Inflation expectations

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The current inflation rate is 8.3 percent, which brings two questions to my mind.

First, is inflation too high? That was the easy question. Just about everyone thinks it is, and the Federal Reserve is even on record saying that it believes the inflation rate should be 2 percent. The second question is tougher to answer. It is: how long will inflation remain above 2 percent? No one knows for sure and opinions vary widely. While economists can't answer this question, they do know what is necessary for inflation to start moving toward the Fed's 2 percent goal. Economists recognize that inflation won't come down until people believe that it will. Or put another way, people's expectations will be self-fulfilling.

To understand why our expectations matter, consider Mac's plight. Mac isn't happy with the 8.3 percent inflation rate. This inflation rate means that prices are going up, on average, by 8.3 percent a year. Since Mac's income remained constant over the last year, he could buy fewer goods and services today than he could a year ago. In fact, Mac would be indifferent between this current scenario and a hypothetical scenario. In the hypothetical scenario, prices remained constant and his salary decreased by 8.3 percent. Either way Mac would have 8.3 percent less purchasing power.

So in Mac's mind, the 8.3 percent inflation rate is like an 8.3 percent pay cut. As you can imagine, Mac does not want to take a pay cut. He does good work and thinks he should be getting a raise, not suffering through inflation that has the same effect on him as a pay cut would. Mac can remedy this bad outcome. He can ask for an 8.3 percent raise to compensate him for having to pay higher prices.

If Mac's firm has to pay Mac a higher salary, its cost of producing its product will increase by just a little bit. But if all of Mac's coworkers also demand and get an 8.3 percent raise, Mac's company will see their costs increase substantially. Then, the firm will have to find a way to pay for these higher labor costs. Most likely, Mac's company will increase its prices to generate additional revenue to pay its workers higher salaries.

When Mac's company increases its prices, the average price level will go up a little bit. But this story does not end with Mac's company. Many other companies (perhaps even most companies) will have disgruntled workers. These workers will demand an 8.3 percent raise to offset the negative effect inflation had of their purchasing power. All of these companies will be faced with the same dilemma that Mac's company faced. They will have higher labor costs, which they will respond to by increasing their prices. Now, with most companies increasing their prices, the average price level will rise again, causing inflation.

This new round of inflation is just part of a cycle: inflation is high, workers expect that it will remain high so they demand higher wages; these high wages push up firms' costs; firms respond by raising their prices, causing workers to demand even higher wages and the cycle continues.

The Federal Reserve is actively trying to bring down inflation. If people believe the Federal Reserve is serious and if they believe the inflation rate won't be high in the future, these people won't demand higher wages to compensate them for having to spend their income on goods with rapidly increasing prices. In this case, the Fed would have adopted a policy that lowered the rate of expected inflation. This outcome would be good news. The expectations-induced cycle of high inflation rates would be broken and inflation would move closer to its target level. Let's hope the Fed is successful in changing inflation expectations.