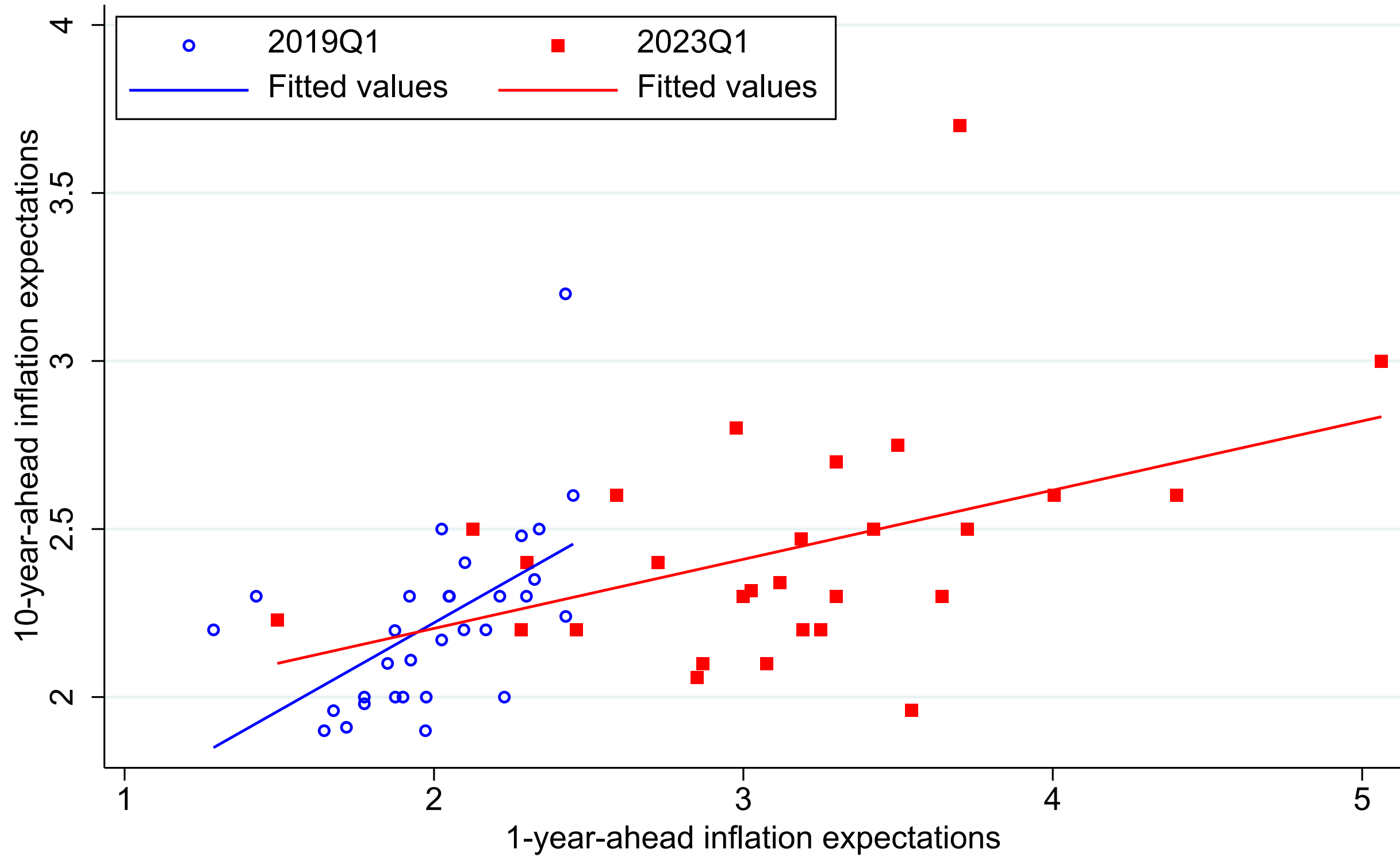
COMMENT #3: UTILIZE MORE INFORMATION FROM SPF
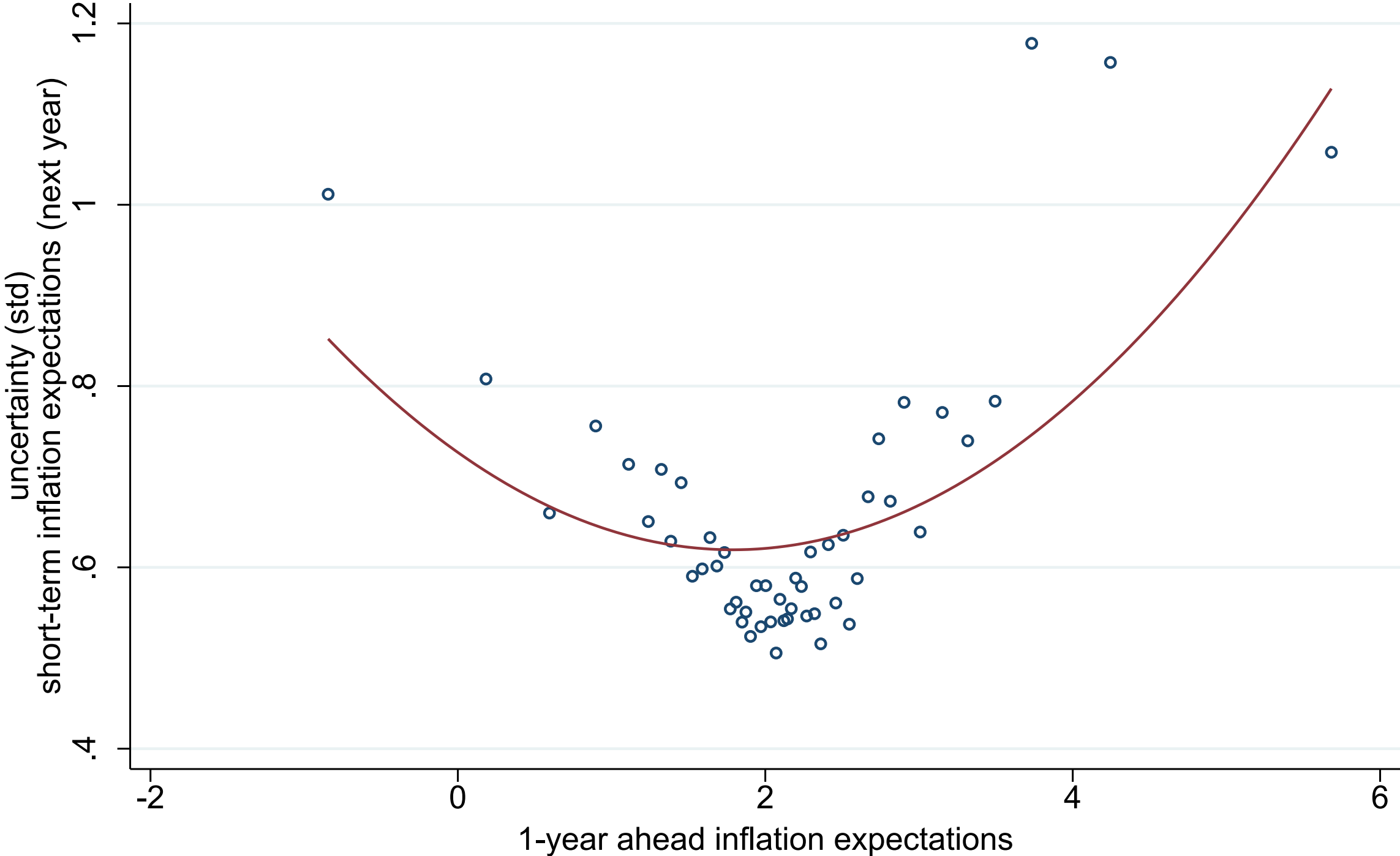
Uncertainty varies with the level of inflation

COMMENT #3: UTILIZE MORE INFORMATION FROM SPF
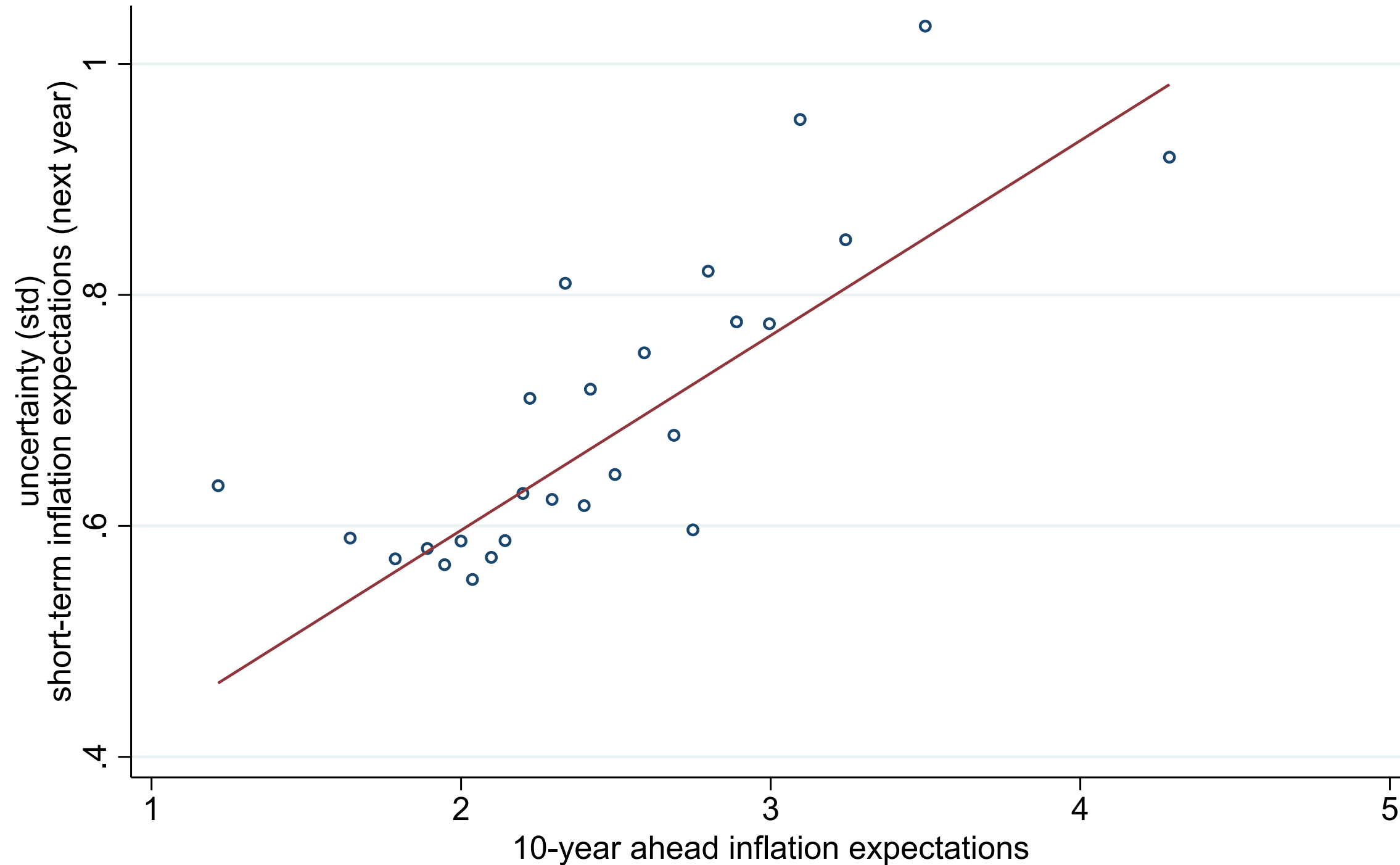
Short-term uncertainty is correlated with the level of LT inflation expectations

COMMENT #3: UTILIZE MORE INFORMATION FROM SPF
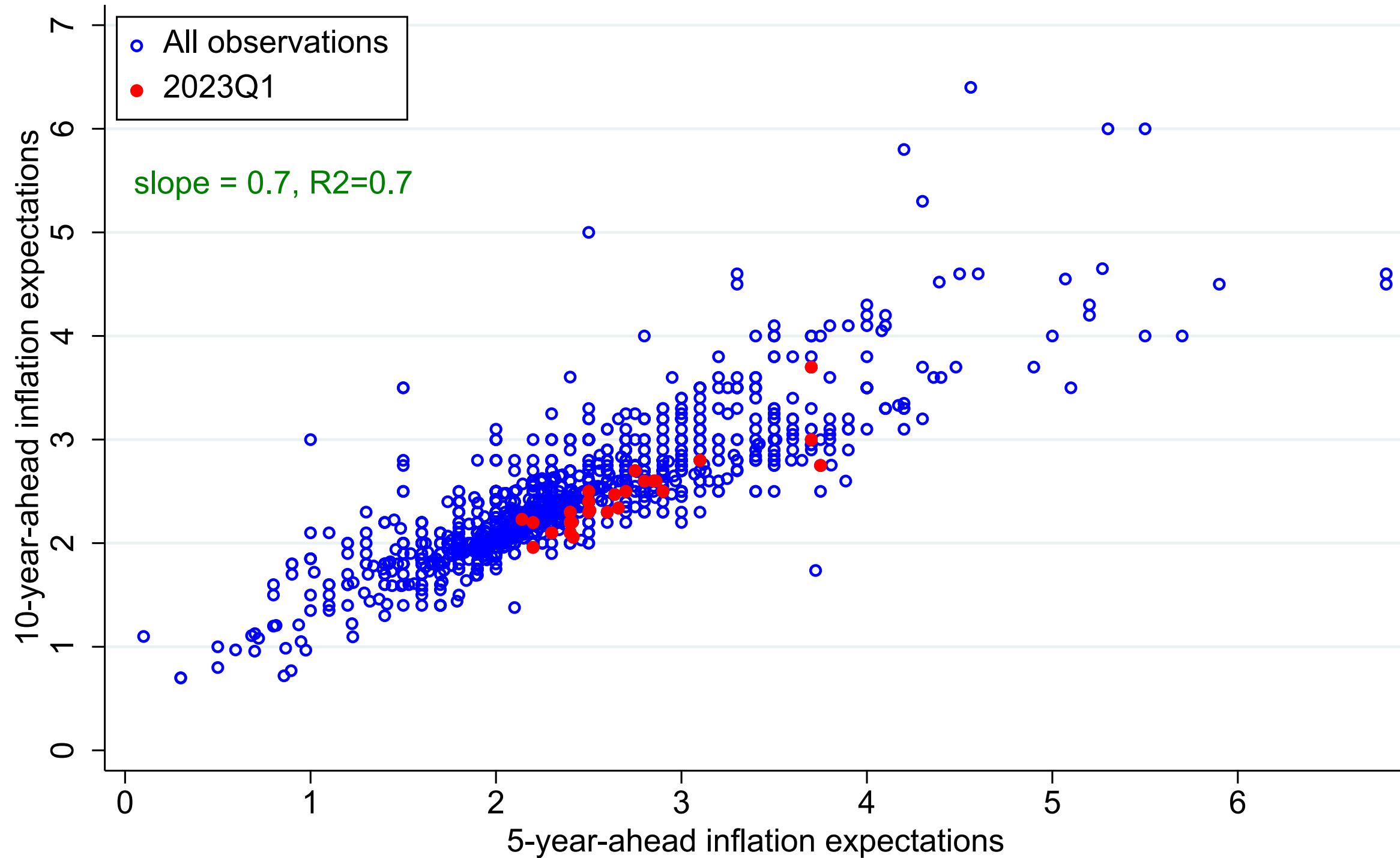
Why do 5- vs. 10-year expectations differ?

COMMENT #3: UTILIZE MORE INFORMATION FROM SPF

Term structure of inflation expectations: $\pi^i_{t+h|t} = \rho \pi^i_{t+h-1|t} + error$

source: Goldstein d Gorodnichenko (2021)

Note: p-value (equality of estimated coefficients) <0.01

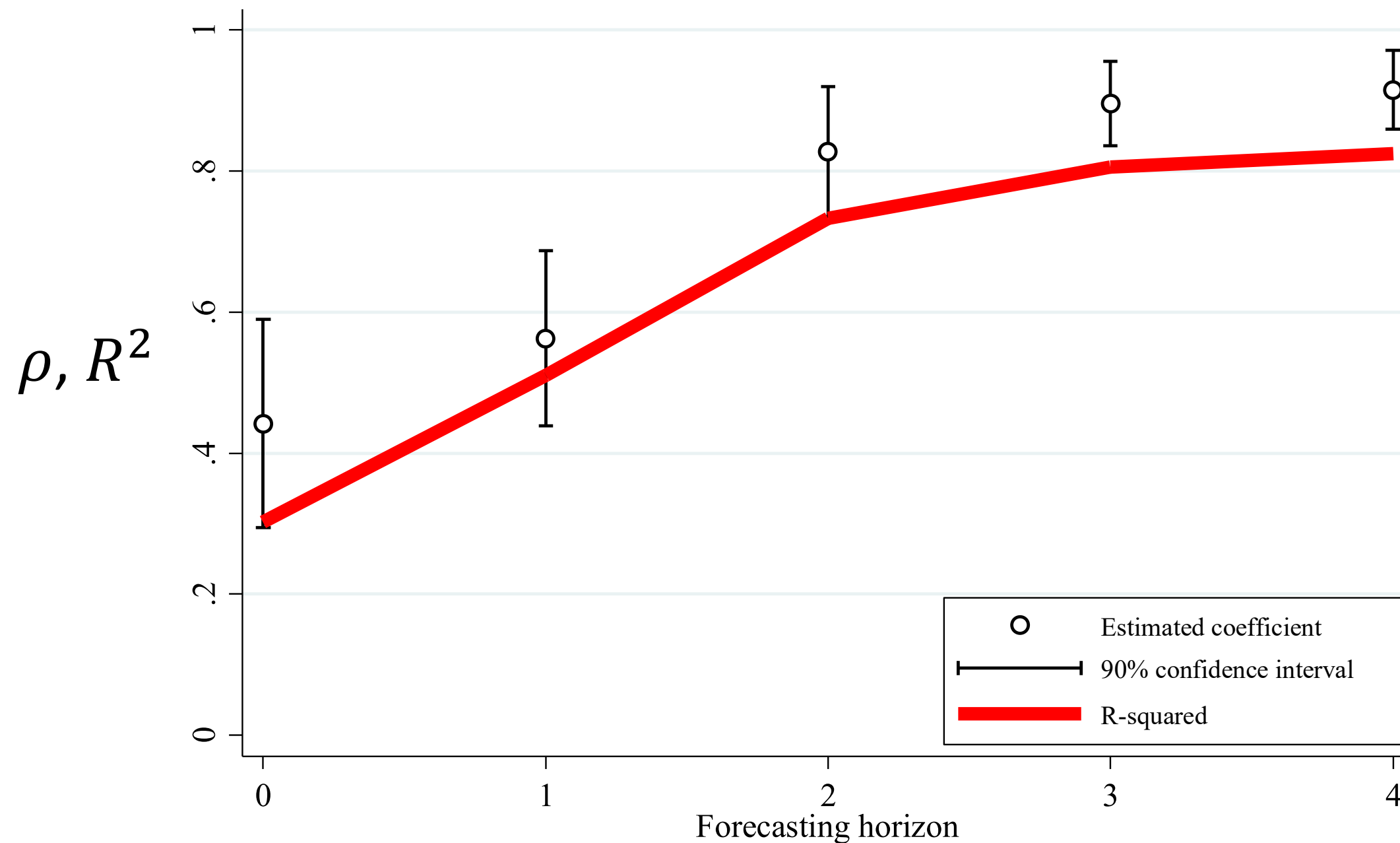# COMMENT #4: FORWARD INFORMATION

Practice (SPF): (80% of forecasters do this according to a special survey of SPF)

$$x_{t+h|t}^i = \rho^h x_{t|t}^i + \{add\ factor\}_{t,i,h}$$

OECD: An add-factor is the adjustment made to equation-based projection over the forecasting period. For example, if an equation has under-predicted a variable in recent periods, then an "add factor" may be added to the equation if it is judged that the equation will under-predict over the forecast period as well. In short, add factors are equation-residuals applied over the forecast period.

Larry Klein: "After the preparation of preliminary predictions from the … Wharton-EFU Model, there is a discussion of the assumptions and properties of the prediction with business and government specialists. A priori information on impending labor disputes, hedge purchasing, production bottlenecks, major economic decisions and similar phenomena are then suggested for further modification of parameter or residual values, and a revised forecast in prepared."

Add factor is information about the future ("forward information", "news", etc.)

COMMENT #5: OTHER PLAYERS IN THE ECONOMY
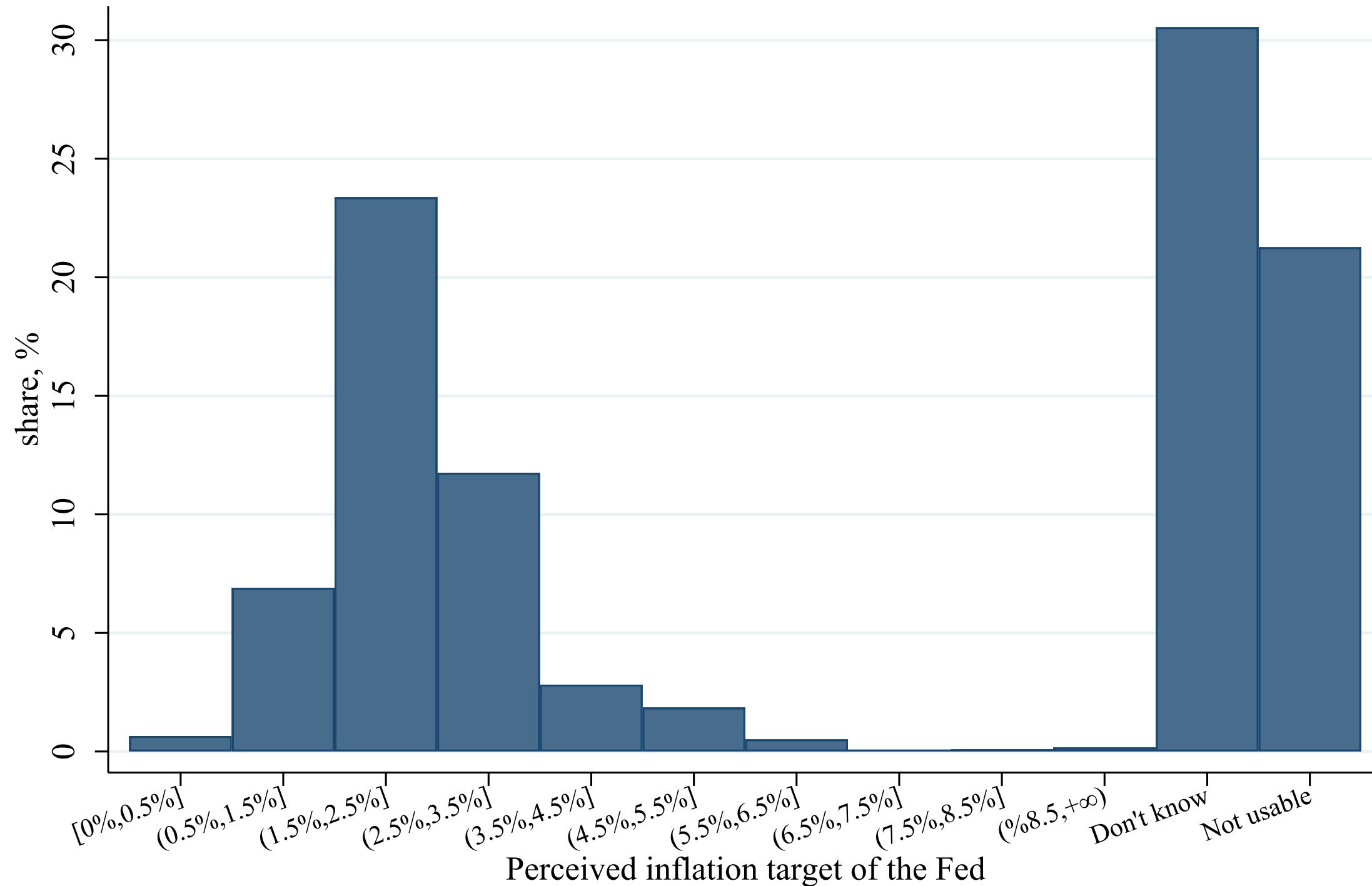
source: Candia, Coibion, and Gorodnichenko (2021)

Households and firms have little knowledge about the inflation target of the Fed.

CONCLUDING REMARKS

- Some key questions
  - o Where do expectations come from?
  - o What shapes expectations?
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- A new sense of urgency $\implies$ a very timely paper