[Fiscal Events and Anchored Inflation Expectations]

CFM-DP2024-10

Ethan Ilzetzki

Centre for Economic Policy Research, Centre For Macroeconomics and London School of Economics and Political Science

With inflation surging worldwide, some commentators have speculated whether inflation expectations have become unanchored. This policy note, prepared for the !0th Asian Monetary Policy Forum in May 2023, presents a framework to evaluate whether an inflationary spike is due to temporary shifts in policy or the real economy on one hand, or due to an unanchoring of inflation expectations.

The model is a conventional "textbook" New Keynesian model as in Galí (2015) but accommodates many of the views of unanchored expectations in the existing literature. We review the model's predictions to a variety of conventional shocks, including supply shocks, demand shocks, and a monetary policy shock. As in the conventional model, we assume that while policy shocks are possible, the policy rule remains invariant to these shocks. We then consider less conventional policy shocks that reflect policy regime shifts, including a shock to a higher inflation target—representing a central bank that may have lost its credibility—and a fiscal dominance shock—reflecting a central bank that stands ready to monetize the public debt.

We then take a novel approach, matching the model not to realized macroeconomic data, but rather to real-time asset prices, which reflect financial market expectations of macroeconomic data. These data can then be used to evaluate which of the shocks described are most consistent with financial market expectations.

I find little to suggest that inflation expectations became unanchored in the US, the UK, or Japan, at any point during the inflationary surge of the past few years. Nevertheless, inflation expectations are stubbornly below the central bank's target in Japan, and above the target in the UK. Instead, US data is most consistent with a delayed monetary policy response to inflationary supply (e.g. global energy prices) shocks, possibly exacerbated by expansionary demand shocks (e.g. the American Rescue Plan). Asset prices following UK mini-budget for 2022 shows little signs of fiscal dominance and are most consistent with expectations that the Bank of England would respond aggressively to the strong demand induced by the budget, pushing against supply constraints due to the war in Ukraine.

In contrast, inflation expectations show substantial signs of unanchoring in some emerging market economies, particularly Brazil and Turkey. The Brazilian inflationary surge was likely caused by highly expansionary fiscal policy during Covid-19 exacerbated by global inflationary pressures. But asset prices indicate market expectations of fiscal dominance. This is despite the fact that the Central Bank of Brazil raised interest rates earlier and more aggressively than most countries. Yet, inflation expectations have been stubbornly high and the combined asset price movements indicate concerns that the debt may be monetised.