

# A NOVEL METHOD FOR ELICITING BUSINESS INFLATION EXPECTATIONS\*

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December 23, 2024

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\*This blog originates from a complete draft titled “Unit Cost Expectations: Firms’ Perspectives on Inflation.” Xuguang Simon Sheng gratefully acknowledges financial support from SAS-IIF Grant that promotes research on forecasting. Any opinions and conclusions expressed herein are those of the authors and do not necessarily represent the views of the Federal Reserve Bank of Atlanta.

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“Price stability is that state in which expected changes in the general price level do not effectively alter business or household decisions.”

–Federal Reserve Chairman Alan Greenspan, July 1996, FOMC Meeting<sup>1</sup>

Inflation expectations play a central role in many macroeconomic models. For monetary policy-makers, monitoring and understanding the public’s inflation expectations are crucial to achieving their policy goals. However, much of the literature on survey measures of inflation expectations reveals that the public has trouble holding well-formed expectations that conform to economists’ notions of aggregate inflation, especially when inflation is low. As former Federal Reserve Chairman Alan Greenspan’s quote implies, during (or following) times of low, stable inflation, inattention may be a feature of price stability (not a bug). Unfortunately, that also implies tracking survey measures of aggregate inflation expectations in a stable inflation environment is an exercise fraught with many challenges. This suggests the exploration of alternative approaches to eliciting forward-looking information on costs and price growth that both matter for respondents and connect up to the concept of aggregate inflation that policymakers care about.

In this paper, we propose a new approach to tracking anticipated inflationary pressures in the economy. Specifically, our approach centers on eliciting own-firm unit cost expectations from business decision-makers. We utilize the Federal Reserve Bank of Atlanta’s Business Inflation Expectations (BIE) survey, which has been continuously collecting subjective probability distributions over own-firm future unit costs from a panel of business executives (CFOs, CEOs, and business owners) monthly since October 2011. The BIE stands out across various dimensions by opting to concentrate on firms’ own anticipated unit costs, rather than relying on an aggregate inflation expectation, and by eliciting firm-level expectations in a probabilistic format. Our main result can be summarized as follows:

1. Once aggregated, **firms’ unit cost realizations closely comove with U.S. inflation statistics**. Firms’ unit cost growth covaries quite closely with changes in the GDP Price Index and with other *official* U.S. price statistics.
2. **Unit cost expectations provide unique insight into the likely trajectory of future inflation**. In aggregate, firms’ unit cost expectations significantly outperform households’ inflation expectations when inflation is low, and are at least as accurate as the expectations of professional forecasters in pseudo out-of-sample forecasting exercises in both high and low inflation environments.
3. At the firm level, **unit costs are a primary determinant for own-firm price setting behavior**.

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<sup>1</sup><https://www.federalreserve.gov/monetarypolicy/files/FOMC19960703meeting.pdf>

4. Implementing randomized controlled trials in three separate years, we find evidence that **information treatments about aggregate inflation and policymakers' forecasts do little to alter firms' unit cost expectations.**

Chairman Powell, in an August 2022 address at the Jackson Hole Symposium, discussed the role inattention plays in aggregate inflation expectations. In particular, he noted, “*One useful insight into how actual inflation may affect expectations about its future path is based in the concept of “rational inattention.” When inflation is low and stable, they are freer to focus their attention elsewhere.*”<sup>2</sup> This notion aligns with our perspective. In a low-inflation environment, households and firms appear to hold aggregate inflation expectations that are disconnected from the underlying inflation environment. During these low inflation periods, eliciting expectations from firms (or households) that they pay attention to and connect up to the aggregate inflation statistics that monetary policymakers endeavor to monitor is crucial. Aggregating up own-firm unit cost expectations does just this. Moreover, during the current high inflation environment, we show that unit cost expectations perform similarly to other measures that elicit aggregate inflation concepts, highlighting its durability as an essential determinant of the inflation expectations of firms.

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<sup>2</sup><https://www.federalreserve.gov/newsevents/speech/powell120220826a.htm>