

[Food prices matter most: Sensitive household inflation expectations](#)

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Food prices matter relatively more than other components in the consumption basket, including energy, and that expectations are particularly sensitive to increases in food price-driven inflation. There is also significant heterogeneity in the degree to which different demographic groups are exposed to price changes within the consumption basket, with above-median income households particularly sensitive to food price inflation.

What we do

We combine household data on UK inflation expectations from the Inflation Attitudes Survey (IAS) with household data on UK personal expenditure from the Living Costs and Food Survey (LCFS) and granular CPI inflation rates to investigate the sensitivity of household expectations to price changes across the consumption basket. Based on UK household expectations IAS data, we observe that the perceived current inflation rate of households co-moves closely with expected future inflation, in both the short- and long-run; implying that inflation perceptions could be an important determinant of inflation expectations. We also document that both perceived and expected inflation are each consistently upwards biased, in aggregate, relative to actual inflation and significantly heterogeneous in the cross-section. Given these observations in the data, could we explain aggregate inflation expectations dynamics and understand cross-sectional heterogeneity better?

What we find

In aggregate, we document that short-run inflation expectations are sensitive to changes in experienced personal inflation driven specifically by food prices, and insensitive to changes in inflation driven by other components of the consumption basket: energy, core goods, or services prices. We identify the perceived current rate of inflation of households as a crucial determinant of their expectations for future inflation; entirely accounting for the sensitivity of expected inflation to changes in experienced inflation and explaining up to half of the aggregate variation in short- and medium-run expectations, and 30% of that in long-run expectations. Zooming in, then, to investigate the formation of households' perceptions of current inflation, we document sensitivity also to changes in energy price-driven inflation, though to a significantly lesser extent than food, and without in turn influencing short-run expectations. Moreover, we show that the sensitivity of

households' perceived inflation to food and energy components of the basket is excessive - responding to changes in these components of non-core driven inflation over and above the change in 'total' experienced inflation - and, in relation to food price-driven inflation, are asymmetrically sensitive to increases relative to decreases in inflation. In the cross-section, we document heterogeneity in both the degree to which different demographic groups are exposed to different components of the basket - given the composition of their respective consumption baskets - and in the degree to which they are sensitive to price changes in specific components for a given level of exposure. In particular, above-median income households are especially sensitive to changes in food price-driven inflation, despite their consumption baskets being less exposed to food than those of peers, while younger cohorts, renters and mortgagors are more sensitive to changes in energy price-driven inflation than are peers. We then use these findings to rationalise a number of empirical puzzles relating to household inflation expectations. First, the asymmetric sensitivity to increases in food price-driven inflation (0.6pp in magnitude) can explain nearly half of the documented upwards bias in households' perceptions of inflation, relative to the actual rate of inflation that they experience (1.4pp in magnitude, on average, over the sample period). Second, the sensitivity of perceived inflation to specifically noncore components of the consumption basket, coupled with the degree of cross-sectional heterogeneity, across demographic groups, in exposure to those components, can rationalise all of the cross-sectional heterogeneity in perceived inflation across income and house tenure groups, and half that across age groups. Finally, our results can also rationalise a recently documented empirical puzzle that households seem to have a 'supply-side' view of shocks to the economy.

Policy implications

The policy implications of our findings are significant. Taken together, our findings indicate that household expectations may be most responsive to shocks to non-core components of the consumption basket, and particularly amongst a set of (above-median income) households potentially amplifying the impact of any such shock. Additionally, the asymmetry of households' responsiveness to increases relative to decreases in inflation indicate that expectations could subsequently be slower to fall after such a shock has subsided. A monetary authority seeking to maintain a strong anchor on inflation expectations and limit persistence of shocks may thus optimally respond more strongly to shocks in non-core, than core, components of the consumption basket.