



Infographic on

INFLATION

Why is what people expect inflation to do so important?

Inflation expectations exert an **important influence** on actual inflation outcomes. A wide

range of decisions made by households, businesses, and investors depends on where they expect inflation will settle over the longer term—generally thought of as a period beyond the next several years. Everything from the prices a business charges and the investment projects it undertakes to an individual's decisions about if and when to buy a house and how much of a raise to ask for can hinge on these expectations.

Inflation?



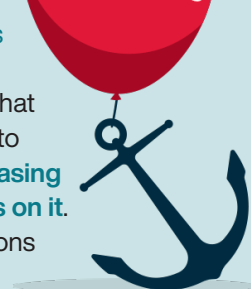
Where is inflation going?

There's a **"self-fulfilling" aspect** to this process. If people act on their beliefs about where inflation is going, they tend to generate outcomes matching those beliefs. **If everyone expects prices to rise by 5 percent** over the next couple of years,

businesses will want to raise prices by 5 percent and workers will ask for similar-sized raises. All else equal, if inflation expectations rise by one percentage point, actual inflation will tend to rise by one percentage point as well. The opposite holds true when inflation expectations decline.

Because of this influence on current inflation, policymakers carefully monitor the movement of inflation expectations. **If long-term inflation expectations are stable** and very **close to a central bank's inflation target**—currently 2 percent for the Federal Reserve—it would indicate that **people** are confident in the Fed's ability to achieve its inflation goal and **likely are basing their economic and financial decisions on it.** In this situation, when inflation expectations are "well-anchored," consumers and businesses are less likely to change those decisions if inflation climbs above that level or below it, making it easier for the Federal Reserve to meet its inflation target.

Inflation Expectations



But if people's long-run inflation expectations were to drift away persistently from the inflation target, then **it becomes harder** and more complicated **for the Fed to meet its inflation objective.**

Despite the importance of inflation expectations, **tracking their movement is challenging** because they **can't be directly observed.** Policymakers must try to **gauge them from surveys and economic models.**

THE BOTTOM LINE

The recent surge in inflation and persistent elevated readings of it have concerned policymakers because of the hardships it has imposed on people and because of the increasing risk that long-run inflation expectations could move higher on a sustained basis. Because these expectations can influence current inflation, policymakers have closely monitored and often cited their movement as they chart a course back to price stability and achievement of the Fed's 2 percent inflation goal.

