Why did inflation rise and fall in 2021-24? Channels and evidence from expectations

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This article uses inflation expectations to investigate the mechanisms that linked supply and demand shocks to inflation outcomes during 2021-24. It describes several theoretical mechanisms through which shocks led to inflation, highlighting the role of expectations in this process. It uses multiple sources of expectations data for the US, EA, and UK to evaluate each of these channels. Finally, it surveys the literature that has used expectations data to make sense of the 2021-24 inflation surge. The article applies the results from this investigation to assess how well anchored inflation expectations were during the surge and at the end of it.

Each section in this paper uses a different type of expectations data for the US, EA, and UK to clarify the mechanisms and the role of policy in the inflation surge of 2021-24. In each of the sections, I start by sketching the theory behind the mechanisms. I then present some original empirical work, which is inspired by the literature that looked directly at particular features of inflation expectations during this period. After presenting the main findings using some simple statistics, I survey the papers that have established the facts more thoroughly. I find that the expectations data indeed speak quite decisively about which mechanisms transmitted the shocks to inflation. I conclude each section by asking whether inflation expectations were anchored during 2021-24, and whether they are anchored now. Unsurprisingly, that answer is invariably: “it depends”, but what it depends on is useful.

Section 2 starts with inflation expectations for long horizons provided by financial markets. These are particularly useful to test Fisherian (or monetarist) mechanisms that emphasize the credibility of the central bank’s inflation target. Surveys of professionals working in financial institutions complement them. Section 3 turns to survey data from households and firms at 1-year horizons, with which to test Phillips curve channels that rely on the pricing behavior of workers and firms. Section 4 then uses the expectations from institutional forecasts to look for the extent to which the inflation surge was fiscally-driven. Finally, section 5 uses the expectations of policymakers to reveal their preferences and justify their actions. Section 6 concludes by collecting the facts and stating the answers to the question of whether inflation expectations were and are anchored.