



The Daily Dish

Consumer Sentiment and Inflation

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Eakinomics: Consumer Sentiment and Inflation

This past Friday the University of Michigan [announced](#) that the preliminary August index of consumer sentiment fell to 70.2, down from 81.2 in July. That decline was the third largest on record (behind the Great Recession and the onset of the pandemic). Consumer sentiment is a powerful predictor of household spending, so this is an unwelcome development in the recovery.

Most commentators focused on the spread of the Delta variant of the coronavirus as the key driver of the decline in confidence. Historically, however, sentiment is sensitive to inflation, and the report indicated that “The survey also showed consumers raising their expectations for medium term inflation, another measure the central bank is closely monitoring to ensure that inflation expectations remain anchored. The survey’s one-year inflation expectation edged lower to 4.6%, down from 4.7%, but its five-year inflation outlook ticked up to 3.0% from 2.8% in July.”

Public health policy will shoulder responsibility for controlling the Delta (and other) variants. The economic policy challenge is the future path of inflation. The White House has shifted from saying that inflation is simply transitory to that its policy will help fight inflation. The arguments for the anti-inflation benefits of its policies are either [questionable](#) or [flat out wrong](#), while the arguments for the transitoriness of inflation are belied by the inflation dynamics in the data.

To see these dynamics, think about the fact that the Producer Price Index (PPI) for finished goods rose by 1 percent in the most recent [report](#). What does this mean for future consumer price inflation? To illustrate the point, I used the past 10 years of Consumer Price Index (CPI) and PPI data to quantify the relationship between increases in the PPI and future increases in the CPI. The results are instructive.

Suppose that a by-now-famous supply chain disruption drives a 1-time, 1 percent rise in the PPI. The data indicate that - other things being the same - this hike will pass through as a 0.4 percentage point increase in year-over-year CPI inflation one month later. But the data also indicate the ripple effects of the supply shock are quite persistent. After three months, year-over-year inflation has tapered to only 0.2 percentage points higher, but after six months it is back to 0.4 percentage points and one year later it peaks at 0.6 percentage points.

The numbers don't have to be exactly right to make the point. There is general persistence in inflation dynamics, so "transitory" should be thought of in terms of years and not months. Worse, it means that policy errors causing the inflation will have repercussions on household sentiment for the foreseeable future.