Inflation Experience and Inflation Expectations: Spatial Evidence

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Abstract

Understanding inflation expectations is an integral part of understanding asset pricing and real economic decisions. We study the role of inflation experience in the formation of inflation expectations by investigating whether and to what extent inflation expectations of different forecasters are affected by the inflation they observe in the area they are residing in. In particular, we focus on the expectations of professional forecasters from different countries of euro area inflation and ask whether their forecast errors are correlated with the observed inflation in the forecaster's country at the time the expectation was formed. We find that forecasters perceive the world to be more spatially correlated than it actually is: higher inflation in the home country leads to abnormally—in the rational expectations sense--higher expectations of future euro area inflation that result in more pronounced and forecastable forecast errors. This has important implications for asset pricing in internationally diversified portfolios and correlations of international asset prices.