

### ASSESSING RECENT MOVEMENTS IN CONSUMERS' INFLATION EXPECTATIONS

The ECB monitors developments in consumers' inflation expectations, as these can provide information on how consumers perceive the nature of the shocks driving prices and may help to assess possible consumer reactions to these shocks. For example, consumers' inflation expectations may play a significant role in wage formation and can therefore be an important determinant of HICP inflation. According to the European Commission's Consumer Survey, short-term inflation expectations of private households have increased recently. This box discusses these developments.

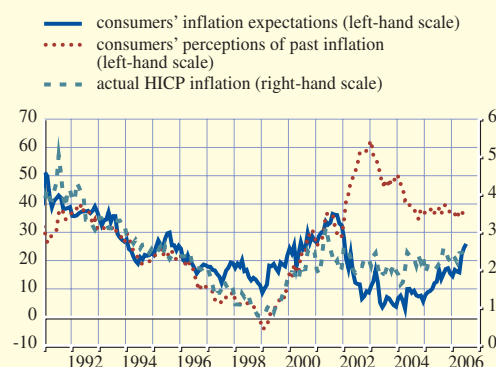
In the European Commission's monthly Consumer Survey,<sup>1</sup> around 20,000 consumers are asked the following question: "By comparison with the past 12 months, how do you expect consumer prices to develop in the next 12 months? Will they: (1) increase more rapidly, (2) increase at the same rate, (3) increase at a slower rate, (4) stay about the same, (5) fall, or (6) NA/don't know". The qualitative expectations are computed as a balance statistic, calculated as a difference between the weighted average of the percentage of those replying (1) or (2) and the weighted average of the percentage of those replying (4) or (5).<sup>2</sup>

While qualitative in nature, the European Commission's indicator provides some information on the direction and pace of price changes expected by consumers and can therefore be directly contrasted with actual developments in HICP inflation. As shown in the chart, historically consumers' perceptions of past inflation have moved broadly in line with actual inflation, but this close relationship broke down at the time of the introduction of the euro banknotes and coins in 2002. At that time, inflation expectations, which are linked in the survey to the question on the perceived prevailing level of inflation, declined and remained relatively low for some time.

In terms of more recent dynamics, the qualitative indicator of consumers' inflation expectations has been on a steady upward path since the beginning of 2005. The increase over the course of 2005 in all probability reflects the impact on inflation of increases in oil prices. More recently, since May 2006, there has been another strong increase in consumers' inflation expectations. This increase was almost entirely due to developments in Germany and in all likelihood reflects the significant impact on inflation expected from the 3 percentage point German VAT increase in January 2007.

#### Consumers' inflation expectations and perceptions and actual HICP inflation

(percentage balances; annual percentage changes)



Sources: European Commission and Eurostat.

1 For further information, see the article entitled "Measures of inflation expectations in the euro area" in the July 2006 issue of the Monthly Bulletin.

2 In the weighting procedure, the more extreme answers, i.e. (1) or (5), are given double the weight of the more moderate answers, i.e. (2) or (4).

In general, even though in Germany consumers have recently incorporated information on the future VAT increase, overall, at the aggregate euro area level, the qualitative measure of inflation expectations has tended to follow better past and contemporaneous inflation rather than to forecast, as the survey question might imply, one-year-ahead inflation developments. Indeed, among the correlations between changes in inflation expectations and changes in the annual inflation rate, only the contemporaneous correlation, with a value of around 0.3, is close to being statistically significant, while there has apparently been little correlation between future price developments and consumer inflation expectations. All this cautions against overinterpreting the forward-looking information content of this indicator.