



**University of
Zurich** ^{UZH}

Inflation, expectations, and financial decisions of households

Bachelor's Thesis

Author

Terry Schweizer

Supervision

Jan Toczynski

Prof. Dr. Christoph Basten

Assistant Professor of Banking

Department of Banking and Finance

University of Zurich

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Executive Summary

In light of the return of high interest rates to the European economy, this thesis investigates some of the different roles inflation plays in household decision making. As households' reactions to inflation might differ significantly from that of professional market participants or agents in economic models, it is important to understand how households perceive inflation and what they conclude from these perceptions.

Accordingly, I examine the impact of current inflation perceptions on expectations of future inflation. In addition, this thesis investigates the role of inflation expectations on two important household decisions. First, I consider the effect on households' spending plans. Second, I do the same for households' borrowing decisions.

For this analysis, I use survey data from the European Central Bank (ECB) Consumer Expectations Survey (CES). The CES is a monthly online survey among households in the six largest economies in the Euro Area (EA). I employ linear and logistic regression models during the analysis of the data in question.

Preceding the analysis, I provide a review of the relevant literature and the theoretic background. Based on this review, I form hypotheses about the effects I expect to find in the data. For all three relationships, I assume a positive correlation.

The project finds that there is a positive connection between inflation perceptions and inflation expectations. I find inflation expectations to increase by between 0.4 and 0.6 percentage points for every increase of inflation perceptions by one percentage point, which indicates that households base their expectations on the currently perceived level of inflation and alter these expectations based on other indicators such as household specific characteristics or outlooks of future macroeconomic indicators. I am further able to show that this effect is subject to limited heterogeneity and appears across different countries and age groups.

Results on the relationship between inflation expectations and spending are in line with theory as well. I identify a positive effect of between 0.1 and 0.3 percentage points per one percentage point increase in inflation expectations. This contradicts parts of the literature.

However, I am not able to confirm the hypothesis that household borrowing increases with inflation expectations. Instead, I could not identify a statistically significant connection. This might be due to less straight forward econometric methods used due to the limited availability of suitable data in the CES.