

## Expected Inflation

What determines expected inflation?

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## Monetary Theory of Inflation

In the monetary theory of inflation, money growth is the cause of inflation. Fluctuation in the rate of money growth is the primary cause of fluctuation in the rate of inflation.

One expects inflation because one expects money growth. Monetary policy sets money growth in the short run. In the long run, fiscal policy is important for money growth. In the short run a large government deficit can be financed by borrowing, but borrowing must be repaid eventually. In the long run, a large government deficit most likely is financed by printing money, so a large government deficit creates an expectation of long-run money growth.

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## Alternative

An alternative point of view is that there is an independent role for the expectation of inflation, independent of what one expects for money growth. Inflation happens because people expect inflation.

A firm creating a price catalogue for its wares will set higher prices if it expects inflation.

A labor union bargaining for a three-year contract will demand greater pay raises, if it expects inflation. Increased labor costs will cause firms to raise prices, and inflation spreads in the economy (“cost-push inflation”).

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## What Causes an Expectation of Inflation?

Under this alternative, different factors affect the expectation of inflation. An important factor is the business cycle. In a recession, excess production capacity keeps prices from rising. Another important factor is current and past inflation; if prices are or have been rising, then people expect prices to rise even more.

Under this alternative, expected inflation may have little to do with expected money growth.

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## Federal Reserve Policy

An interpretation of Federal Reserve policy is that it sees expected inflation, not expected money growth, as the primary cause of inflation. It wants to avoid inflation, so it is very concerned that people view prices as stable, and it downplays any instance of rising prices. Government policymakers commonly cite figures for the rate of “core inflation,” a nebulous measure of inflation that excludes food and energy price changes. These policymakers argue that food and energy prices are sensitive in the short run to fluctuating shifts in demand and supply, so the changes in these prices should be ignored in forecasting future inflation.

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A cynic might say that the Federal Reserve thinks that it must use deception to prevent inflation. Food and energy prices have risen considerably. If one ignores this increase and looks only at goods that have changed little in price, then there is no inflation, and so there should be no expectation of future inflation.

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## **Interest and Expected Inflation**

A standard point of view is that the expectation of inflation sets the nominal interest rate. The real interest rate is set by fundamental real economic forces. The nominal interest rate equals the rather fixed real rate, plus expected inflation.

The federal government has a huge budget deficit. Since its debt is rising rapidly and is nearing the level of gross domestic product, a policy concern is the market nominal interest rate.

Any rise in the rate will increase the cost of financing the debt, and the budget deficit will jump even higher. To keep expected inflation low is important, to prevent a higher interest rate and higher deficit.