LOSING THE INFLATION ANCHOR
by Ricardo Reis (LSE)

Discussion by
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Response to the COVID crisis: Back to the 1970s?

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- Interest rates at record-low levels
- Massive Quantitative Easing (+ trillions on the Fed’s balance sheet)
- Promise to keep interest rates low until 2023 (forward guidance)
- Assortment of lending facilities
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Too much? Larry Summers: “[new fiscal stimulus will] set off inflationary pressures of a kind we have not seen in a generation.”
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  ▪ Central bankers have a “credibility/inattention” capital

  ▪ Explains compounding of mistakes (little knowledge/measurement of inflation expectations, bad theories, etc.)
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- Watch in households’ inflation expectations
  - The right tail in the cross-sectional distribution
  - Rising disagreement in households’ inflation expectations
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  - Leading indicator: increases in disagreement and mean forecasts may signal rising inflationary pressures
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  - Brazil, 2011-2016
  - Turkey, 2018-…
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Great paper full of insights!
INFLATION EXPECTATIONS: STATE OF KNOWLEDGE

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- Janet Yellen (2016): “Perhaps most importantly, we need to know more about the manner in which inflation expectations are formed and how monetary policy influences them.”
INFLATION “SCARES”

Source: Michigan Survey of Consumers
1970s: high expectations and disagreement
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“False alarms”: inflation scare 1993-94
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Households can confuse relative prices with inflation.
WHAT DRIVES INFLATION EXPECTATIONS AND POLICY RESPONSE

[Graph showing inflation expectations and gasoline price over time]
Transitory vs. persistent shocks to salient prices? Confuse relative price changes with inflation?
MSC tracks gas prices but SPF does not
COVID CRISIS

MSC tracks gas prices but SPF does not... repeat of 2011-2012?

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OR IS SPF MAKING A MISTAKE?

West Texas Intermediate (WTI) crude oil price and NYMEX confidence intervals

Note: Confidence interval derived from options market information for the five trading days ending Aug 5, 2021. Intervals not calculated for months with sparse trading in near-the-money options contracts.

Sources: U.S. Energy Information Administration, Short-Term Energy Outlook, August 2021, CME Group, Bloomberg, L.P., and Refinitiv an LSEG Business
CONCLUDING REMARKS

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  - Much has been learned
  - Many questions (measurement and theory) remain unanswered
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- Are we back to the 1970s? *Enormous uncertainty in the economic outlook*...
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• Are we back to the 1970s? Enormous uncertainty in the economic outlook… but watch for the dynamics of salient prices (gasoline, milk, etc.).