Box 1: The importance of inflation expectations

The credibility of central banks acting within an inflation targeting framework is extremely important, since it allows the sustainable anchoring of economic agents’ expectations. As a direct consequence, their decisions and behaviour will rely to an increasing extent on the information supplied by the central bank, especially if it pursues a transparent communication with the public.

Inflation expectations are one of the most important channels whereby monetary policy influences the economic activity. They play a salient role in the process of consumer goods price formation at both producer and retailer level. Economic agents find it relatively costly to adjust prices very often, since they have to bear the costs related to promoting and advertising the new prices. However, this does not necessarily preclude them from formulating a set of inflation expectations underlying their decisions when carrying out a new price adjustment. Inflation expectations are incorporated in the model for analysis and medium-term forecasting of inflation (MAMTF) used by the NBR for its quarterly macroeconomic projections and they provide the explanation for CORE2 inflation and fuel price inflation dynamics (these components jointly account for 72 percent of the CPI basket). As for the other components of CPI basket (administered prices and volatile prices of vegetables, fruit and eggs), exogenous scenarios are used, given the manner in which such prices are formed, rather discretionary in the former case and less predictable in the latter.

Along with the structural characteristics of the labour market, productivity developments and inflation expectations are the major landmarks in formulating wage claims. Nominal wages are eroded by inflation and, hence, employees and trade unions tend to seek compensation for *expected inflation*, given that wage bargaining is usually conducted once a year. In case of real wage dynamics overtaking productivity gains, companies will face higher unit labour costs which – if they cannot be offset by shrinking profitability margins – will feed through to consumer goods prices, thus generating inflation.

Inflation expectations have a paramount role in the transmission mechanism of interest rate stimuli to the real economy. This refers to the way in which the ratio between household saving and consumption is influenced by real interest rates, a component of real monetary conditions. *Ceteris paribus*, the lower the inflation expectations, the higher the real interest rates* on saving instruments and, hence, the higher the propensity of households to save by way of sacrificing current consumption; in addition, this would render lending products more expensive in real terms and would encourage households to reduce consumption financed through borrowings. Lower private consumption and increased saving further contribute to alleviating pressures on the growth rate of consumer prices stemming from aggregate demand.

** Real interest rate is calculated as the difference between the nominal interest rate and the expected inflation rate.*