

Floods, Droughts, and Inflation Expectations

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The impact of precipitation-related natural disasters like floods and droughts on inflation expectations of consumers is examined. Using data from Reserve Bank of India's inflation expectations survey, the article finds that, on average, an additional flood event in the past three months within a state raises households' short-term (three-month-ahead) inflation expectations by 6.7%. An additional drought event raises the short-term inflation expectations by 5.2%. Our findings highlight the increasing risk of dispersed inflation expectations among Indian states, which can impede the effectiveness of monetary policy in a world with increasing climatic events.

Climate change has threatened economic stability across many dimensions, including consumption, manufacturing, agricultural production, and prices of goods and services. This article focuses on the effect of climatic events on household beliefs about the macroeconomy. It examines the sensitivity of household inflation expectations¹ in response to precipitation-related disasters—floods and droughts. India is one of the most vulnerable countries in the world to flood and drought risks. It is ranked first in terms of the number of people affected by floods, and among the top-five countries most affected by drought risk (Kuzma and Luo 2020; Kuzma et al 2023).

A key question is whether frequent occurrence of disruptive climatic events such as floods and droughts increases inflation expectations of households. Inflation expectations matter significantly for household decision-making. Households base their consumption spending, especially on durable goods, on their inflation expectations (Andrade et al 2023). This also matters for employment-related decisions, as well as decisions to borrow and save, among other pertinent decisions. Understanding how inflation expectations of households evolve with climatic events allows us to infer whether households perceive these disasters to be significant shocks to their financial health.

The data on inflation expectations used in the article is based on the Inflation Expectations Survey of Households (IESH) conducted by the Reserve Bank of India (RBI).² This data includes point estimates of inflation expectations over two horizons—expectations for three-months-ahead (short-term) and one-year-ahead (long-term) inflation. The data on disasters is sourced from Emergency Events Database (EM-DAT), a database for

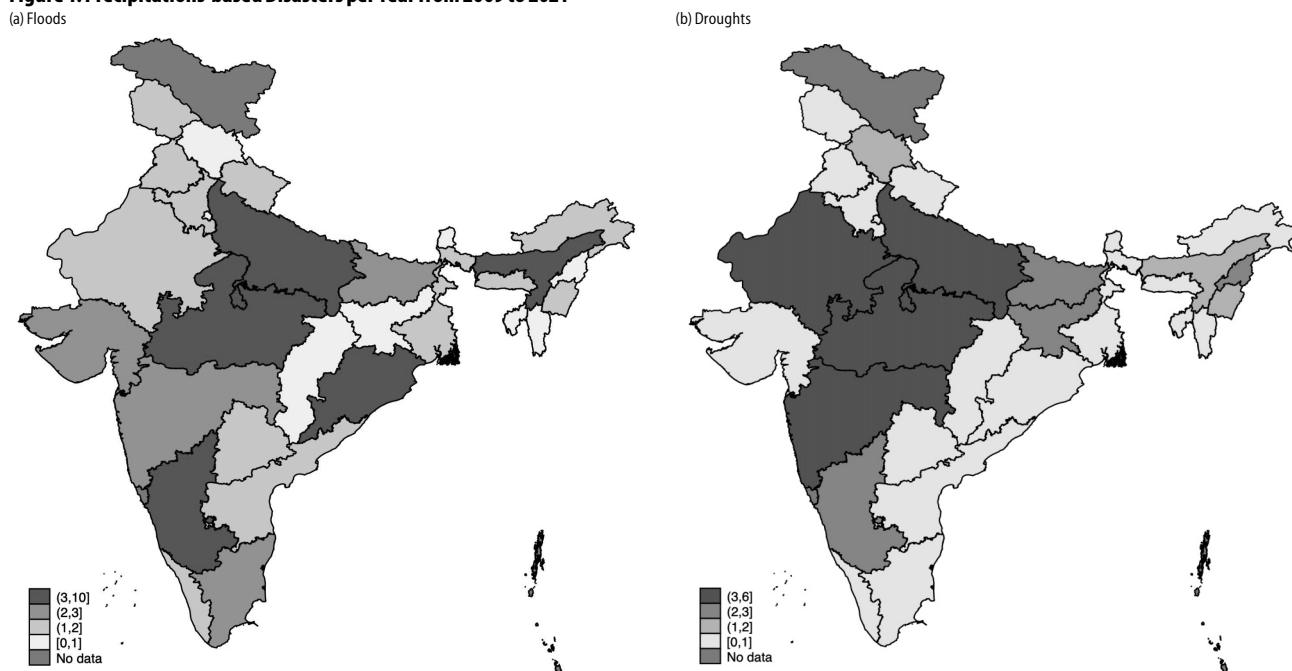
recording natural disasters across the globe.³ The variation in flood and drought incidences across states is used to determine how occurrence of floods and droughts influence average inflation expectations within a state. Higher occurrence of both floods and droughts within a state significantly raise inflation expectations of households at all horizons.

The occurrence of floods within a state in the past three months significantly increased inflation expectation of households. On average, three-month-ahead inflation expectations of households, within a state, increased by 6.7% and one-year-ahead inflation expectations by 14.5%, if they experienced floods in the last quarter. This effect is transitory and dissipated after six months. The effects of droughts on expectations are lower but more persistent. On average, households within a state expected 5.2% more inflation over the next three months and 6.3% over the next one year if they experienced droughts in the last quarter. Experiencing floods and droughts also increases the disagreement among households about inflation expectations, especially at the one-year horizon.

Linking with Existing Literature

Recent literature has tried to understand the economic cost in countries facing high risk of natural disasters. Agarwal et al (2024) study the effect of Chennai floods on household finances and find that both consumption and income fell significantly after the disaster. Karim (2018) also uses survey data for Bangladesh to understand the impact of flood-related disasters on household income and expenditure and find significant negative effects on both variables in the short run. Economic damage from climate change is also a source of concern for developed countries. Frame et al (2020) find that damages associated with flooding events in New Zealand have cost upwards of \$140 million and those associated with drought events have cost \$300 million to consumers and insurers between 2007 and 2017. Cavallo et al (2014) show that earthquakes in Chile and Japan had significant effects on supply disruptions

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Figure 1: Precipitations-based Disasters per Year from 2009 to 2021

The map is only for representational purposes and does not, in any way, indicate the national boundaries.

Average number of floods and drought events per year in each state. The sample period of disasters data for states ranges from 2009 to 2021.

Source: Figures are based on authors' own calculations using data from EM-DAT disasters database.

but also find that price adjustments were slow and prices did not rise until a few months after the shock. Events such as floods and droughts also affect household decision-making. Gandhi et al (2022) use a large panel of countries to study how households living in areas with recurrent floods respond to increasing risk and find that adaptation to damages caused by floods decreases over time.

This article contributes to the larger literature studying determinants of inflation expectations of households. Baker et al (2020) examine how professional forecasters⁴ revise their expectations in response to temperature shocks, finding that such forecasters pay attention to disasters that are reflected in their inflation forecasts. However, this analysis does not address how temperature shocks influence the expectations of households. This is a critical gap, as the channels through which consumers and firms form inflation expectations directly influence actual inflation. Most modern central banks have significantly improved their communication with the public and voiced their commitment to keep inflation stable and expectations anchored. This article looks at the effect of understudied

but increasingly important climate shocks on inflation expectations. Higher inflation expectations due to climate shocks may result in greater price disparities across regions in India.

Data and Sources

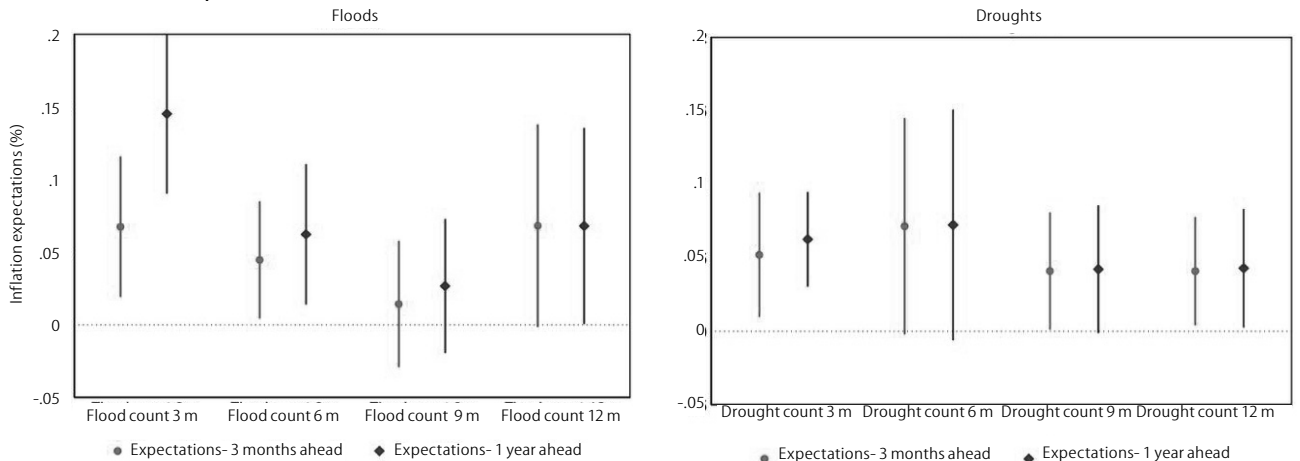
The article constructs a panel data combining household-level inflation expectations with occurrences of flood and drought events at the state level since 2013. This section provides details on each of the main datasets used in our paper.

Disasters: Data on disasters is obtained from the Geocoded Disasters Dataset (GDIs). GDIs provides locations and coordinates for all global disasters recorded in the EM-DAT. While the dataset records all types of natural disasters, we restrict our analysis to precipitation-related disasters—floods and droughts—that occur within the geographical regions of India.⁵ The dataset includes geographical coordinates that allow us to identify the Indian state(s) affected by each disaster. However, the geocoded data is only available from 1970 to 2018 in EM-DAT. Since 2018, EM-DAT records the locations of the disaster. We use this information to identify each state that experienced

the event (for both floods and droughts) and extend our data till end of 2021.⁶

Figure 1 shows the average number of floods and droughts per year from 2009 to 2021 in each state. This highlights the geographical heterogeneity of precipitation-related disasters in Indian states. Floods are common occurrence across most of the country, with states such as Assam, Uttar Pradesh (UP), Madhya Pradesh (MP), Odisha, and Karnataka being most affected in recent years. The risk of floods in eastern states is aggravated by the presence of the Ganga and Brahmaputra, two of world's largest river basins, while the western states are susceptible to both riverine and coastal flooding. The drought risks are more significantly concentrated in the western states like Rajasthan and Maharashtra. Large states like UP and MP are most prone to uneven precipitation, including extreme events like floods and droughts.

Household inflation expectations: We measure inflation expectations using the RBI's IESH. The survey data is available since September 2008 and measures inflation expectations of Indian consumers. The survey was conducted

Figure 2: Estimates of β_1 at Different Horizons

The estimated β_1 on regression of three-month-ahead and one-year-ahead inflation expectations on floods and droughts are represented as circles and diamonds, respectively. Estimates are reported at four different horizons: events in past three months, six months, nine months, and 12 months. The bars around the circles and diamonds represent the 95% confidence intervals around the point estimates.

Source: Authors' own calculations using data from RBI–IEHS and EM-DAT disasters database.

once every three months (quarterly) until September 2016, and once every two months since November 2016. The data includes information on the individual's age, employment status, gender, city of residence, and their current inflation expectations, as well as their three-month-ahead (short-term) and one-year-ahead (long-term) inflation expectations. Respondents pick their inflation expectations from a range between a minimum of 1% and a maximum of 16%, with increments of 1% in each bracket. Individuals who expected inflation to be less than 1% or greater than 16% are prompted to enter the numerical value for their inflation expectations. For each respondent, we define their average inflation expectations as the average of the bin. For example, the average inflation expectation of a respondent who reported inflation of 13%–14% is 13.5%. Individuals who do not enter a number less than 1% or greater than 16%, after selecting those brackets, are dropped from the sample.⁷

We winsorise the responses for inflation expectations at 1st and 99th percentile for both three-month and one-year horizons.⁸ We then take the average of the inflation expectations across all respondents within a state for each round of the survey.⁹

Ranjan and Mallick (2023) criticise the use of inflation expectations in India due to its high correlation with the current inflation data. This observation is not unique to India and exists even for the Survey of Professional Forecasters in the

United States (us). However, the correlation of inflation expectations with current inflation does not imply insignificance of survey data. Also, the correlation between current inflation and expectations weakens at longer time horizons.

Empirical framework: We combine the two datasets to create a panel data at the state level between 2008 and 2021. This is an unbalanced panel, as the number of states for which data on inflation expectations were collected increased over time. Thus, the final dataset comprises monthly inflation expectations and total monthly flood and drought events in each state, to get an unbalanced panel of state–month observations from December 2008 until November 2021. We use a panel data model with fixed effects to investigate how precipitation events affect inflation expectations within a state. The empirical specification is as follows:

$$E_t \pi_{i,t+j} = \alpha_i + \beta_1 \text{Disaster}_{i,t-k} + \beta_2 X_{i,t-1} + \gamma_t + \epsilon_{i,t} \quad \dots (1)$$

where $E_t \pi_{i,t+j}$ is the average of self-reported three-month-ahead ($j = 1$) and one-year-ahead ($j = 4$) inflation expectations of households in a month t in state i . We test the effect on inflation expectations of two major climatic disasters—floods and droughts. $\text{Disaster}_{i,t-k}$ is the total number of disaster events in a state i in k quarter before the survey was conducted where $k \in \{1, 2, 3, 4\}$. The slow adjustment of prices after earthquakes

found by Cavallo et al (2014) motivates us to investigate the effects of flood and drought shocks at different lags, starting from three months before the expectations were formed and including six-month, nine-month, and 12-month lags. The lag on disaster ensures that all climatic events are part of the individual's information set when reporting their inflation expectations. We also control for the lagged average inflation expectation in a state ($X_{i,t-1}$). All regressions include state and year fixed effects.

Results and Discussion

Figure 2 summarises our main results across time horizons and precipitation disasters. The left panel shows the effect of flood events and the right panel shows the drought events within a state on three-month and one-year-ahead inflation expectations of households in that state. The solid dots are the point estimates from regression of flood and drought events at four different horizons—three months (3m), six months (6m), nine months (9m), and 12 months (12m). The bars are the 95% confidence intervals for each estimate.

Inflation expectations within a state increase significantly at both three-month and one-year-ahead horizons when the state experiences a flood event in the past three months. The effects are lower but significant if a flood event is experienced in the past six months and is insignificant at the nine-month horizon.

Recent experiences of flood-related disasters increase concerns about inflation significantly. However, effect on inflation expectations dissipates from flood events that were further in the past. The results for droughts are similar with statistically significant effects on inflation expectations within a state from drought events in the past three months in that state. Contrary to the evidence for floods, we find that the effects of drought events are highly persistent on inflation expectations—both short term (three month ahead) and long term (one year ahead).

The key mechanism is through the supply side—precipitation-related disasters reduce agricultural productivity (Goyari 2005) and rural wages in the short run (Banerjee 2007). The results suggest that households expect significant damages to supply chains from flood disasters in the short horizon but do not expect these effects to persist. The results are in line with studies that show that negative effects of climatic disasters are temporary and even reversible in the long run (Banerjee 2007; Parida et al 2021). The effects of droughts on inflation expectations are quantitatively smaller but more persistent than floods. The literature on precipitation disasters have also found droughts to have more persistent effects on agricultural production and employment (Carpena 2019).

Tables 1 and 2 show the point estimates that were represented graphically in Figure 2. An additional flood event within a state raises three-month and one-year-ahead inflation expectations of households. We do a simple back of the envelope calculation, which can help us better understand the results. Take the example of Bihar which, on average, experienced 2.2 flood events per year. In our sample, the average three-month-ahead and one-year-ahead inflation expectations of households in Bihar are 9.7% and 10.8%, respectively. On experiencing an additional flood event within Bihar in the past three months, three-month-ahead inflation expectations of an average household in Bihar increases by 6.74% (Table 1, column 1) to 10.35%, while the one-year-ahead expectations increased by 14.5% (Table 2, column 1)

to 12.37%. Smaller quantitative effects are present for drought events. An additional drought event within Bihar raises three-month-ahead inflation by 5.2% (Table 1, column 5) to 10.2% and one-year-ahead inflation by 6.25% (Table 2, column 5) to 11.48%.

Expectations

Another dimension across which climatic events can affect inflation dynamics is through its influence on disagreement among households about future inflation. There has been evidence that disagreement in inflation expectations reduces the efficacy of monetary policy. Falck et al (2021) finds that where disagreement in inflation expectations is high among

the us households, a contractionary monetary policy shock can raise inflation expectations as it provides households with information about the future state of the economy. We measure disagreement by calculating the standard deviation of inflation expectations of individuals within a state and survey round for both three-month and one-year-ahead expectations and use this dispersion as our main dependent variable in equation (1). The results are reported in Tables 3 and 4 (p 30). At three months, recent episodes of droughts increase disagreement among households while flood events do not cause higher disagreement. We find that both flood and drought events increase disagreement

Table 1: Three-months-ahead Inflation Expectations

	Floods			
	(1) 3m	(2) 6m	(3) 9m	(4) 12m
Lagged inflation exp	0.516*** (0.0413)	0.512*** (0.0433)	0.517*** (0.0423)	0.506*** (0.0432)
Flood events	0.0674*** (0.0226)	0.0446** (0.0189)	0.0143 (0.0203)	0.0681* (0.0327)
Observations	738	738	738	738
Within R sq	0.416	0.416	0.414	0.422
	Droughts			
	(5) 3m	(6) 6m	(7) 9m	(8) 12m
Lagged inflation exp	0.523*** (0.0421)	0.522*** (0.0411)	0.522*** (0.0411)	0.522*** (0.0409)
Drought events	0.0519** (0.0198)	0.0713* (0.0345)	0.0410** (0.0187)	0.0409** (0.0173)
Observations	738	738	738	738
Within R sq	0.416	0.42	0.417	0.418

*** p-value<0.01, ** p-value<0.05, * p-value<0.1. Robust standard errors in parentheses.

Source: Authors' own calculations using data from Reserve Bank of India IEHS and EM-DAT disasters database.

Table 2: One-year-ahead Inflation Expectations

	Floods			
	(1) 3m	(2) 6m	(3) 9m	(4) 12m
Lagged inflation exp	0.552*** (0.0351)	0.546*** (0.0378)	0.551*** (0.0369)	0.545*** (0.0369)
Flood events	0.145*** (0.0257)	0.0622** (0.0226)	0.0266 (0.0216)	0.0679** (0.0316)
Observations	738	738	738	738
Within R sq	0.485	0.479	0.476	0.481
	Droughts			
	(5) 3m	(6) 6m	(7) 9m	(8) 12m
Lagged inflation exp	0.559*** (0.0367)	0.557*** (0.0358)	0.557*** (0.0359)	0.558*** (0.0358)
Drought events	0.0625*** (0.0151)	0.0722* (0.0367)	0.0421* (0.0204)	0.0428** (0.0188)
Observations	738	738	738	738
Within R sq	0.478	0.48	0.478	0.479

*** p-value<0.01, ** p-value<0.05, * p-value<0.1. Robust standard errors in parentheses.

Source: Authors' own calculations using data from Reserve Bank of India IEHS and EM-DAT disasters database.

of one-year-ahead inflation expectations. For droughts, both recent and relatively distant events increase disagreement of one-year-ahead expectations. Putting together with our baseline results, we find that floods and droughts increase the level of inflation expectations as well as the disagreement about the level of future inflation, especially for one-year-ahead forecasts.

We also replicate our analysis for inflation expectations at the individual level to complement our main state-level analysis. Here, the dependent variable or the outcome of interest is the inflation expectations of each individual surveyed. The survey does not repeat households, which means we have data on a cross-section of households in each round. We

are thus unable to control for lagged inflation for the household-level model. However, we can control for household-level characteristics known to influence inflation expectations—gender, employment status, and age of the respondent. The results are similar to the state-level results and are not reported here.

Policy Implications and Conclusions

Managing inflation expectations is a key objective of monetary policymakers to keep inflation stable, especially for central banks pursuing inflation targeting, which includes the RBI. This sentiment was echoed by then governor of RBI, Shaktikanta Das (2022), in his speech on conduct of monetary policy:

Monetary policy is ultimately about managing expectations of various economic agents—from households to financial markets. In this context, over the past three years, we backed our actions with clear forward guidance and tweaked it as necessary with reference to the evolving circumstances.

Inflation expectations also matter for household decision-making—how much to spend and save, how much to work are among the decisions that are affected by a household's inflation expectations. There is also evidence that higher inflation expectations are self-fulfilling and raise local prices (Binder et al 2025).

Rising climate disaster events have threatened the stability of inflation around the world (Faccia et al 2021). We look at how the increasing risk of precipitation-based disasters like floods and droughts change inflation expectations of Indian households. While households in all states experience similar national prices, a regional shock such as floods and droughts can make short-run inflation expectations differ across states which experienced the shock relative to those that did not experience such shocks. Such dispersion in inflation expectations can impede the effectiveness of monetary policy, making the job of monetary policymakers harder. We also find evidence of increased disagreement in inflation expectations following climatic events, which, as shown by Falck et al (2021), can hinder the effectiveness of monetary policy in controlling inflation.

With the expected rise in global temperatures and larger, more variable temperature and precipitation events, the findings here suggest that anchoring inflation expectations will be harder, especially in regions vulnerable to such disasters. Goyal and Parab (2020) find that adoption of inflation targeting and increased communication from the RBI has achieved greater anchoring of household inflation expectations. In line with this, the RBI's communication strategy has effectively incorporated messaging on the transient nature of price effects from climatic shocks.

There is also evidence that stronger commitment to inflation targeting lowers the inflationary pressure of natural disasters and thus lowering inflation expectations (Fratzscher et al 2020). Therefore, while monetary policy cannot directly

Table 3: Dispersion of Three-months-ahead Inflation Expectations

	Floods			
	(1) 3m	(2) 6m	(3) 9m	(4) 12m
Lagged dispersion	0.544*** (0.0448)	0.541*** (0.045)	0.544*** (0.0437)	0.541*** (0.0427)
Flood events	0.00542 (0.0171)	0.0261** (0.00903)	0.00745 (0.013)	0.0335 (0.0193)
Observations	738	738	738	738
Within R sq	0.559	0.56	0.559	0.562
	Droughts			
	(5) 3m	(6) 6m	(7) 9m	(8) 12m
Lagged dispersion	0.544*** (0.0442)	0.543*** (0.0454)	0.543*** (0.0454)	0.543*** (0.0453)
Drought events	0.0375*** (0.0116)	0.0169** (0.00769)	0.0118 (0.00679)	0.0096 (0.00624)
Observations	738	738	738	738
Within R sq	0.561	0.56	0.56	0.56

*** p-value<0.01, ** p-value<0.05, * p-value<0.1. Robust standard errors in parantheses.

Source: Authors own calculations using data from Reserve Bank of India IEHS and EM-DAT disasters database.

Table 4: Dispersion of One-year-ahead Inflation Expectations

	Floods			
	(1) 3m	(2) 6m	(3) 9m	(4) 12m
Lagged dispersion	0.586*** (0.0296)	0.583*** (0.0299)	0.585*** (0.0295)	0.584*** (0.0279)
Flood events	0.0468** (0.0191)	0.0282** (0.00995)	0.0123 (0.011)	0.0337 (0.0195)
Observations	738	738	738	738
Within R sq	0.616	0.615	0.615	0.617
	Droughts			
	(5) 3m	(6) 6m	(7) 9m	(8) 12m
Lagged dispersion	0.586*** (0.0302)	0.585*** (0.0309)	0.585*** (0.0309)	0.585*** (0.0307)
Drought Events	0.0394*** (0.00922)	0.0194** (0.00697)	0.0119* (0.00617)	0.0105* (0.00561)
Observations	738	738	738	738
Within R sq	0.616	0.615	0.615	0.615

*** p-value<0.01, ** p-value<0.05, * p-value<0.1. Robust standard errors in parantheses.

Source: Authors' own calculations using data from Reserve Bank of India IEHS and EM-DAT disasters database.

mitigate supply-side inflation pressures in the short run, a strong commitment to keeping inflation low can lower expectations at all horizons.

Keeping inflation stable is a key objective for not only the central bank but also the state and Union governments. As disasters exacerbate the supply-side constraints, fiscal policies supporting supply chains in flood- and drought-prone areas can lower inflationary pressures of these events. In general, significant disaster management and mitigation efforts could reduce the negative effects of climatic events on economic activity reducing adverse effects on inflation expectations (Parida et al 2021).

Using survey data, the article tries to understand how precipitation-related disasters affect household inflation expectations. One finding is that the occurrence of both floods and drought events increase inflation expectations with a larger short-run quantitative effect from floods but a more persistent effect from droughts. The analysis shows that households perceive natural disasters as adverse supply shocks in the short run, which raises their inflation expectations at both three-month and one-year horizon.

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NOTES

- This refers to a household's expectation on the rate at which prices will increase over different time horizons.
- The survey data is publicly available at Reserve Bank of India statistical database, <https://www.rbi.org.in/Scripts/Statistics.aspx>.
- The EM-DAT database is owned by the Center for Research on Epidemiology of Disasters, a research unit located at University of Louvain, Belgium. The data is publicly available for download at <https://www.emdat.be/>.
- Professional forecasters are experts in the financial sector who produce predictions of economic indicators using data and models.
- We include all events categorized as general floods in EM-DAT which include coastal flood, riverine flood, and flash floods. Droughts are measured in EM-DAT as extended period of low precipitation that create a shortage of water for animals and humans.
- Our dataset contains all 28 states and 6 union territories excluding the union territory of Daman and Diu, and Ladakh. For simplification, union territories will be referred to as "states" in rest of the analysis.
- These are 5.6% of the whole sample of households from 2009 to 2021.
- The reported inflation expectations range from 1.5% to 124% for three-month ahead, and 1.5% to 291% for one year ahead during the period of analysis.
- IESH surveys households representatively across a city, not state. We merge the cities with states to conduct state-level analysis.

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