Governor's notes on the inflation expectations of households

Prepared for the discussion at the General Council Meeting on 26 September 2024

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Good morning, President Lagarde, dear colleagues.

Let me give you an insight into how we (at the CNB) approach the inflation expectations of households.

Methodology

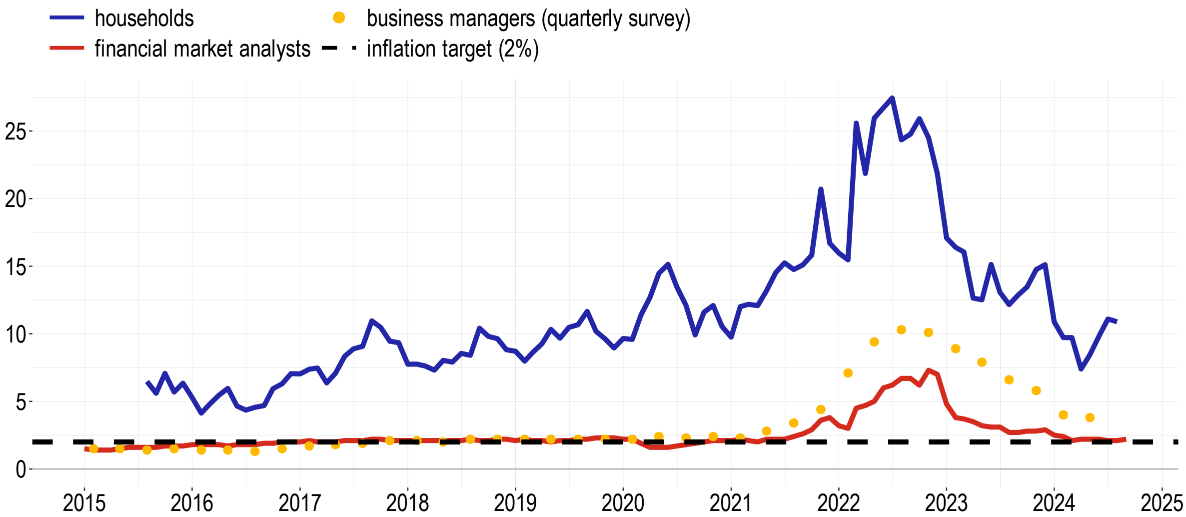
We have data on the short-term (12-month) inflation expectations of households from monthly business and consumer surveys. The surveys have been conducted for the Czech Statistical Office and the European Commission by Data Collect, a market research company. The survey is conducted via telephone interviews, using a sample of 1,000 randomly selected households.

Since August 2015, we have numerical estimates of:

1. **Expected inflation**: respondents are asked, "*How do you think consumer prices will develop in the next 12 months compared to the previous 12 months?"*
2. **Perceived inflation**: respondents are asked, "*How much do you think consumer prices have changed over the past 12 months? Please estimate in per cent."*

Inflation expectations: households vs. financial market analysts and business managers

Inflation expectations in the Czech Republic
(12-month horizon, %)



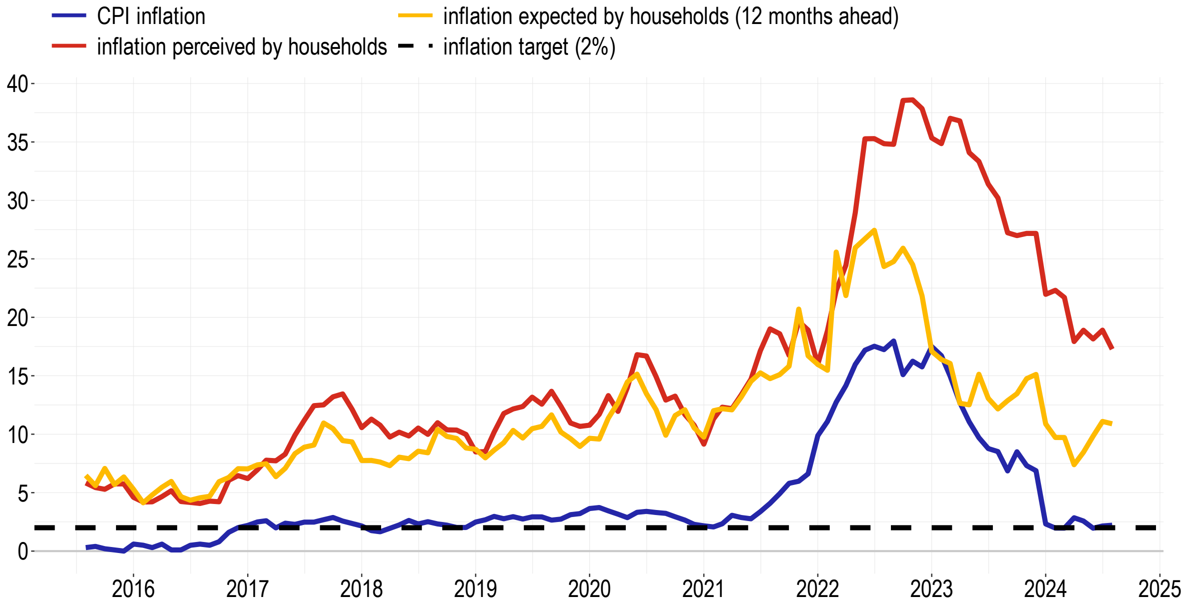
Source: Czech National Bank, Data Collect

Across the entire sample, households consistently expected higher inflation than business managers and financial market analysts. This can be observed in most countries.

Households’ inflation expectations were above the inflation target of 2% even before inflation began to rise.

On the other hand, analysts and business managers had stable expectations before the pandemic, anchored at 2%.

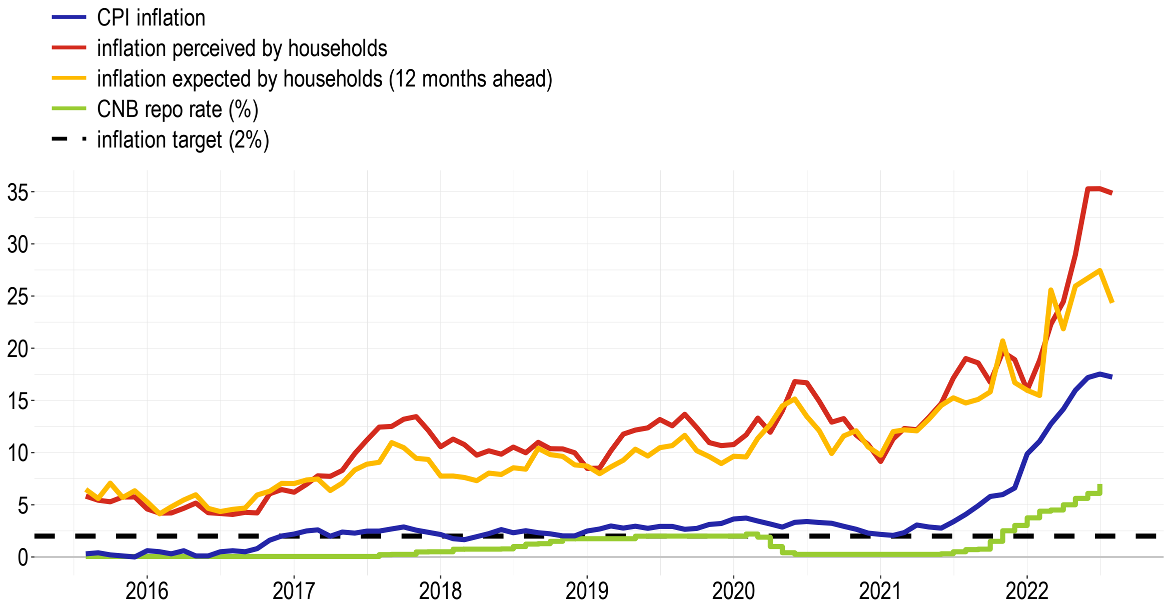
Actual, perceived and expected inflation



Source: Data Collect, Czech Statistical Office

Both expected and perceived inflation were higher than actual inflation; perceived inflation was more than twice as high as published inflation at the peak of the inflation wave in 2022.

Monetary policy response in the 2nd half of 2022, when I became governor



Source: Data Collect, Czech Statistical Office

I became governor in July 2022. At that time, actual inflation was 17.5%, the key interest rate was 7%, perceived inflation was 35% and inflation expected in 12 months was 27%.

The textbook approach prescribes that the central bank should keep raising key interest rates. When inflation expectations rise, interest rates should rise to control demand and inflation.

Our approach: We kept interest rates stable; the repo rate remained at 7%. This approach was controversial and contrary to the mainstream opinion of economists in the Czech Republic.

This strategy was based on two main arguments:

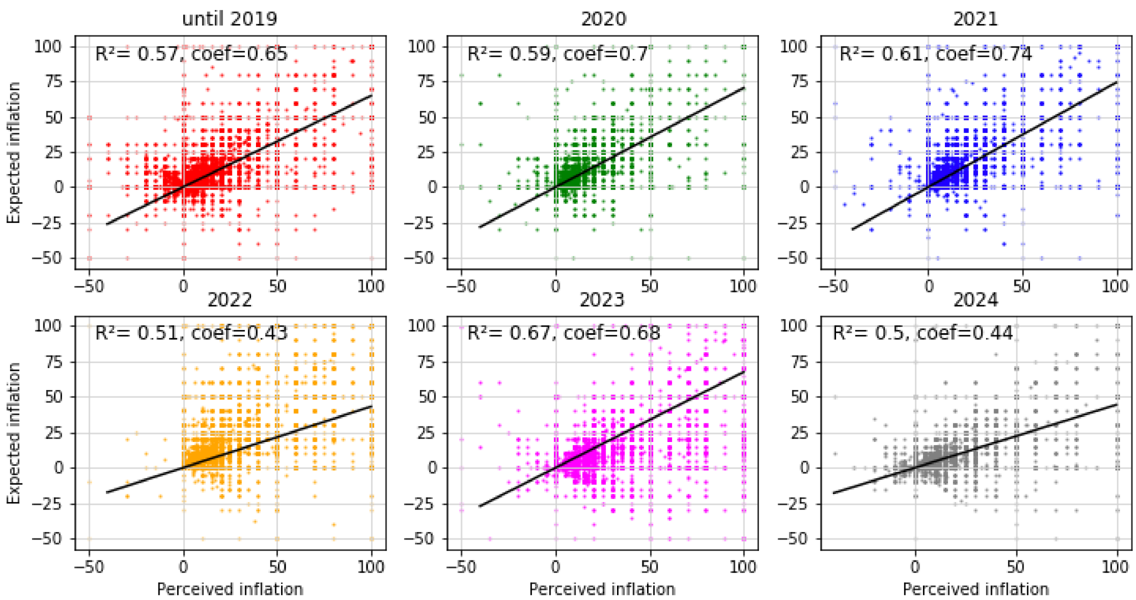
(1) We concluded that inflation expectations are adaptive, and therefore ex ante real rates would rise once inflation falls. We expected inflation would peak soon, as supply shocks were not repeated and inflation momentum was declining.

(2) We observed a sharp decline in household consumption, a contraction in lending and a slowdown in money supply growth (M2).

Expected and perceived inflation are highly correlated

Expected inflation is closely related to perceived inflation, with correlation coefficients ranging from 0.4 to 0.74 in different years.

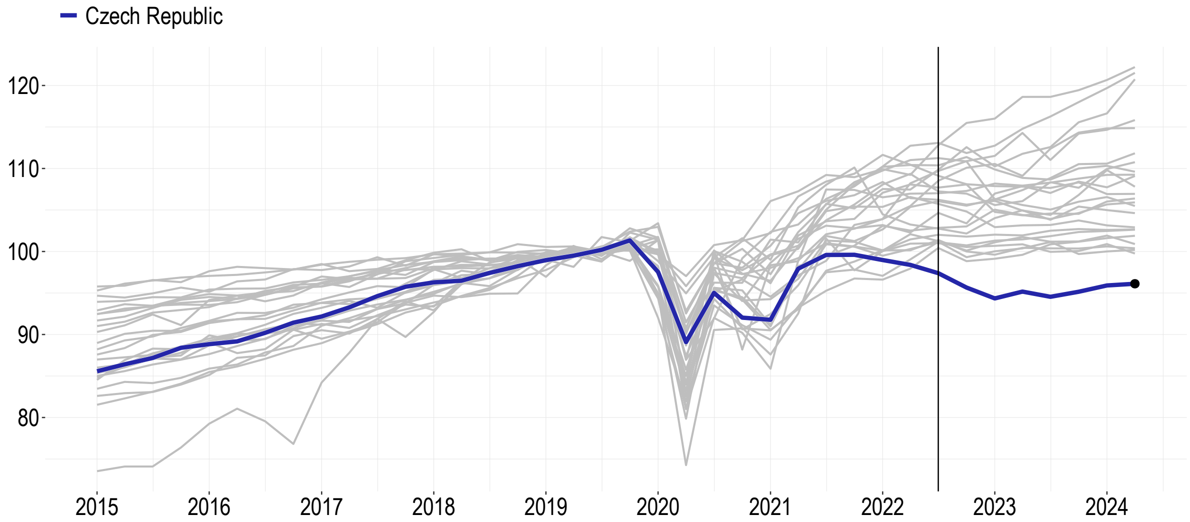
This suggests that inflation expectations were/are adaptive. In addition, they are not a reliable predictor of future inflation.



Consumption was falling despite elevated inflation expectations

We carefully analysed consumption trends, which typically reflect demand pressures in the economy. Despite high inflation expectations, consumption fell sharply.

Household consumption across EU countries
(index, 2019 = 100)



Source: Eurostat

This contradicts economic theory: higher inflation expectations ⇒ people consume more now because they expect prices to rise in the future

Household consumption fell sharply for the following reasons:

- A sharp decline in real disposable income
- High savings rates, influenced by economic uncertainty (precautionary savings) and restrictive monetary policy

Our approach to monetary policy in times of elevated inflation expectations

To summarise our strategy for taming inflation:

We decided to keep nominal interest rates stable at 7% from July 2022 to December 2023.

We focused on maintaining a strong exchange rate (through verbal intervention), which reached an all-time high against the euro in spring 2023, making imports cheaper. In addition, the strong exchange rate tightened monetary conditions for domestic exporters who had taken on loans in euros.

Inflation peaked in October 2022. Inflation expectations also started to fall (due to their adaptive nature) and ex ante real interest rates started to rise, although nominal rates were stable.

Together, positive real interest rates and the exchange rate resulted in the tightest monetary conditions. Lending activity fell sharply and money supply (M2) eased. The monetary overhang disappeared over time.

We also focused on communication:

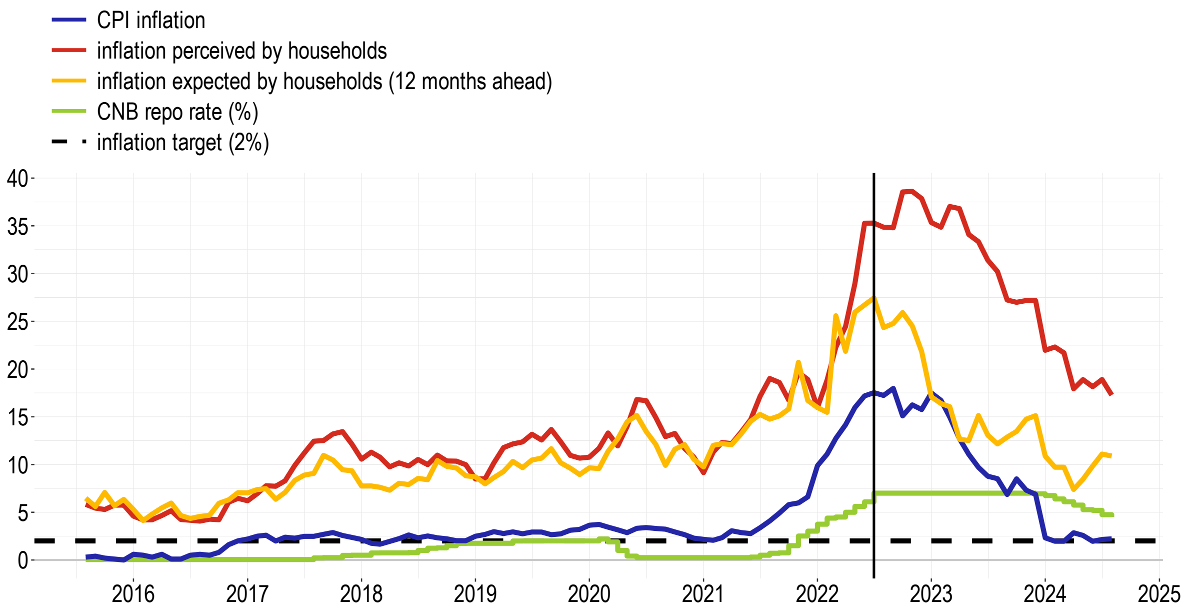
- We emphasised that inflation momentum was declining, although annual inflation was still high[1]

[1] For example, https://www.cnb.cz/en/about_cnb/cnblog/Inflation-is-falling-an-interim-assessment-of-the-disinflation-process-in-the-Czech-Republic/

- We stressed that monetary policy was working and that interest rates would remain high for longer

Our approach to elevated inflation expectations during price stability

After two years, CPI inflation was exactly 2% in February, March and June of this year. It currently stands at 2.2%. At the same time, the inflation expectations of households appear to be elevated (median at 5%, mean at 11%).



Source: Data Collect, Czech Statistical Office

This time, we cannot rely on the two factors dragging down consumption. Real incomes of households are recovering, and economic uncertainty, although still high, has decreased significantly.

Our approach: We have cautiously eased monetary policy from 7% to 4.25% since December. We have been closely monitoring whether these expectations are having an impact on lending activity, consumption and wage negotiations.

So far, the data shows no significant impact on consumption, which is slowly recovering. Wage growth remained elevated at 6.5% in the second quarter of 2024, but appears to be slowing. Lending activity is recovering moderately.

We are taking a careful approach and communicating that markets should expect higher rates in the longer term than in the 10 years prior to Covid.