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Households' Preferences Over Inflation and Monetary Policy Tradeoffs*

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Abstract

We document novel facts about U.S. household preferences over inflation and monetary policy. Many households are highly attentive to news about monetary policy and to interest rates. The median household perceives the Federal Reserve's inflation target to be three percent, but would prefer it to be lower. Quantifying the tradeoff between inflation and unemployment, we find an average acceptable sacrifice ratio of 0.6, implying that households are likely to find disinflation costly. Average preferences are well represented by a non-linear loss function with near equal weights on inflation and unemployment. These preferences also exhibit sizable demographic heterogeneity.

Keywords: Household Survey, Attention, Inflation Target, Sacrifice Ratio, Dual Mandate

JEL: D12, E52, E58

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1. Introduction

Congress has mandated the Federal Reserve to promote maximum employment, stable prices, and moderate long-term interest rates. This mandate does not specify how to weigh these objectives when they are in conflict. It also leaves open the precise definition of each objective, including the inflation target. One way to establish such prescriptions is through the use of macroeconomic models, especially those that were built in the New-Keynesian tradition. However, the resulting policy prescriptions vary greatly with the assumptions embedded in these models—for example, the slope of the Phillips curve, the degree of competition in the economy, and the form of households' utility function (Woodford, 2003). Instead of relying on such models to postulate numerical objectives and their relative weighting, in this paper we ask households directly about their preferences over inflation and monetary policy tradeoffs.

We designed a special survey with questions regarding attention to news, interest rate expectations, and preferences and attitudes toward monetary policy. The special survey was fielded in June 2023 as part of the well-established Survey of Consumer Expectations (SCE) of the Federal Reserve Bank of New York. Our first finding is that households are surprisingly attentive to monetary policy. About half of respondents reported paying attention to federal funds rate at least at a quarterly frequency. More than half of the respondents reported paying attention to news about the Federal Reserve at least monthly. The frequency of attention to news about the Federal Reserve significantly increases with educational attainment, reported income, for middle-age respondents, and for male respondents.

Second, we ask respondents about the inflation objective of the Federal Reserve, and find a fair degree of disagreement in their responses, with a median response of 3 percent. About one-third of the respondents answer 2 percent, the actual target pursued by the Federal Reserve.[1] Higher income households report a lower perceived target, while female respondents report a higher perceived target. We also ask respondents about their perceptions of the *optimal* inflation rate for the American economy. Households display significant disagreement when answering this question. 59 percent of households think a positive inflation rate is optimal; of those, the median response is 2 percent. However, 41 percent of all respondents replied that they think it is optimal for the American economy to have deflation.[2] These respondents have more than 1 percentage point higher perceptions of the FOMC's inflation objective than those who think positive inflation is optimal. Overall, the difference of the perceived and the optimal inflation target is about one percentage point. This difference is higher for students and female respondents and lower for those with higher educational attainment. Additionally, we observe that short- and medium-run inflation expectations are positively correlated with the perceived and especially the optimal inflation target.

Third, we elicit respondents' relative preferences over inflation, unemployment, and interest rates by asking respondents to evaluate several hypothetical scenarios. Our findings provide the first direct

[1] See the FOMC's Statement on Longer-run Goals and Monetary Policy Strategy.

[2] Shiller (1997) and Stantcheva (2024) report reasons for households' aversion to inflation. Also, during the inflation surge in 2021–23, Armantier et al. (2022) observe a sizable increase in households expecting deflation for all forecast horizons in the SCE. Households who expect deflation rationalize their forecasts with price mean reversion and generally expect *better* economic outcomes, not worse.

evidence of how U.S. households would want the different parts of the Federal Reserve's mandate to be weighed relative to each other. At the time of the survey, 80 percent of the respondents preferred a reduction in inflation to a reduction in unemployment, while their relative preferences over interest rates were more dispersed: A majority of the respondents found lower interest rates to be desirable and a quarter preferred higher interest rates.

Fourth, we quantify the perceived tradeoff between inflation and unemployment. Our analysis reveals that U.S. households place a large weight on the employment side of the Federal Reserve's dual mandate. We construct the *acceptable* sacrifice ratio—the increase in unemployment that households would find just acceptable to reduce inflation by one percentage point. By contrast, the existing literature focuses almost exclusively on the *necessary* sacrifice ratio by estimating the costs that are necessary to reduce inflation via macro-econometric models (see, for example, Ball, 1994, Cecchetti and Rich, 2001, and Tetlow, 2022). Our acceptable sacrifice ratios are much lower than the necessary sacrifice ratios estimated in the literature, implying that U.S. households are likely to find disinflation costly. That said, there is considerable non-linearity and heterogeneity in the weight households place on inflation stabilization. Acceptable sacrifice ratios are higher when inflation is high, for more educated households, for those that have higher numeracy, and for retirees. In addition, female and Latino respondents tend to have lower sacrifice ratios.

Finally, we estimate a flexible simple loss function that nests the quadratic loss function widely used in the evaluation of monetary policy strategies and New-Keynesian models in particular. The estimated weight on unemployment is about the same as that on inflation, implying a preference for unemployment stabilization that is much stronger than in the standard New-Keynesian model. This finding has important consequences for the conduct of monetary policy. In the standard New-Keynesian model, optimal monetary policy under our survey-implied preferences reduces unemployment fluctuations at least threefold relative to optimal policy under model-implied preferences.

A precursor to our analysis of the perceived inflation-unemployment tradeoff are Di Tella et al. (2001) and Wolfers (2003) who calculate a necessary sacrifice ratio from time-series correlations of life satisfaction indexes with unemployment and inflation in several countries, but notably excluding the United States due to data limitations. Instead of relying on time-series correlations, our survey module aims at directly eliciting preferences through the evaluation of hypothetical scenarios. Despite this difference in methodology, our estimated average sacrifice ratio for American households, at 0.6, is close to the estimates of Di Tella et al. (2001) for European countries. More recently, Binetti et al. (2024) document results from a survey, conducted about a year after ours, in which respondents are asked a series of binary choices between hypothetical scenarios. Their results yield a sacrifice ratio of about 2. The difference may be attributable to their assumption of linear preferences and very high values for inflation in the scenarios. Indeed, in line with the assumptions in macroeconomic models, we find strong evidence of curvature in utility, implying that the sacrifice ratio increases with the level of inflation.

The survey was conducted in an elevated inflation environment and some of the results regarding attention and expectations could depend on this environment. Previous research has shown that the formation of inflation expectations depends on the environment and that consumers are more