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INNOVATIONS IN WORLD-WIDE EXPERT SURVEY ‘IFO WORLD ECONOMIC SURVEY’ – NEW QUESTION ON MEDIUM-TERM INFLATION EXPECTATIONS

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In light of growing concerns about deflation in the euro area and amid debate over the present anchoring of inflation expectations, the Ifo Institute decided to extend the inflation-related questions in its worldwide expert survey ‘Ifo World Economic Survey’ (WES) last year. The quantitative question on the expected inflation rate in the current year and the qualitative question on the likely development in the next six months, which have both been asked since 1991 on a quarterly basis, were complemented as of the 4th quarter of 2014 by an additional quantitative question on the expected inflation rate in three to five years. The results of this question, which – like all other questions in the WES – refers to the country in which the experts surveyed are located, are published as individual data on countries, as well as aggregated data for important economic areas (like the euro area). This study aims to present the first results of the newly introduced question.

New question on medium-term inflation expectations in the Ifo World Economic Survey

Since 1981 the objective of the Ifo World Economic Survey (WES) has been to draw as accurate a picture as possible of the current economic situation and outlook in around 120 industrial, emerging and transformation countries. The 1,100 survey participants work for research institutes, universities, think tanks or financial institutions like banks or insurance compa-

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nies. Some respondents are affiliated to (industrial) companies or are representatives of associations or chambers of industry or trade. The WES panel is highly heterogeneous in terms of the institutions that its experts are affiliated to. However, this heterogeneity, combined with widespread economic monitoring in a large number of countries, gives the WES results a certain added value compared to other business and expert surveys, which are either more homogenous in terms of the participating experts (due to the fact that only financial analysts are surveyed, for example) or because the focus lies only on certain countries or aggregated data for economic areas (like the euro area, for instance).

Very few surveys on medium-term inflation expectations have been launched to date. Since 1999, the Survey of Professional Forecasters (SPF) of the European Central Bank (ECB) asks quarterly for a point forecast of inflation over specific time horizons. This survey offers no data on individual member countries, but only for the euro area as a whole. The survey participants are similar to WES, as they include experts from both financial and non-financial institutions. On average, the survey receives 58 responses, of which mean, median and a frequency distribution of the point forecasts are published. Consensus Economics also publishes a survey-based indicator of inflation expectations. The survey respondents are prominent financial and economic forecasters. The survey is conducted on a monthly; however long-term forecasts are only available as special surveys on a bi-annual basis in April and October respectively. The content of these surveys are point forecasts on inflation for individual countries, but also for the euro area as a whole for several time horizons (current year, as well as five-year horizons). Unlike the SPF, Consensus provides an additional time horizon after the fifth year as a long-term projection for the 6–10 year period average. The number of institutions polled varies across countries and ranges from 14 to 30. The Consensus survey covers about 85 nations in industrialised countries, Eastern Europe, Asia Pacific and Latin America. However, these data are difficult to access. As far as data providers like Reuters’ Datastream is concerned,



an additional fee-based subscription is necessary to obtain detailed data.

This overview highlights the need for additional survey-based indicators for medium-term inflation dynamics: 1) for a wider range of countries, 2) on a higher frequency and 3) available to a wider public. With a very broad-based expert panel, which includes all Eurozone countries and covers all regions of the world, the Ifo Institute hopes to be able to successfully fill this gap and to provide added value to the existing survey-based indicators for medium-term inflation expectations.

The relevance of medium-term inflation expectations

Interest in the quantification of medium-term inflation expectations has increased significantly over the past two decades. One of the reasons for this might be the decision of many central banks worldwide to focus their monetary policy on price stability, the so-called inflation targeting framework. The idea of this strategy is to make public the objective of monetary policy by defining a definite target value for the inflation rate. The Bank of New Zealand, which already concentrated its mandate to achieve a quantitative inflation target in 1990, is one of the pioneers of such inflation targeting. Canada successfully implemented this strategy one year later; while Britain, Sweden and Finland followed suit in 1992 and Spain in 1994. The European Central Bank has also oriented its monetary policy towards the objective of price stability since the beginning of its activity in 1999. The ECB's Governing Council sees such stability as guaranteed if the increase in consumer prices is below, but close to 2 percent. In the United States and in Japan public announcements of a definite target for the inflation rate were first introduced in the years after the recent world financial crisis. According to an overview of the web-based platform 'Central Bank News' (<http://www.centralbanknews.info/>), central banks in 55 countries or monetary areas (EMU, West African Economic and Monetary Union) are currently pursuing inflation targeting frameworks.

Besides an orientation of monetary policy towards a definite target for inflation, an additional element of the inflation targeting frameworks is the notion that inflation does not need to be held at the target rate at each point in time, but that short-term deviations are in line with the central bank's mandate. The idea be-

hind this is that central banks are simply unable to encounter unexpected changes in the level of consumer prices, which might for example be caused by sudden changes in commodity prices. For this reason, many central banks define a ± 1.0 percentage target range, within which the inflation rate is allowed to float. Others, like the ECB or the Bank of England for example, limit their monetary policy to a definite target value, but explicitly state that this target has to be achieved only within a certain time horizon, due to the fact that monetary measures have a lagging effect.¹ The ECB, in particular, highlights, that its mandate consists of achieving an increase in consumer prices in the European Monetary Union of below, but close to 2 percent, over the medium term (European Central Bank 2011). What is not clear is how long the medium term actually is in the central bank's view.

In light of this medium-term element of the inflation target, the evaluation of central bank's monetary policy is carried out by using medium-term inflation expectations. They serve as an indicator of the credibility of a central bank's inflation target. By studying the ECB's bulletins, the most likely definition of a medium-term time horizon is consistent with a five-year horizon. In its communications, for example, the ECB emphasises the inflation expectations in five years, which are part of its own Survey of Professional Forecasters (European Central Bank 2012). As long as the expectations of economic agents are well anchored at the value of the inflation target, the inflation target is implicitly included as an expected price increase in the setting of perennial nominal contracts (wage, rental or credit agreements). The more such contracts are concluded, the higher the probability that the inflation rate in the medium-term indeed meets the inflation target. Should inflation expectations be out of line with the central bank's target over longer periods of time, nominal contracts would be adjusted accordingly and the realised inflation rate would move away from this target. The central bank would have to react with rigorous and probably costly measures to this kind of de-anchoring process to regain its credibility.

¹ The Bank of England states on its website: "a target of 2 percent does not mean that inflation will be held at this rate constantly. That would be neither possible nor desirable. Interest rates would be changing all the time, and by large amounts, causing unnecessary uncertainty and volatility in the economy. Even then it would not be possible to keep inflation at 2 percent in each and every month. Instead, the MPC's [Monetary Policy Council's] aim is to set interest rates so that inflation can be brought back to target within a reasonable time period without creating undue instability in the economy" – see <http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx>.

Selected results of medium-term inflation expectations

In the Ifo World Economic Survey of the 4th quarter 2014 experts were asked for the first time about their medium-term inflation expectations. The question, mainly answered by the experts in the first two weeks of the first month in the respective quarter, is as follows: “The expected rate of inflation in 3 to 5 years will be _ percent”.² The country results (mean, median, number (N) of respondents for each country, minimum and maximum, as well as standard deviation) of the medium-term inflation expectations of both surveys can be found in Table 1. The euro area aggregate was calculated as a weighted average by using the share of foreign trade in the total world trade, as usual in the WES.

Medium-term inflation expectations for individual countries in the euro area are very heterogeneous and range from just above 1 percent in Greece, Cyprus and Portugal to way over 2 percent in the Baltic States in the most recent survey. On average, experts expect the inflation rate to be 1.6 percent in the euro

area in the years 2018 to 2020 and thus broadly in the target objective of the European Central Bank of below, but close to 2 percent. In short, future price increases will be lower in the euro crisis’ most afflicted countries than in the core and in Eastern European member countries. These different inflation dynamics make an important contribution to restoring the relative price competitiveness within the currency union.

Out of the 250 experts’ responses in euro member countries, a frequency distribution for the expected inflation rate in the euro area can be constructed. In a first step, a relative frequency distribution for each member country is generated. In a second step, this distribution is weighted with the respective share of foreign trade, which, in a last step, is aggregated to a frequency distribution for the euro area. On the one hand, this procedure provides information on the uncertainty of survey participants with regard to future inflation rates. The wider (or flatter) the distribution, the more widespread the average deviation of the responses from the average expected inflation rate (1.6 percent) and thus the more hesitant experts are about the rates in three to five years. The degree of this uncertainty is the standard deviation of the distribu-

² To ensure a better comparability with other surveys, the observed time horizon will be five years as of the 2nd quarter 2015: “The expected rate of inflation in 5 years will be _ percent”.

Table 1

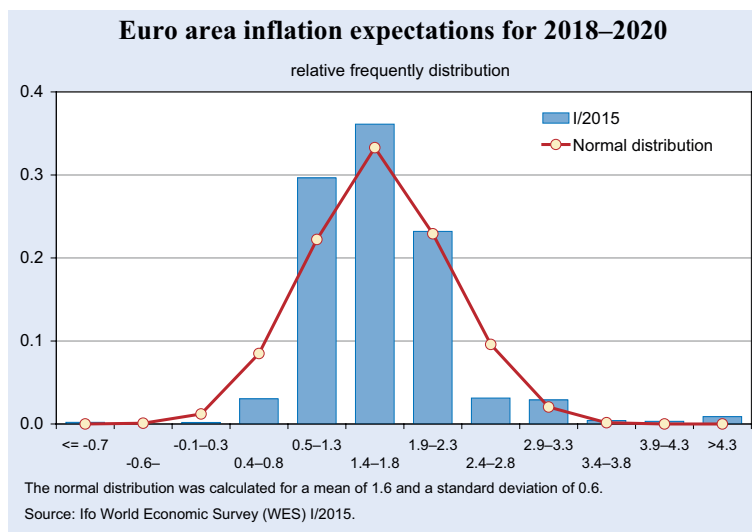
Medium-term inflation expectations for selected countries in %

	Mean		Median		N (Number)		Min		Max		Standard deviation	
	IV/14	I/15	IV/14	I/15	IV/14	I/15	IV/14	I/15	IV/14	I/15	IV/14	I/15
Austria	1.8	1.8	1.9	1.8	16	13	0.9	1.5	2.6	2.5	0.4	0.3
Belgium	1.5	1.4	1.5	1.3	17	18	0.5	0.5	2.0	2.0	0.5	0.5
Cyprus	1.3	1.3	1.3	1.3	2	2	1.0	1.0	1.5	1.5	0.4	0.4
Estonia	2.4	3.3	2.4	3.3	2	2	1.7	3.0	3.0	3.5	0.9	0.4
Finland	1.6	1.5	1.6	1.5	23	22	0.6	0.2	2.5	2.0	0.4	0.4
France	1.4	1.4	1.3	1.0	14	12	0.8	0.8	2.5	3.0	0.5	0.7
Germany	1.8	1.7	1.8	1.5	48	43	0.5	1.0	5.0	5.0	0.6	0.6
Greece	1.5	1.2	2.0	1.1	11	11	-1.0	-1.0	3.0	2.0	1.1	0.9
Ireland	1.4	1.7	1.5	2.0	4	3	1.0	1.2	1.6	2.0	0.3	0.5
Italy	1.5	1.4	1.5	1.2	21	17	0.7	0.6	3.0	2.5	0.7	0.5
Latvia	2.9	2.6	2.3	2.3	13	12	2.0	1.0	6.0	7.0	1.2	1.6
Lithuania	2.2	2.6	2.0	3.0	7	6	1.0	1.5	3.5	3.0	1.0	0.7
Luxembourg	1.9	1.9	2.0	1.8	4	4	1.5	1.5	2.0	2.4	0.2	0.4
Netherlands	1.8	1.6	2.0	1.5	16	18	1.5	1.0	2.0	2.0	0.3	0.4
Portugal	0.9	1.3	1.0	1.5	12	15	-0.5	-1.0	1.8	2.0	0.7	0.8
Slovakia	2.2	2.2	2.0	2.0	12	12	1.0	1.5	5.0	5.0	1.1	0.9
Slovenia	1.7	1.9	1.7	1.7	6	6	1.0	1.0	3.0	4.0	0.8	1.1
Spain	1.6	1.6	1.5	1.5	32	35	0.5	0.5	3.0	4.0	0.6	0.7
Euro area	1.6	1.6	1.6	1.4	260	251	-1.0	-1.0	6.0	7.0	0.6	0.6
Japan	1.7	1.3	1.6	1.5	29	27	0.5	0.0	5.0	3.0	0.9	0.6
UK	2.4	2.1	2.1	2.0	11	10	1.8	1.1	4.0	3.0	0.6	0.6
USA	2.4	2.3	2.1	2.0	24	24	1.0	1.4	5.0	3.3	0.9	0.5
Switzerland	0.9	1.0	0.9	1.0	16	16	0.4	0.0	2.0	2.0	0.4	0.6

Note: For Malta, which is member of the European Currency Union since 2008, no survey responses are available.

Source: Ifo World Economic Survey (WES) IV/2014 and I/2015.

Figure 1



tion, which resulted in 0.6 percentage points in both survey waves. On the other hand, the frequency distribution also contains information on the asymmetry of the distribution. Figure 1 shows that the distribution of medium-term inflation expectations is steeper on the left-hand side of the middle interval (1.4 percent to 1.8 percent) than on the right-hand side, compared to a symmetric normal distribution. Two conclusions can be drawn from this left-steep (or right-skewed) distribution. On the one hand, a majority of experts expects inflation rates in the range between 0.5 percent and 1.3 percent to be more likely than rates ranging from 1.9 percent to 2.3 percent. This information is certainly highly relevant to the European Central Bank, which justifies its decision to make monthly asset purchases worth a total of 60 billion euro with increasing downside risks for its price stability objective.³ On the other hand, there are more survey responses at the higher end of the distribution (above 2.9 percent) than at the lower end (up to 0.3 percent). Even if any deflation expectations are of no importance, there are still some experts who expect inflation rates to be far higher than the inflation target of the ECB.

For Japan experts assume, that the deflation that stubbornly prevailed between 1999 and 2013 will not persist. After the inflation rate reached positive ground by rising to 2.7 percent last year, economic experts seem

³ The decision to announce an expansion of the asset purchase programme on January 22, 2015, was justified by the ECB as follows: “The Governing Council took this decision in a situation in which most indicators of actual and expected inflation in the euro area had drifted towards their historical lows. As potential second-round effects on wage and price-setting threatened to adversely affect medium-term price developments, this situation required a forceful monetary policy response” (see European Central Bank 2015).

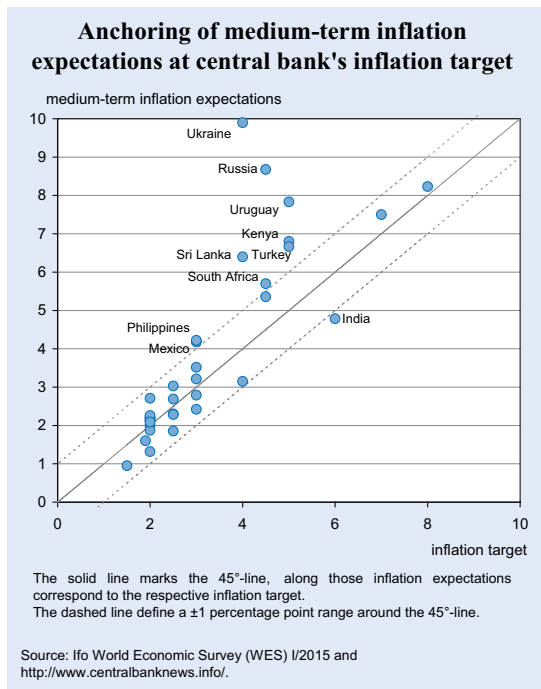
to be convinced that the policy change of the Bank of Japan in 2013 will lead to a sustained increase in inflation rates. The Bank of Japan introduced an inflation target of 2 percent in January 2013 and announced a considerable expansion of its asset purchase programme in April 2013. According to the latest WES results, inflation expectations for 2018–2020 are at 1.3 percent (after 1.7 percent in October 2014) and none of the 27 experts surveyed expect negative inflation rates in the medium term.

In Britain and the United States the risk of a deanchoring of the medium-term inflation expectations seem to be low. WES experts expect the inflation rate to be 2.1 percent (UK) and 2.3 percent (US) in the period 2018–2020. These expectations are in line with the quantitative inflation target of 2 percent, which is pursued by the central banks of both countries.⁴ For Switzerland WES participants expect inflation rates of around 1 percent in the medium term. This expectation is closely aligned with the Swiss Central Bank’s inflation target, whose definition is an increase in consumer prices of less than 2 percent per year.

While in many industrialised countries the danger of deflation was apparent in the years after the world financial crisis, a series of central banks in emerging markets are concerned about inflationary tendencies. Figure 2 shows that survey participants mainly in Russia and Ukraine have medium-term inflation expectations that are significantly higher than the respective central bank’s inflation targets. The situation is similar in Uruguay, Kenya, Sri Lanka and Turkey. In Russia and Ukraine deep uncertainty over the conflict between these countries plays a major role, which is also reflected by a high standard deviation of the inflation expectations in 2018–2020 in both countries. Not quite as pronounced is the deviation from the inflation target in South Africa, the Philip-

⁴ Contrary to common practices, the Federal Reserve in the United States has expressed an inflation target for the deflator of private consumption. Conceptually, this inflation measure lies on average 0.4 percentage points below the inflation rate, which results from the basis of the consumer price index (McCully et al. 2007). Due to the fact that in all countries covered by WES the changes in the consumer price index are of interest, a reduction of the WES inflation expectations of about 0.4 percentage points would be necessary by comparing them with the inflation target of the Federal Reserve.

Figure 2



Philippines and Mexico. Here, inflation expectations are about one percentage point above the inflation target of the respective central banks. India is currently the only country in which the medium-term inflation expectations are more than one percentage point below the central bank's inflation target. The objective was introduced by the Reserve Bank of India in the beginning of last year.

Concluding remarks

By introducing the new question on medium-term inflation expectations in its WES the Ifo Institute is making an important contribution to the economic policy debate. The survey is conducted on a quarterly basis and covers about 120 industrialised, emerging and developing countries, including nearly all member countries of the euro area. In contrast to the ECB's Survey of Professional Forecasters, data for the euro area is aggregated from the individual member countries. Thus, the WES provides additional country-specific information, which is of great economic policy importance, given the high degree of heterogeneity in the common currency area. A comparable information basis is only provided by the survey of Consensus Economics, which offers country individual and medium-term forecasts for about 85 countries. However, the data for medium-term inflation expectations are only available on a bi-annual basis and results are lim-

ited to the participants or only accessible by additional fee-based subscriptions. The WES also provides additional information in so far as that it covers developing countries in Africa.

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