[House Price Expectations and Inflation Expectations: Evidence from Survey Data]

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Recent literature on salience has found that individuals focus disproportionately more on frequently observed prices and large price changes when forming their inflation expectations, even if those items account for low weight in official inflation measurement. Amidst cognitive and informational constraints, it has been observed that households rely on their personal experiences and frequently observed prices, such as groceries and gasoline, to form expectations about inflation. In our work, we find a novel channel through house prices.

The motivation for examining the salience of house prices comes from the observation that house prices have increased dramatically in the years prior to 2007 and have also received extensive media attention, especially since the global financial crisis. The preoccupation of US households with housing markets has always been strong such that it has been noticed that "house price watching has become a national pastime". Houses are typically the largest asset in the household portfolio and are associated with significant wealth and collateral effects. A large majority of the population in the US are homeowners and there is high geographic mobility suggesting that house prices are closely watched.

It is also important to note that the Consumer Price Index (CPI) only accounts for the consumption part of houses, that is, *housing services*, through rents and imputed rents, and not houses as assets. This implies that there is no direct impact of house prices on inflation. But households, as non-specialists, may not be able to make the distinction between the asset aspect of house prices and the price of housing services. They may see house prices changing and gauge signals from that to form their inflation expectations. This could potentially lead to overweighting of house price expectations to overall inflation expectations.

We find that households tend to overweight house price expectations when forming their inflation expectations (relative to a properly defined benchmark). This result is robust across several specifications and two survey data sets for the United States. We also observe a significant effect of the cognitive abilities of households as more sophisticated households overweight house price inflation less.

We model this household behaviour in a two-sector New Keynesian model and examine its monetary policy implications. In this setup, we show that to gauge the correct interest rate response, the central bank needs to be aware that some sectors are overweighted by households and that movements in expected inflation in such sectors are important for monetary policy. Once the central bank takes that into account, it is able to deliver the appropriate nominal interest rate.