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# Determinants of households' inflation expectations in Japan and the United States

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### ABSTRACT

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Using a VAR model that includes survey data on households' inflation expectations for Japan and the US, we investigate their determinants and influences on the economy and compare their properties in two countries. Short-term non-recursive restrictions are imposed taking account of simultaneous co-dependence between realized and expected inflation. We find that responding to changes in exogenous prices and to monetary policy shocks, inflation expectations adjust more quickly than does realized inflation. Compared with Japan, the effects of exogenous prices on inflation and inflation expectations in the US are not only large but also long lasting and shocks to expectations have self-fulfilling effects on inflation. *J. Japanese Int. Economies* **24** (4) (2010) 503–518. Institute for Monetary and Economic Studies, Bank of Japan, 2-1-1 Nihonbashi-Hongokuchō, Chūō-ku, Tokyo, Japan.

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## 1. Introduction

Inflation expectations are important in conducting monetary policy. Their self-fulfilling property causes actual inflation. It is often said that an uncontrollable increase in inflation expectations generated the hyper-inflation of the 1970s. As Figs. 1 and 2 indicate, both in Japan and the United States, inflation expectations lead realized inflation (see Section 2 for detailed discussion). Furthermore, inflation expectations affect real interest rates, and thereby the real economy and actual inflation. The effect of monetary policy is thus greatly constrained by how expectations are formed.

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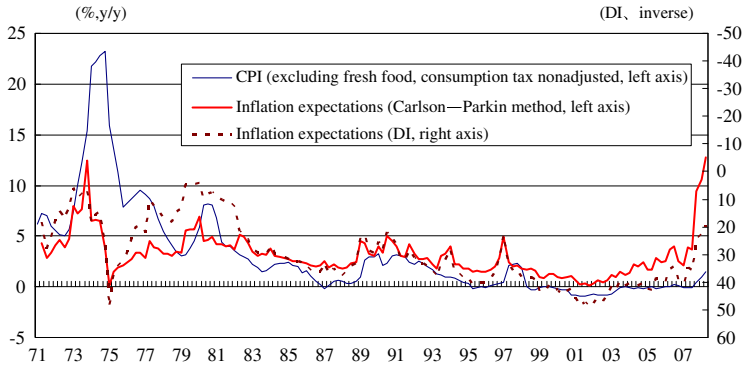


Fig. 1. Movement of inflation expectations (Japan).

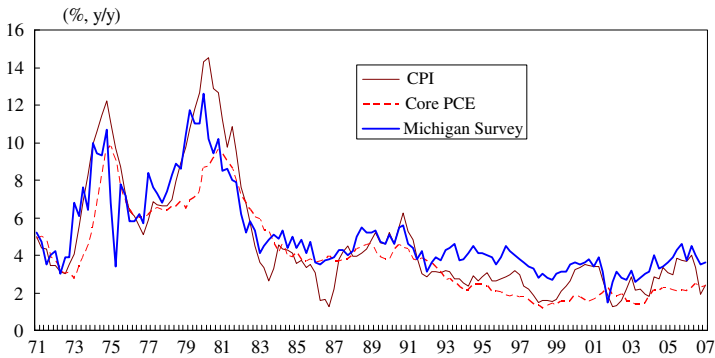


Fig. 2. Movement of inflation expectations (the United States).

In this paper, we empirically tackle two questions regarding inflation expectations. First, we investigate the determinants of inflation expectations and their effects on the economy. In particular, we ask the reason why inflation expectations appear to lead realized inflation. Second, we compare the properties of inflation expectations in Japan with those in the United States. We consider why Japan experienced a quicker decline in inflation than the United States in the 1980s.

To this end, we use a structured VAR (SVAR) model using households' survey data on inflation expectations for Japan and the United States. We construct a four-variable VAR in which the endogenous variables are the output gap, the short-term nominal interest rate, realized inflation and inflation expectations. The exogenous variables are energy price changes and (fresh) food price changes. Taking account of simultaneous co-dependence between realized inflation and expected inflation, we impose a non-recursive restriction to identify structural shocks.

Our analyses reveal that, first as to the determinants of inflation expectations and their relation to realized inflation, responding not only to changes in energy prices and food prices, but also to monetary policy shocks, inflation expectations adjust more quickly than does realized inflation. This explains why Japanese and US data indicate that inflation expectations lead realized inflation. It is also shown that our SVAR procedure resolves the price puzzle; an interest rate rise decreases prices even on impact. Changes in energy prices and food prices have large effects on both inflation and inflation expectations. Shocks to expectations occasionally fluctuate greatly, and may have self-fulfilling effects on realized inflation.

Second, in comparison between two countries, our analyses reveal that the changes in energy prices and food prices have only short-run effects on inflation and inflation expectations in Japan,

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