

THE IMPACT OF INFLATION EXPECTATIONS ON HOUSEHOLD WELL-BEING: AN EMPIRICAL ANALYSIS

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Abstract: For decades, understanding financial and subjective well-being has been central to research, given its relevance to individual quality of life and policy decisions (Helliwell et al., 2019; Brügger et al., 2017). Both financial freedom and self-reported happiness are essential aspects of well-being, which are influenced significantly by inflation, including past experiences, current levels, and future expectations (Cupak & Siranova, 2023; Dolan et al., 2009; Coibon et al., 2019). The literature, however, presents mixed results: while some studies suggest that inflation negatively impacts well-being (Prati, 2023), others suggest a more positive relationship (Golem et al., 2010). This paper investigates the link between inflation expectations and well-being from the household perspective, addressing a notable gap in the research, particularly relevant during periods of high inflation and economic instability. Using HFCS data from 2021—a year marked by the COVID-19 pandemic and heightened economic uncertainty—this study examines household perceptions of price dynamics, general financial conditions, and their collective impact on well-being in a time of considerable disruption.

Keywords: Well-Being, Inflation, Expectations, Households, HFCS

JEL Classification: D10, D94, I31

INTRODUCTION

Subjective well-being, measured through self-reported happiness, or financial well-being, assessed from the perspective of financial freedom, has been a key area of research for decades due to its importance for individual quality of life and policy decisions (Helliwell et al., 2019; Brügger et al., 2017). Inflation, including historical experiences, current rates, and expectations about future trends, plays a crucial role in shaping well-being (Cupak & Siranova, 2023; Dolan et al. 2009; Coibon et al., 2019). Yet, the literature presents mixed findings, with some studies suggesting that inflation reduces well-being (Prati, 2023), while others find the opposite (Golem et al., 2010). This paper seeks to explore the relationship between inflation expectations and well-being from the household perspective, addressing a gap in the literature, particularly in times of high inflation and its fluctuations. This study examines HFCS data from the turbulent year of 2021, marked by the ongoing COVID-19 pandemic and heightened uncertainty regarding future economic developments. The analysis seeks to assess household sentiment, perceptions of price dynamics, and general financial conditions, exploring their impact on their well-being during this period of unprecedented challenges. The paper is structured as follows. In the second section, we briefly discuss the review of prior literature on inflation expectations and subjective well-being. The third section defines the methodology and data. In the next section, we show the results on the relationship between inflation expectations and household subjective well-being. The last section summarizes the key findings.

1. LITERATURE REVIEW

Subjective well-being, often measured through self-reported happiness, life experiences, or satisfaction, has been studied by researchers for decades. Gaining insight into subjective well-being is crucial not only for improving individual quality of life but also for informing policy decisions aimed at enhancing societal well-being (Helliwell et al., 2019). When we narrow the concept down to the definition of financial well-being, it refers to a state of being happy and free from financial worry (Zimmerman, 1995) or to the ability to maintain both the current and desired standard of living, both today and in the future, while also enjoying financial freedom (Brüggen et al., 2017).

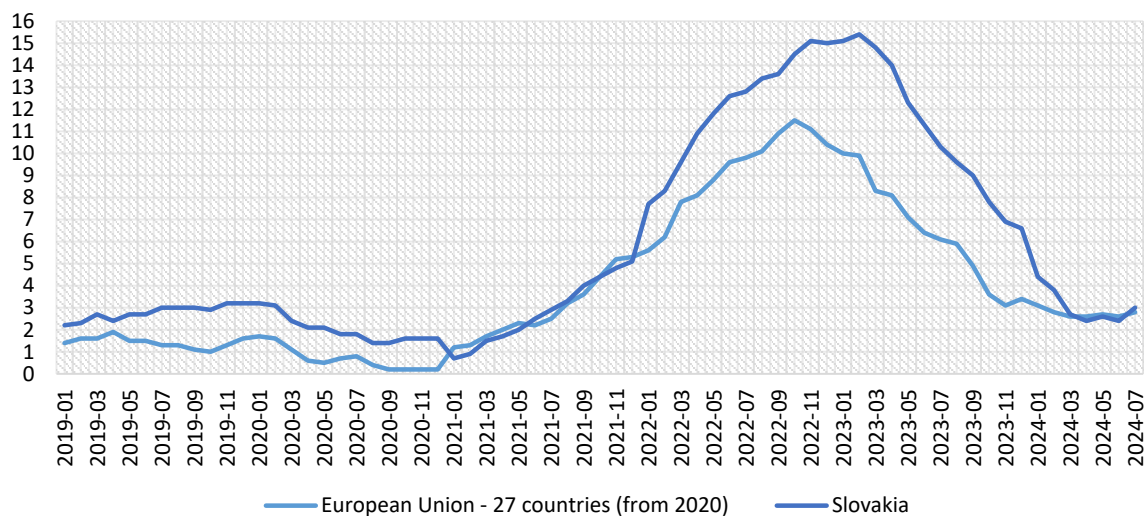
Historical inflation experiences, along with the actual and perceived current inflation rates and inflation expectations, play a crucial role in shaping well-being. According to a theoretical literature review on determinants of subjective well-being by Dolan et al. (2009), the current inflation rate has been consistently shown to negatively impact subjective well-being, and a fluctuating inflation further decreases life satisfaction. Ryan (2012) in a comprehensive study on changes in financial well-being following shifts in life circumstances, notes that households facing negative financial events - such as high inflation, among other factors - often report lower levels of financial well-being. Candia et al. (2020) demonstrate that for households, higher inflation is linked to worse economic outcomes such as higher unemployment or slower economic growth. Surprisingly, however, households, firms and professional forecasters do not consistently interpret these outcomes in the same way. Prati (2023) concludes that perceived disaggregate inflation rates are negatively correlated with well-being. The paper highlights criticism of the Consumer Price Index (CPI) as a measure of inflation and instead uses Opinion Price Index as a proxy for perceived inflation. Additionally, it considers variations in consumer groups' consumption baskets to infer differences in the experienced inflation. Households with a history of experiencing higher inflation tend to report noticeably lower levels of happiness in the present (Cupak and Siranova, 2023). Using EU-level Household Finance and Consumption Survey (HFCS) data, the authors conducted a regression analysis and showed the negative impact of lifetime inflation experiences on revealed utility. On the contrary, according to Perovic and Golem (2010) and Akgun et al. (2022), a positive correlation exists between inflation and happiness. Perovic and Golem (2010) suggest that perceived happiness does not remain consistent across all inflation rates, as moderate inflation positively affects happiness. Akgun et al. (2022) used a quantile regression approach to support these findings.

The inflation a person expects influences their decisions on saving, when and what to buy, what type of mortgage to take out, or what salary to ask for. Consequently, households anticipating higher inflation may reduce their spending rather than raise it. As inflation expectations rise, households report a lower frequency of both large and small purchases, leading to an overall decrease in total spending (Coibon et al., 2019). However, some papers (e.g. see D'Acunto et al., 2015 or Vellekoop and Wiederholt, 2019) reached the opposite conclusion, finding that that inflation expectations increase total consumption, particularly on durable goods.

In times of high inflation and its fluctuations, it is especially important to understand how households perceive it and what future developments they expect, as this might significantly impact their overall well-being and economic behavior. Based on the literature reviewed, the evidence regarding the relationship between inflation expectations and well-being remains mixed. Relatively few studies have considered inflation expectations as a critical factor in examining the relationship between inflation and well-being.

Unprecedented events such as the COVID-19 pandemic and the deteriorating geopolitical situation in Europe have led to a significant increase in the prices of goods and services. Figure 1 illustrates the annual rate of change in the Harmonized Index of Consumer Prices (HICP) for the European Union and Slovakia. Both the EU and Slovakia experienced relatively stable inflation rates from January 2019 to early 2021, with changes fluctuating between 0 % to 3 %. By mid-2021, inflation started to rise steeply.

Fig. 1 Annual rate of HICP change (all items) in %



Source: Eurostat

Not only significant fluctuations are observable in overall inflation but also variations in how different individuals perceive inflation rates, as highlighted by Prati (2023). We aim to contribute to the relatively limited body of literature that examines inflation expectations from the perspective of households and their impact on well-being. While the macroeconomic implications of inflation expectations are well-documented, their influence on individual household well-being remains underexplored.

In this paper, we examine the relationship between inflation expectations and their impact on household subjective well-being. Inflation expectations can be framed in multiple ways: like the difference between income and prices, anticipated overall price development, expected changes in house prices, or general outlook for the financial situation over the coming year. Following Candia et al. (2020), we hypothesize that households viewing inflation as a signal of worsening economic conditions may experience diminished well-being. Although prior literature has often focused on inflation rates or on past inflation experiences, we anticipate that expected inflation might correlate with lower levels of happiness or satisfaction. Following Perovic and Golem's (2010) findings, which indicate that happiness levels vary across inflation rates and show a positive relationship between lower inflation rates and well-being, we suggest that during periods of economic uncertainty, high inflation may foster negative expectations among households. When measuring inflation through anticipated house price changes, it is essential to consider the wealth and collateral hypotheses. These hypotheses propose that an increase in a homeowner's property value raises their overall wealth (see e.g., Attanasio et al., 2005). Therefore, when inflation is assessed via house price changes, the relationship with household well-being may be inversely correlated.

Our hypotheses are as follows:

H1: Expected lower income increase than increase in prices in next 12 months leads to decrease in household well-being.

H2: Expected significant growth in prices in the next 12 months leads to decrease in household well-being.

H3: Expected (much) worse financial situation in a year leads to decreased household well-being.

H4: Expected high increase in house prices (more than 5 %) leads to increase in household well-being.

2. METHODOLOGY AND DATA

In this paper we use the data from Household Finance and Consumption Survey (HFCS). HFCS collects micro-data on the distribution of the portfolio of assets and financial liabilities of households and their

consumption decisions. The dataset contains responses from 2 174 Slovak households for the year 2021. The data are obtained from the survey and assigned individual weights, which are accounted for in the calculations. We estimate the effect of inflation expectations on household subjective well-being by the following regression:

$$Y_i = \beta_0 + \beta_1 X_{1i} + \beta_2 X_{2i} + \beta_3 X_{3i} + \epsilon_i \quad (1)$$

where Y_i is the subjective well-being of the household, which they report on a scale from 0 to 10 as an expression of overall satisfaction with their life. The average well-being in the entire dataset is 7.09. The main variables of interest are inflation expectations (X_{1i}) i.e., the household's expectations regarding changes in prices, wages and the overall expected financial situation in a year. The expectations of households are divided into four groups: expectations regarding changes in property prices, income growth, price changes and financial situation a year from now (in the next 12 months). The sign of the estimated β_1 tells us whether households inflation expectations report significantly higher/lower levels of well-being. X_{2i} includes different measures of consumption. We control for relevant socioeconomic characteristics (X_{3i}). For individual models, we considered the correlation matrix, and thus there are no highly correlated independent variables in our models.

Subsequently, we adjusted the variables for our needs like this. We created dummy variables for the group of households that expected a given property price change (fall or rise) with a probability higher than 50 %. For the variable of expected household income growth, we created dummy variables for each of the possible household responses: expecting higher/lower income growth versus price growth in the next 12 months or about the same income growth versus price growth. For the variable expected growth in household prices, we also created dummy variables for each of the possible responses of households: expectation of significant price growth, expectation of moderate price growth, price stay at the same level or expectation of price decline. The variable "financial situation in the year" did not require additional adjustments.

3. RESULTS

By adjusting the variable of the expectation of a change in the property price, we obtained four adequate variables that contain households whose probability of occurrence in the given situation is higher than 50 %, e.g. variable a property price drop by more than 5%, represents 10.45 % of the households. Another part is the expectation of income growth versus price growth: 7.77 % of households expected their income growth in the next 12 months to be higher than price growth, and the majority of households (63.7 %) expected lower income growth such as rising prices. The majority of households expected prices to rise in the next 12 months (58.73 % expected significant growth and 38.69 % expected moderate growth). Only a negligible number of households expected prices to fall or remain unchanged. The majority of households did not expect a change in their financial situation in the next 12 months (66.25 %). 16.2 % of households expected it to improve and 17.55 % expected it to worsen.

Negative expectations of property price changes are accompanied by lower well-being. If a household expects property prices to drop by more than 5% during the year, their average well-being is only 6.34. If their expectation of a property price decrease is between 2% and 5%, well-being is at 6.44. As long as households have positive expectations, so they expect property prices to growth by 2% to 5%, their well-being will increase to the level of 6.97 and with an expected growth property prices by more than 5%, households reported well-being of 7.15.

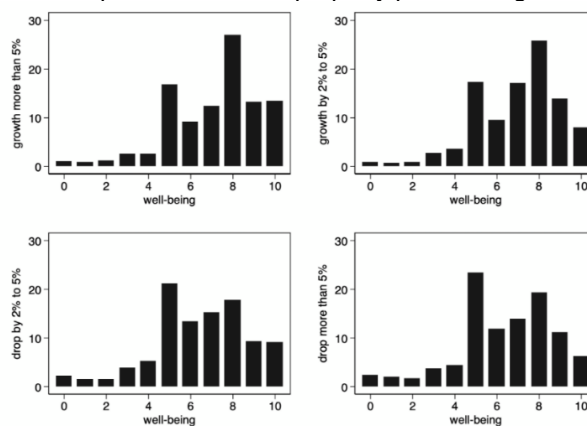
Households that in the next 12 months expect the same increase in their total income as the increase in prices will report an average well-being of 7.44. Households with a negative outlook for income growth compared to prices (they expect lower income growth compared to price growth) reduced well-being to 6.88.

On the other hand, households with positively formulated expectations, i.e. they expect faster income growth than price growth, have well-being at the level of 7.58.

Most households expect a significant increase in prices (prices in the next 12 months will be much higher) and their average well-being is 6.94. Households with expectations of a slight increase in prices (prices in the next 12 months will be higher) report average well-being at the level of 7.34. Households with expectations of price declines or unchanged prices in the next 12 months constitute a low sample for analysis.

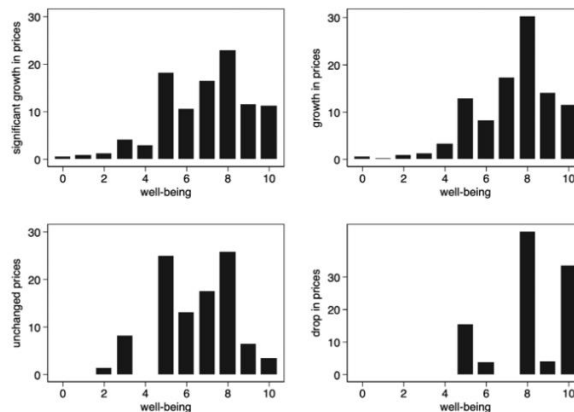
The majority of households do not expect a change in their financial situation during the next 12 months and their average well-being is 7.23. If households expect an improvement in their financial situation (better financial situation in a year), their average well-being also increases to 7.58. On the contrary, households that expect their financial situation to worsen (worse or much worse financial situation in a year) reduced their average well-being to 6.28 and 5.57.

Fig. 2: Well-being of household's expectations about property price changes



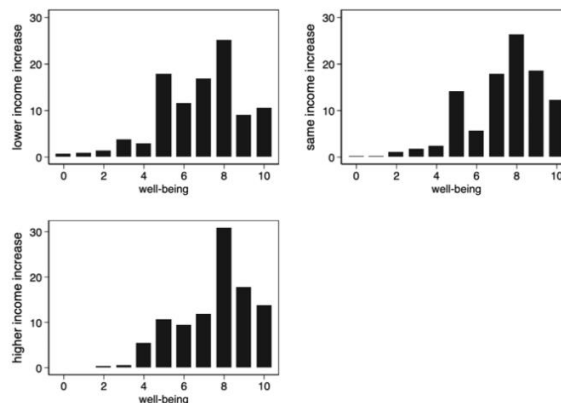
Source: NBS HFCS 2021

Fig. 3: Well-being of household's expectations about price changes



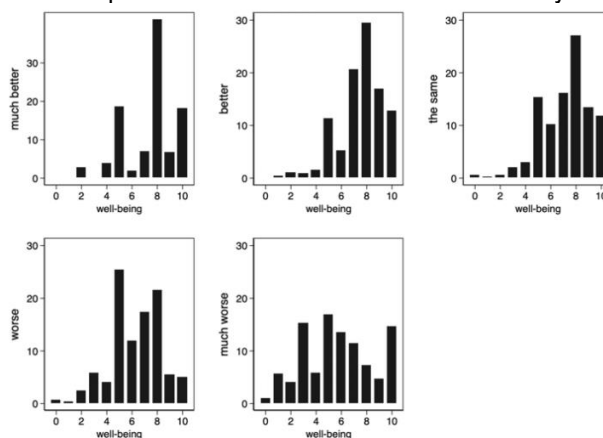
Source: NBS HFCS 2021

Fig. 4: Well-being of household's expectations about income growth



Source: NBS HFCS 2021

Fig. 5: Well-being of household's expectations about financial situation in a year



Source: NBS HFCS 2021

The results of the descriptive and graphic analysis show the impact of negative inflation expectations on the reduction of household well-being, and positive inflation expectations have a positive effect on household well-being. We decided to further test the observed effects through regression analysis, OLS regressions and to find out whether it is a significant effect of the variables.

The following tables 1, 2, 3 show the results of OLS regression according to individual types of household expectations. Table 1 shows the dependence of household well-being on expectations regarding the growth of real estate prices. A significant and negative impact was confirmed for the negative expectations of the household, i.e. that the price of their property will fall within the next 12 months (Model 1 and Model 2). In the case of positive expectations, i.e. if households expect an increase in real estate prices, which has an impact on the growth of their wealth, the positive effect on well-being was confirmed only with a significant increase in property prices (by more than 5% – Model 4), but the effect is not significant. According to the prospect theory, households react more sensitively to expected loss (fall in property price) than to gains (rise in property price), where feelings of loss significantly affected their subjective well-being.

Tab. 1: Subjective well-being models by expectations of property price changes

VARIABLES	(1)	(2)	(3)	(4)
<i>property price drop by more than 5%</i>	-0.841***			
	(0.210)			
<i>property price drop by 2% to 5%</i>		-0.762***		
		(0.180)		
<i>property price growth by 2% to 5%</i>			-0.201*	
			(0.121)	
<i>property price growth by more than 5%</i>				0.0880
				(0.130)
<i>Constant</i>	7.182***	7.201***	7.169***	7.067***
	(0.0593)	(0.0606)	(0.0716)	(0.0677)
<i>Observations</i>	2,174	2,174	2,174	2,174
<i>R-squared</i>	0.017	0.018	0.002	0.000
<i>Standard errors in parentheses</i>				
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$				

Source: NBS HFCS 2021

Table 2 shows the dependence of household well-being on expectations regarding the growth of total income versus price growth. All options of expectations confirmed a significant impact on well-being. If income growth is expected to be higher than price growth (Model 5), this is a positive effect. If income growth is expected to be lower than price growth (Model 6), this is a negative effect.

Tab. 2: Subjective well-being models by expectations of income growth versus price growth

VARIABLES	(5)	(6)	(7)
<i>the growth of total household income will be higher than the growth of prices</i>	0.528*** (0.196)		
<i>the growth of total household income will be lower than the growth of prices</i>		-0.590*** (0.117)	
<i>the growth of total household income will be same as the increase in prices</i>			0.483*** (0.126)
Constant	7.053*** (0.0607)	7.469*** (0.0926)	6.956*** (0.0681)
Observations	2,174	2,174	2,174
R-squared	0.005	0.020	0.012
Standard errors in parentheses			
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$			

Source: NBS HFCS 2021

Table 3 shows the dependence of household well-being on price growth expectations. In the case of positive (Model 10) and neutral (Model 11) expectations regarding price growth, we have a small number of observations, which we attribute to the non-confirmation of the results. Model 8 examines the impact of significant price growth in the next 12 months, and thus the effect of these expectations is significantly negative on welfare. If households expected only a modest increase in prices in the next 12 months (Model 9), the effect on subjective well-being was positive. We explain this result by the fact that households count on a certain stable rate of inflation (the ECB has set the goal of keeping inflation at the level of 2%), and thus a moderate increase in prices is acceptable to them and they do not perceive it as a negative impact on their well-being.

Next, we tested the robustness of our results. Table 4 and Table 5 only test the variables from our hypotheses. In individual models (Models 12 to 16, Models 17 to 21), we changed the consumption variable, which represents the household's share of a given type of consumption in relation to total income. We divided consumption behavior into spending on food at home (Model 12 and Model 17), spending on consumer goods (Model 13 and Model 18), spending on food outside the home (Model 14 and Model 19), housing costs (Model 15 and Model 20), vacation expenses (Model 16 and Model 21). Consumption behavior divides households into individual categories and the results confirm the significant influence of variables. Regressions without control variables yielded the following results: a significant effect was not confirmed only in the case of expectations of real estate price growth. Again, we attribute this result as a consequence of the prospect theory, households do not attach a high weight to the expected profits from the rise in property prices, and thus this does not affect their subjective well-being. Expectations of lower income growth compared to price growth, significant price growth in the next 12 months, and the expectation of a year's deterioration in the financial situation have a significant negative impact.

Tab. 3: Subjective well-being models by expectations of price growth

VARIABLES	(8)	(9)	(10)	(11)
<i>prices will be much higher</i>	-0.368*** (0.116)			
<i>prices will be higher</i>		0.406*** (0.117)		
<i>prices will be lower</i>			1.091 (0.671)	
<i>the prices will be about the same</i>				-0.641* (0.334)
Constant	7.310*** (0.0866)	6.937*** (0.0758)	7.088*** (0.0580)	7.107*** (0.0587)
Observations	2,174	2,174	2,174	2,174
R-squared	0.008	0.010	0.002	0.002
Standard errors in parentheses *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$				

Source: NBS HFCS 2021

Table 4 and Table 5 contain the control variables. Based on previous literature, see e.g. Prati (2023), we decided to include gender, university education, age, subjective health status, and income quintiles. Because of the high correlation between control variables and income quintiles, we tested two sets of control variables. In Table 4, after the inclusion of income control variables, the effects of negative expectations remained negative, in some cases there was a decrease in significance.

In Table 5, after the inclusion of other control variables, the effects of negative expectations also remained negative, in some models the significant effect of worsening the financial situation in a year disappeared. Households that can afford higher vacation expenses relative to their income (Model 21) experience subjectively higher well-being and the effect is significant at the 0,01-significance level.

Tab. 4: Subjective well-being models by different expectations and consumption with income quintiles

VARIABLES	(12)	(13)	(14)	(15)	16)
<i>property price growth by more than 5%</i>	0.0933 (0.120)	0.0928 (0.120)	0.0894 (0.120)	0.0934 (0.120)	0.0460 (0.118)
<i>the growth of total household income will be lower than the growth of prices</i>	-0.212* (0.122)	-0.213* (0.122)	-0.199 (0.122)	-0.212* (0.122)	-0.182 (0.120)
<i>prices will be much higher</i>	-0.337*** (0.0970)	-0.335*** (0.0971)	-0.324*** (0.0982)	-0.337*** (0.0971)	-0.276*** (0.0963)
<i>financial situation in a year</i>	-0.212* (0.111)	-0.211* (0.111)	-0.222** (0.111)	-0.212* (0.112)	-0.231** (0.109)
<i>expenditure on food as a share of total income</i>	0.0584 (0.130)				
<i>expenditure on consumer goods as a share of total income</i>		0.0708** (0.0313)			
<i>spending on food outside the home as a share of total income</i>			1.959** (0.956)		
<i>expenditure on housing services as a share of total income</i>				0.0286 (0.130)	
<i>vacation expenses as a share of total income</i>					8.203*** (1.913)
<i>Control variables</i>	Income	Income	Income	Income	Income
<i>Constant</i>	7.401*** (0.327)	7.357*** (0.325)	7.297*** (0.335)	7.420*** (0.324)	7.105*** (0.323)
<i>Observations</i>	2,167	2,167	2,167	2,167	2,167
<i>R-squared</i>	0.129	0.130	0.134	0.129	0.156
<i>Standard errors in parentheses</i>					
<i>*** p<0.01, ** p<0.05, * p<0.1</i>					

Source: NBS HFCS 2021

Tab. 5: Subjective well-being models by different expectations and consumption with control variables

VARIABLES	(17)	(18)	(19)	(20)	(21)
property price growth by more than 5%	0.0484 (0.116)	0.0477 (0.116)	0.0458 (0.117)	0.0471 (0.116)	0.0197 (0.115)
the growth of total household income will be lower than the growth of prices	-0.231** (0.115)	-0.236** (0.115)	-0.238** (0.115)	-0.228** (0.115)	-0.229** (0.114)
prices will be much higher	-0.374*** (0.0909)	-0.378*** (0.0908)	-0.376*** (0.0914)	-0.373*** (0.0909)	-0.344*** (0.0907)
financial situation in a year	-0.176* (0.107)	-0.172 (0.107)	-0.175 (0.107)	-0.176* (0.107)	-0.187* (0.106)
expenditure on food as a share of total income	-0.299 (0.195)				
expenditure on consumer goods as a share of total income		-0.0773 (0.0822)			
spending on food outside the home as a share of total income			0.881 (0.841)		
expenditure on housing services as a share of total income				-0.382 (0.276)	
vacation expenses as a share of total income					5.791*** (1.598)
Control variables	YES	YES	YES	YES	YES
Constant	9.392*** (0.678)	9.347*** (0.681)	9.195*** (0.683)	9.400*** (0.681)	8.999*** (0.675)
Observations	2,167	2,167	2,167	2,167	2,167
R-squared	0.167	0.166	0.166	0.168	0.178

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Source: NBS HFCS 2021

CONCLUSION

In conclusion, the findings underscore the importance of household expectations in shaping well-being, especially during inflationary uncertainty in 2021 and 2022. Notably, households largely anticipated higher price levels in the coming year, with many expecting income growths to lag rising prices. Despite the limited context—focused mainly on COVID-19 impacts and unaware of escalating geopolitical tensions or the impending energy crisis—households accurately foresaw the challenges inflation would pose to their future well-being. Negative expectations regarding income growth relative to prices were strongly associated with lower well-being, while anticipated improvements in financial outlook or modest price increases correlated with higher well-being scores. These results point to the substantial psychological impact of inflation expectations, where both positive and negative outlooks significantly influence household financial sentiment. Robustness checks further validated key hypotheses: households expecting income to grow slower than inflation or an increasingly challenging financial situation over the year experienced marked declines in well-being. Conversely, only expectations of significant house price increases (above 5%) demonstrated a positive, albeit non-significant, impact.

Future research using panel data could delve deeper, confirming causality beyond the correlational insights provided by cross-sectional data. Additionally, studying household inflation expectations following periods of acute inflationary and geopolitical stress would yield valuable insights into adaptive financial behavior in complex economic environments.

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