

Rational Inattention and Inflation

The war against inflation will be won when we no longer need to worry about it.

By Carl Tannenbaum



During his brief (9 minute) address to this year's Jackson Hole conference, Federal Reserve Chairman Jerome Powell used a term that sent listeners scurrying to their browsers. Said Powell: "One useful insight into how actual inflation may affect expectations about its future path is based in the concept of rational inattention."

Rational inattention is a notion found in behavioral economics. A range of studies have illustrated that human beings have limited capacity to ingest and process information. Doing so is costly, in terms of time and stress. This leads us all to sort incoming news into buckets based on their immediacy and their complexity. The most pressing and simple issues are front of mind; the rest are shepherded to the rear.

Economists have long held that inflation expectations are very important to the evolution of actual inflation. If people think that prices will stay low, they will not press as hard for higher wage increases and investment returns. The settled state of inflation during the decade prior to the pandemic cemented low inflation expectations and allowed consumers to focus their attention on other things.

Consumers have been able to ignore inflation, until recently.



The last twelve months have put that perspective to the test, as inflation has broken free of its boundaries. Yet while prices have surged, long-term inflation expectations have remained reasonably well-anchored. Wage increases, while elevated, have not yet matched increases in the price level; and one could argue that the acceleration in wages has more to do with labor scarcity and less to do with inflation compensation.

The worry that Powell highlighted is that more persistent price pressures will bring the subject to the fronts of our minds. In that instance, we'll focus more on ensuring that our pay and our portfolios are keeping pace, which could serve to sustain today's higher inflation levels.

This makes it imperative that central banks remain aggressive in their battle to bring inflation down, and resist the temptation to ease off prematurely. Because when it comes to inflation, ignorance may be bliss.

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