Seven reasons why high inflation could be here to stay

- Central banks and many other forecasters may be underestimating the risk of persistently high inflation. While our view is that inflation is likely to recede next year, the outlook is highly uncertain, with evidence underscoring the risk of a more gradual slowing. Inflation expectations appear weakly anchored and public support for central banks patchy. Sluggish past disinflations add to the reasons why inflation could stay elevated.

- The longer inflation stays high, the more embedded it is likely to become. Surveys point to growing public awareness of price rises, accompanied by a perception that inflation is at record levels. With some signs of passthrough to both workers’ desire for higher pay and businesses’ wage and price setting, the risk of a wage-price spiral appears to be increasing.

- Polls like our own Global Risk Survey of businesses show near-term inflationary pressures feeding through to the level of inflation expected further ahead. Medium-term inflation expectations have tended to rise significantly since the pandemic began, albeit to varying degrees across countries. In many cases, a high probability is now attached to inflation remaining high (Chart 1).

- The idea that the low inflation of recent decades reflects central bank credibility appears misplaced. Surveys show many people to be either unaware of the objectives of central banks or doubtful over their ability to meet inflation targets. More worryingly, appetite for low inflation – and the painful measures required to bring inflation down – also seems relatively limited.

- Central bank confidence in the return of inflation to target could reflect excessive weight being placed on the low inflation experience of recent decades. Bank of England estimates imply less than a 1-in-20 chance of 4%+ inflation in the UK in the medium term; as our modelling illustrates, earlier periods point to a far greater chance of persistently high inflation.

Chart 1: Households and businesses see a substantial risk of persistently high inflation

![Chart showing estimated likelihood of 4%+ inflation in the medium term](chart.png)

*A minimum of 3-years ahead. Two US household measures are shown. Probability <5% for ‘Central bank (UK)’.  
5%+ unit cost inflation for ‘Businesses (US)’. As of June for ‘Markets’. See box for full details.
1. The public are increasingly aware that inflation is high

The inflationary period of the 1970s is often attributed to a structural change in people's perceptions and attitudes to inflation. Former Fed Chair Yellen describes the emergence of an inflationary psychology in which a rise in inflation led people to revise up their expectations for future inflation, causing actual and expected inflation to ratchet higher over time. There are some signs of a similar shift now.

One indication is the attention people pay to inflation. Research highlights thresholds: at inflation rates below certain thresholds people may (rationally) pay little attention to price developments; at higher inflation rates, they are likely to be much more attentive. In general, inflation currently lies well above thresholds estimated in recent research (Chart 2).

Chart 2: Inflation currently lies well above estimates of attention thresholds

Consistent with increased attention, consumer awareness of news about higher prices appears to have risen sharply. Based on the University of Michigan's Survey of Consumers, inflation awareness in the US is now even higher than in the late-1970s (Chart 3).

Chart 3: US consumers’ awareness of news about higher prices is exceptionally high

Increased attention is also evident in the language we use. Google searches for the term “inflation” have risen dramatically this year (Chart 4). This is comparable to experience in the 1970s; as documented by Shiller (2022), a “wage-price spiral narrative” took hold at that time and inflation-related language in books became increasingly common.
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Chart 4: As in the 1970s, inflation-related language has become much more common

The result is a sharp increase in the level of inflation that people perceive. Strikingly, in a survey of the US public in April/May, more than half of the respondents judged that inflation was higher than at any time since World War II (Chart 5).

Chart 5: Many Americans think inflation is at a record level

True or false: Inflation is higher now than at any time since World War II

Source: Oxford Economics/Google/Ha, Kose, Ohnsorge (2021) *From 2004 for Google searches. Final data point is latest for 2022; other data are annual.

2. Many expect inflation to stay high

In June, Federal Reserve Bank of St. Louis President Bullard argued that “the current U.S. macroeconomic situation is straining the Fed’s credibility with respect to its inflation target.” This is borne out by direct evidence on the degree to which inflation expectations are anchored.

Medium-term expectations have deviated substantially from target

The most obvious indication of how well inflation expectations are anchored is how closely they align with the central bank’s inflation target – a test highlighted in the past by former Fed Chair Bernanke, among others. In general, central expectations for inflation in the medium term lie well above target, especially among households and businesses (Chart 6). To varying degrees across countries, the deviation from target has tended to increase significantly since the pandemic began.

**Chart 6: Most measures suggest medium-term inflation expectations are well above target**

Source: Oxford Economics/Bank of England/ECB/Federal Reserve/Haver Analytics/University of Michigan  *A minimum of 3-years ahead. Chart includes two alternative US household measures. 5%+ unit cost inflation for ‘Businesses (US)’. For ‘Markets’, note possible distortion due to recent market illiquidity and UK relates to RPI inflation. See box for full details.

Central bank views suggest contained medium-term inflation, however. For the US, participants at the September FOMC meeting judged that overall inflation would be back to 2% by 2025, although a majority thought core inflation was most likely to still lie slightly above target in 2025. In the UK, the Bank of England’s August projections in August – conditioned on market interest rates – pointed to very subdued inflation in three years’ time, comfortably below 1%.

**Inflation views are more polarised**

Disagreement among forecasters can provide an early steer on the extent to which inflation expectations are shifting. Whereas different forms of informational rigidities can result in a delayed response of mean forecasts to macroeconomic shocks, disagreement about the central outlook for inflation would be expected to rise if, for example, some have updated their views more recently than others to take into account the latest developments.

Surveys point to heightened disagreement, especially among households. In the US, consumers’ views are especially polarised: a high proportion anticipate deflation in the medium term, but even more expect 4%+ inflation (Chart 7). The UK has also seen a marked increase in polarisation of the public’s views about the outlook for inflation since the start of the pandemic. In the case of the eurozone, analysis suggests substantial heterogeneity, both across countries and across individuals.
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Chart 7: Views about the medium-term outlook for inflation are highly polarised


Overall inflation uncertainty is high

If longer-term inflation expectations were anchored, we would also expect investors to be confident about the inflation outlook (Candia et al., 2022). But recent research (Hilscher, Raviv and Reis, 2022) highlights a surge since the pandemic in the market-implied probability of 4%+ inflation five to 10 years ahead, particularly for the US (Chart 8). At the same time, the estimated likelihood of deflation has fallen, dramatically in the case of the eurozone.

Chart 8: Investors see an increased chance of elevated medium-term inflation


Businesses surveyed in our Global Risk Surveys have become more uncertain about the inflation outlook, as well (as shown by the widening of the distribution in Chart 9). They now see a 1-in-4 chance of 4%+ inflation in the medium term. Country-level evidence on firms’ own pricing (e.g., for the US and UK) paints a similar picture of heightened uncertainty.
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Chart 9: Businesses see a 1-in-4 chance of 4%+ world inflation in the medium term

Source: Oxford Economics *Histograms show perceived probability of different outcomes in Global Risk Surveys (Q3 2021 and preliminary results for Q4 2022). These are overlaid with illustrative, normally distributed curves, based on mean and variance of survey responses.

Consumer surveys are consistent. Uncertainty among US households has risen sharply since the pandemic began, with risks increasingly perceived as to the upside. Meanwhile, around half of the UK public reports that they are not confident that inflation will be “close” to the 2% target – specified as between 1% and 3% – in two to three years' time (Chart 10).

Chart 10: The UK public are very uncertain over prospects for inflation in the medium term

Source: Oxford Economics/Bank of England Public Attitudes to Inflation survey *Inflation between 1% and 3%.
3. The longer inflation stays high, the more embedded it is likely to become

The sensitivity of medium-term inflation expectations to near-term developments is another common test of anchoring in the literature. In the US, for example, Candia, Coibion and Gorodnichenko (2021) highlight a strong positive correlation between revisions to near-term and longer-term expectations (Chart 11), as well as high levels of business disagreement and individual uncertainty over the inflation outlook.

Chart 11: Expected inflation in the long term appears sensitive to near-term expectations

Our own Global Risk Survey bears this out. Around two-thirds of businesses report revising up over the past year their expectations for inflation over the medium term. Of those, 97% had also revised up their expectations for inflation in 2023 (Chart 12).

Chart 12: Most businesses have revised up both near- and medium-term inflation expectations

Source: Oxford Economics Global Risk Survey (preliminary Q4 2022 survey results) *Figures and size of bubble indicate proportion of respondents.

Given the past co-movement with near-term inflation expectations, medium-term inflation expectations might be expected to decline as near-term inflationary pressures abate. This would be consistent with evidence from professional forecasters' longer-term inflation expectations, at least during the low inflation environment of recent decades. But as described in the Annex, experience from past disinflations highlight...
the risk that inflation expectations could remain elevated for a rather longer period and result in a more sluggish decline of inflation.

4. Workers want higher pay, risking a wage-price spiral

Research at central banks has highlighted in the past an important role for actual inflation and near-term and longer-term inflation expectations to drive wage growth (e.g., US, UK). This is borne out by, for example, detailed surveys in which a sizeable proportion of US households and business managers reported in late-2021 that the increase in inflation would affect their wage bargaining (Chart 13).

This has important implications for price setting. Evidence from the ECB suggests that passthrough from wages to prices is systematically high in periods of high inflation compared with periods of low inflation. Accordingly, many managers have also reported impacts from higher inflation on their price-setting (Chart 13), in line with earlier Italian experimental evidence on the effect of higher inflation expectations on firms’ price setting.

Chart 13: Surveys point to higher inflation passing through to wage and price setting

Impact of high inflation on wage-setting and price-setting

While the upwards pressure on wages and prices would be expected to ease as the macroeconomic backdrop weakens and labour market slack increases, there are risks to the pace at which this happens. One risk relates to how consumers’ expectations adjust in the face of recession. Research highlights a tendency – perhaps related to an association of high inflation with lower standards of living – for US and eurozone consumers to connect weaker growth or rising joblessness with higher, rather than lower, future inflation.

The higher interest rate environment might not help, either. Studies suggest that US households on average believe a rise in central bank’s policy rates would increase inflation. The evidence is more mixed for the UK. But even so, over the history of the Bank of England’s Inflation Attitudes Survey, there has never been a majority believing that higher interest rates would make prices in the high street rise more slowly, either in the near term or over the medium term.

5. The public are largely unaware of central bank targets

Limited knowledge of central bank goals is well-documented and borne out by recent evidence. In an Ipsos survey of the American population earlier this year, only around a third of respondents (34%) were aware that the Federal Reserve is tasked with stabilising prices.

More surprising is the lack of awareness among certain segments of the population, such as CEOs. In a US poll last year, only around a quarter of US CEOs identified that the inflation target lies between 1.5% and 2.5% (Chart 14). Of those who provided an answer, a majority thought the Fed was trying to achieve a higher rate of inflation.
6. Faith in the ability of central banks is limited

People's overall trust in central banks fell in the aftermath of the global financial crisis and, in Europe, the eurozone crisis. The EC’s regular Eurobarometer surveys found that net trust in the ECB – those tending to trust minus those tending not to trust – fell by around 50ppts over this period. Despite some recovery since then, trust remains at moderate or low levels in many of the largest eurozone economies (Chart 15). Similarly, in the US, slightly less than half of the US public (49%) judges that the Federal Reserve makes decisions that are in the best interests of the average American.

Chart 15: Public trust in central banks is limited in many countries

Source: Oxford Economics/EC Eurobarometer survey

The fragility of people’s faith in central banks is important. Evidence suggests that those with more negative views of their central bank are less receptive to its messages, with their medium-term inflation expectations less strongly anchored and less in line with the inflation target.

7. There is a lack of support for low inflation

Support for current inflation targets may be limited, as well. In the Bank of England’s own Public Attitudes to Inflation survey, only 36% of respondents agree with the current UK target (Chart 16). More people think the inflation target is too low than at any time since the global financial crisis.
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Chart 16: Those agreeing with the current UK inflation target are in a minority

<table>
<thead>
<tr>
<th>Public agreement with the UK inflation target</th>
<th>% believing that the target is &quot;about right&quot;</th>
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</thead>
<tbody>
<tr>
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</tr>
<tr>
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</tr>
<tr>
<td>2022</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Oxford Economics/Bank of England Public Attitudes to Inflation survey

Importantly, support for tighter monetary policy does not appear especially high either. For the US, a CNBC survey this month found that more people think it is important “to protect jobs, even if costs continue to rise” than “slow cost increases, even if unemployment rises”, while a Harris poll suggested the public were evenly split. In the UK, only a minority (30%) of respondents to the Public Attitudes to Inflation survey judge that a rise in interest rates would be best for the British economy; half the respondents favour rates being cut or staying at their current level.

This is problematic. Our previous research highlighted a broad decline in the effectiveness of policy rates among advanced economies over recent decades. Should that remain the case, painfully tight monetary policy might be required for central banks to bring inflation all the way back to target. Public support for such a policy appears limited.

Annex: Lessons from past disinflations

Comparisons of the current high inflation episode with previous episodes is complicated by statistical methodological changes. For the US, Bolhuis, Cramer & Summers (2022) note that, prior to 1983, the measurement of shelter inflation was mechanically responsive to Fed interest rate policy. This exaggerates both the scale of the initial pickup in inflation and the subsequent decline in earlier episodes.

When calculated on a consistent basis, the disinflation required to return US inflation to 2% from its current high rates is more comparable to the painful disinflation that took place in the Volcker era (Chart 17).

Chart 17: The disinflation required today is comparable to major historical episodes

Source: Oxford Economics/Bolhuis, Cramer & Summers (2022) *To return to 2% from peak.
Disinflations can be gradual

The Volcker experience highlights the risk of only a very gradual disinflation. Following the great inflation of the 1970s, US inflation declined relatively gradually from its 1980 peak. Consumers’ inflation expectations were also slow to adjust: the mean expectation for inflation 5-10 years ahead remained above 5% throughout the first half of the 1980s (Chart 18). If anything, the decline in inflation expectations was even more gradual for professional forecasters.

Chart 18: Inflation expectations eased gradually during the Volcker disinflation

![Chart showing gradual decline in inflation expectations](image)

Source: Oxford Economics/University of Michigan Survey of Consumers *Mean perceived outlook for prices over the next 5 to 10 years.

Central banks may be slow to recognise new inflation regimes

The Bank of England’s latest projections imply a minimal chance of high inflation in the medium term. Based on market interest rates, the central bank’s latest estimates (published in August) imply only a 1-in-10 chance of UK inflation being above 3% in three years’ time; the estimated likelihood of 4%+ inflation is less than 1-in-20 (Chart 1).

Experience prior to the low inflation of recent decades points to a greater risk. In H2 1973 and H1 1974, for example, Federal Reserve staff forecasts repeatedly assumed that near-term price pressures would soon abate and inflation would fall back to earlier levels (Chart 19). Ultimately, US inflation didn’t fall back below 5% until 1982.

Chart 19: Fed staff forecasts during 1973/1974 assumed high inflation would be temporary

![Chart showing evolution of Federal Reserve Greenbook inflation forecasts in 1973/74](image)

Source: Oxford Economics/Federal Reserve *Annualised quarterly GNP inflation.
Box: Alternative measures of inflation expectations

This briefing features a wide range of measures of inflation expectations, reflecting the views of households, businesses, investors, professional forecasters, and central banks. Further details on the measures are provided below.

Chart 1


Households (US, b): Expected inflation during the next five to 10 years, from the Michigan Survey of Consumers. As of August 2022.

Households (UK): Prices in shops in the longer term ("say in five years' time"), from Bank of England/Ipsos Inflation Attitudes Survey, August 2022. Excludes “don’t knows”.

Businesses (World): Medium-term world inflation, based on preliminary results in the Q4 2022 Global Risk Survey, conducted during October.

Businesses (US): Probability of unit costs up very significantly (>5%) per year over the next 5-10 years, from the Atlanta Fed Business Inflation Expectations survey. As of September 2022.

Markets: Average inflation in 5-10 years' time, from Hilscher, Raviv & Reis (2022). As of June 2022.

Professional forecasters (Eurozone): Eurozone longer-term inflation expectations, from the ECB’s Survey of Professional Forecasters. As of July 2022 (Q3 2022 survey).

Central banks (UK): Three-year ahead Bank of England estimate for the UK, based on market interest rate expectations. Estimated probability less than 5%. As of August 2022.

History: Estimated probability of moving from low inflation regime to high inflation regime. See earlier briefing.

Chart 6


Households (US, b): Expected inflation during the next five to 10 years, mean measure, from the Michigan Survey of Consumers. Latest is August 2022. Jan 2020 for ‘Prior to pandemic’.


Households (UK): Prices in shops in the longer term ("say in five years' time"), median measure, from Bank of England/Ipsos Inflation Attitudes Survey. Latest is August 2022. Feb 2020 for “Prior to pandemic”.

Businesses (US): Average unit cost change over the next 5-10 years, from the Atlanta Fed Business Inflation Expectations survey. Latest is September 2022. Dec 2019 for ‘Prior to pandemic’.


Markets: Five-year, five-year forward inflation rate. RPI measure for UK. Latest is 19 Oct 2022; note possible distortion due to recent market illiquidity. 6 Jan 2020 for ‘Prior to pandemic’.


Professional forecasters (Eurozone): Eurozone longer-term inflation expectations, from the ECB’s Survey of Professional Forecasters. Latest is July 2022 (Q3 2022 survey). Jan 2020 (Q1 2020 survey) for “Prior to pandemic”.

Page 12 Jamie Thompson - jthompson@oxfordeconomics.com
Central banks (US): Percentage rates of change in the price index for personal consumption expenditures in the longer run. Latest is September 2022. December 2019 for “Prior to pandemic”.


<table>
<thead>
<tr>
<th>Country</th>
<th>Source</th>
<th>Description</th>
<th>Latest</th>
<th>Prior to Pandemic</th>
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<tbody>
<tr>
<td>US</td>
<td>Central banks</td>
<td>Percentage rates of change in the price index for personal consumption expenditures in the longer run. Latest is September 2022. December 2019 for “Prior to pandemic”.</td>
<td>September 2022</td>
<td>December 2019</td>
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