Anchoring of Inflation Expectations
Do Inflation Target Formulations Matter?

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* *Disclaimer: The views and opinions expressed in the presentation are not necessarily those of the Banque de France or the Eurosystem.*

Why **inflation targeting?**

- Standard today: **delegated policy making**
- Why? Discretionary policy evokes **inflation bias**
- Solution: commit to **conservative inflation target** π^* (Svensson 1997)
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What else does it need for the IT framework to **work in practice**?

- **accountability** (enforcement of π^*)
- **transparency** (improves transmission)
- a **target formulation** (MP design).

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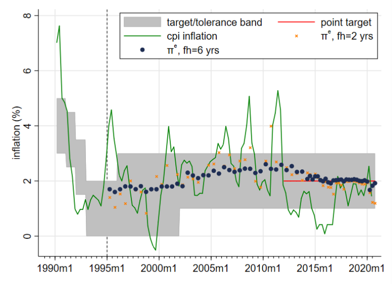
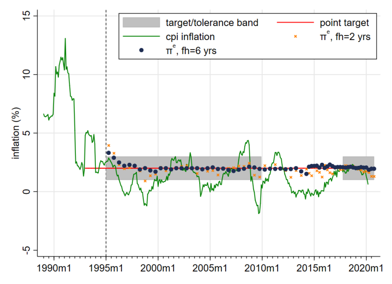
- **Definition: Well-anchored inflation expectations**
  - No widely-agreed definition, ...
  - ... but some recurrent criteria (Afrouzi, Kumar, Coibion, Gorodnichenko 2015)

1. avg beliefs being **close to target**
2. little **dispersion** of beliefs across agents
3. high confidence, little (subjective) **uncertainty**
4. low **revisions** (over longer horizons)
5. little co-movement between long-run and short-run (**'pass-through'**)

Target formulations differ cross-country, and over time.



(a) New Zealand

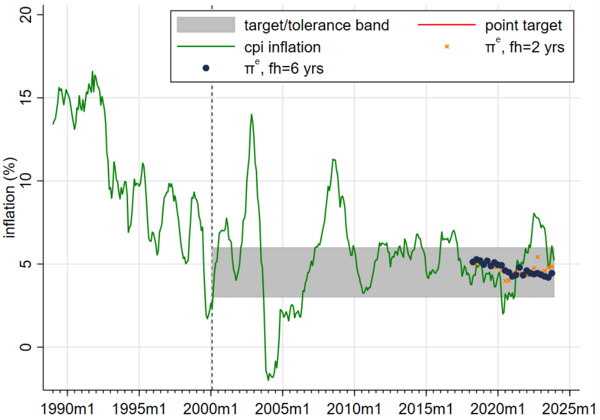


(b) Sweden

Note: Green line=YoY CPI inflation. Vertical, dotted line=start date of a stable inflation target, following Roger (2009), with adjustments and extensions. Blue dots=mean point forecast, $h = 6$ to 10 years. Yellow x=mean point forecast, $h = 2$ years.

SARB

- Inflation targeting since February 2000
- Inflation target range 3-6% (CPI)
- Since 2017 focus on inflation "close to midpoint of 4.5%"



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Question of target formulation not as trivial as it seems ...

- Economic theory: **conflicting predictions:**

1. Precise CB target problematic due to **time-inconsistency pb** [Stein 1989]
   $\rightarrow$ non-numerical definitions of price stability anchor π^e better
2. Ranges are **more credible** [Demertzis Viegi 2009, Andersson Jonung 2017]
   $\rightarrow$ target ranges/corridors anchor π^e better
3. Ranges provide more **flexibility** [Svensson 1997, Orphanides Wieland 2000]
   $\rightarrow$ point-targets anchor π^e better

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$\Rightarrow$ Testable predictions are focus of this paper.

What this paper does

1. Empirical tests in **panel model** (TWFE)
   - 29 countries
   - 2005q5 - 2020q2
   - distinguishing 4 target formulations:
     1.1 no precise numerical target (but quant.def, ex. EA, US*, JP*)
     1.2 target range (ex. AU, CH, IL)
     1.3 hybrid target (ex. CA, NZ*, MX, CZ*)
     1.4 point target (ex. UK*, US*, SE*)

     * Countries that changed the formulation at least once within the sample.
   - *unconditional* and *conditional* performance

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      * Countries that changed the formulation at least once within the sample.
    - *unconditional* and *conditional* performance
2. Construction of a **novel anchoring measure**
    - based on the cross-sectional distribution of π^e from professional forecasters, h=1,2,...6-10 years (Consensus Economics)
    - parametric distribution functions $F(\pi^h_{it})$
    - 3D-panel: time, cross-country, forecast horizon

Main findings

- **Point targets**
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- **Hybrid targets** (tolerance bands)
  - similar unconditional anchoring as point target.
  - slightly less effective in limiting shifts in tails of the belief-distribution during periods of sustained deviations from target.
- **Ranking target formulations w.r.t. anchoring properties:**
  1. point target
  2. $\approx$ hybrid target
  3. $\gg$ target range

Related literature

- **Effect of target formulations**
  - Castelnuovo, Nicoletti-Altimari & Rodriguez-Palenzuela 2003: no significant difference between target formulations
    → update and extension
  - Ehrmann 2021: short-run horizon, weaker pass-through in presence of a range or tolerance band
    → forecast horizon beyond MP lag; level anchoring
- **Inflation Targeting**
  - IT helps to anchor expectations (Fatas, Mihov & Rose 2007, Crowe 2010, Davis 2014)
  - → differences across target formulations
- **Expectations anchoring**
  - **Distribution**: Reis (2021) Losing the Inflation Anchor
  - **Level**: Mehrotra & Yetman 2018, Grishchenko, Mouabbi & Renne 2019
  - **Pass-through**: *short-term to long-term* (Jochmann et al 2010, Pooter et al 2014, Lyziak & Paloviita 2017, Buono & Formai 2018), *realized on long-run* (Levin, Natalucci & Zakrajsek 2004), *long-run break even and news* (Guerkaynak, Levin & Swanson 2012, Beechey, Johannsen & Levin 2011, Bauer 2015, Hachula & Nautz 2018, Speck 2017)
  - → distribution as anchoring criteria.

Data

Anchoring: estimate beliefs about inflation

- Consensus forecasts: country i, quarter t, forecast hor. h =2y, 3y, 4y, 5y, 6y.
  - For long-term forecasts only mean, sd, highest obs, lowest obs.
  - For short-term forecasts full set of answers.
- Fitting skew extended t distribution, $\hat{F}^*_{JF}(\mu, \sigma, a, b)$ (Jones and Faddy 2003)
- Flexible, asymmetric, fat tails ($\rightarrow$ risk management)

Targeted moments

- mean
- standard deviation
- skewness ratio from the data (def. below)
- location of the highest observation (*percentile*), penalized*
- location of the lowest observation (*percentile*), penalized*

$$S^h_{it} \equiv \frac{(high^h_{it} - \mu^h_{it}) - (\mu^h_{it} - low^h_{it})}{high^h_{it} - low^h_{it}}.$$

* penalty based on the distribution of percentiles for 'highest'/'lowest' observations in estimated densities based on a dataset w/ all answers for shorter forecast horizons.

Anchoring (risk) measures (1/3)

- Set $\underline{\pi}_{i,t} = \pi^*_{i,t} - 0.1$ and $\bar{\pi}_{i,t} = \pi^*_{i,t} + 0.1$
- Compute anchoring measure for each country i, time t, forecast horizon h, from estimated $\hat{F}_{JF}(\mu, \sigma, a, b)$:

$$DAL^h_{it} = \int_{-\infty}^{\underline{\pi}_i} dF_{\pi^h_{it}}(\pi^h_{it})$$

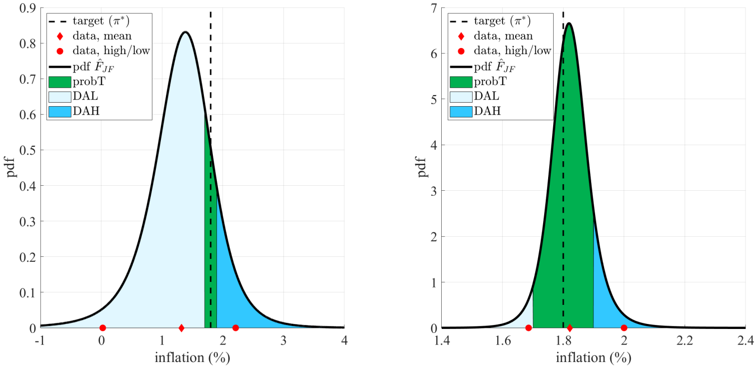
$$DAH^h_{it} = \int_{\bar{\pi}_i}^{\infty} dF_{\pi^h_{it}}(\pi^h_{it})$$

$$\begin{aligned} probT^h_{it} &= \int_{\underline{\pi}_i}^{\bar{\pi}_i} dF_{\pi^h_{it}}(\pi^h_{it}) \\ &= 1 - DAL^h_{it} - DAH^h_{it}. \end{aligned}$$

- $\Rightarrow$ obtain (unbalanced) panel $probT^h_{it}, DAL^h_{it}, DAH^h_{it}$

Anchoring (risk) measures (2/3)

Fig. Example estimated distribution $\hat{F}_{JF}(\mu, \sigma, a, b)$, Euro area (6 April 2020)



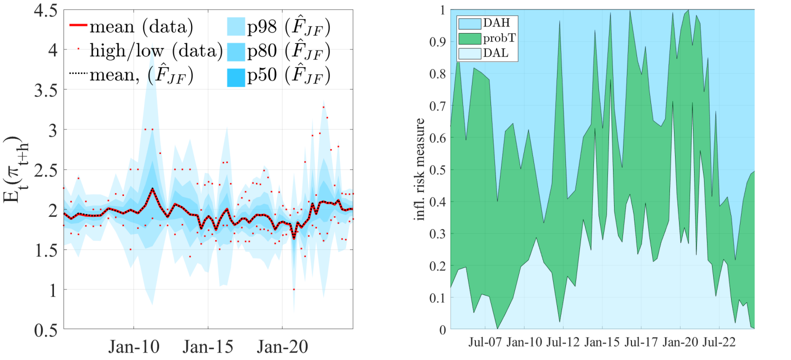
(a) 2-year, fixed-horizon

(b) 6-year, fixed horizon

Note: The skew $t-$distribution $F_{JF}(\mu, \sigma, a, b)$ estimated with simulated method of moments using four moments of the distribution of point forecasts of professional forecasters, namely the mean, the standard deviation, and the highest and lowest reported values from the panel at a given date. The example is based on Euro area data on inflation point forecasts over a 2-year and 6-year fixed-horizon approximation. Underlying raw data stems from Consensus Economics.

Anchoring (risk) measures (3/3)

Fig. Time series properties of densities and anchoring measure, Euro area



(a) Percentiles of $\hat{F}_{JF}$

(b) Expectations anchoring measures

Note: Skew t−distribution estimated via simulated method of moments to professional forecasters' cpi inflation projections over horizons of six years.

Determinants of expectation anchoring

What are determinants of expectations anchoring?

$$X_{it}^{h} = c + \beta_1 d_t^{fh3} + \beta_2 d_t^{fh4} + \beta_3 d_t^{fh5} + \beta_4 d_t^{fh6} + \delta_1 \sigma_{it}^{\pi 24m} + \delta_2 RQ_{it} + \nu_Y + \nu_i + \varepsilon_{it}$$

where X_{it}^{h} is a generic dependent variable in country i, quarter t and horizon h.

- dummy forecast horizon: $d_t^{fh3}, ..., d_t^{fh6}$
- regulatory quality (Worldbank WGI): $RQ_{i,t}$
- condition on volatility of realized inflation, rolling-window (24m): $\sigma_{it}^{\pi 24m}$
- year dummies (ν_Y)
- country FE (ν_i)
- ref. group (const): cross-country avg., 2y horizon

Data: Determinants of expectation anchoring

Tab. 2: Determinants of inflation risk measures

	(1) distAbs	(2) stdev	(3) skewness ratio	(4) probT	(5) DAL	(6) DAH
sd infl. (24m)	0.374***	0.180***	0.00103	-0.000374	-0.0497***	0.0501***
	(0.0130)	(0.00619)	(0.00710)	(0.00536)	(0.00821)	(0.00802)
Regulatory quality	-0.169***	-0.0747***	-0.0270***	0.130***	0.0888***	-0.219***
	(0.0125)	(0.00598)	(0.00688)	(0.00518)	(0.00794)	(0.00776)
d^{fh3}	-0.127***	0.0159	0.0159	0.0469***	-0.0538***	0.00693
	(0.0224)	(0.0107)	(0.0122)	(0.00925)	(0.0142)	(0.0138)
d^{fh4}	-0.170***	0.0276***	0.0318***	0.0685***	-0.0737***	0.00517
	(0.0224)	(0.0107)	(0.0123)	(0.00925)	(0.0142)	(0.0138)
d^{fh5}	-0.198***	0.0182*	0.0550***	0.0964***	-0.0887***	-0.00775
	(0.0224)	(0.0107)	(0.0123)	(0.00925)	(0.0142)	(0.0138)
d^{fh6}	-0.215***	0.00658	0.0737***	0.115***	-0.0962***	-0.0190
	(0.0224)	(0.0107)	(0.0123)	(0.00926)	(0.0142)	(0.0139)
Constant	0.427***	0.290***	0.0270	0.00915	0.302***	0.689***
	(0.0447)	(0.0214)	(0.0245)	(0.0185)	(0.0283)	(0.0277)
adj. R-squared	0.28	0.27	0.04	0.18	0.09	0.23
N.Obs	4483	4483	4435	4483	4483	4483
year dummies	Yes	Yes	Yes	Yes	Yes	Yes

Notes. Pooled OLS, standard errors in parentheses. ***/**/*/ denote statistical significance at the 1%/5%/10% level.

Application: Inflation target formulations

Classification of quantitative inflation targets

- 29 countries (12 AEs, 17 EMEs)
- Inflation target categories (Castelnuovo et al. 2003)
  1. **no numerical target** (Japan pre-2012, US pre 2012Q2, EA)
  2. **range target for inflation** (AUS, ISR, IND, ...)
  3. **hybrid taget** (range target with focal point, point target with tolerance bands) $\rightarrow$ *most frequent* CAN, SWE, and many EMEs
  4. **point target** (UK, US, Korea,...)

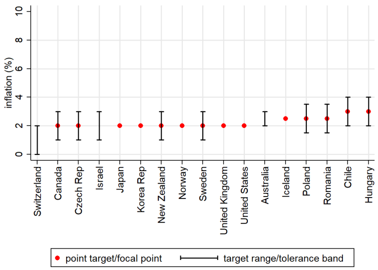
Tab. 1: Summary statistics of inflation targets

	mean	sd	min	max	groups	obs
no IT	1.74	.37	1	2	3	71
IT(all)	2.5	.73	1	5	28	855
Inflation target classifications						
Range target	2.35	.88	1.5	4.5	9	161
Range with focal point	2.2	.25	2	2.5	2	49
Point with tolerance band	2.74	.76	2	5	16	438
Point target	2.18	.36	1	3	8	207

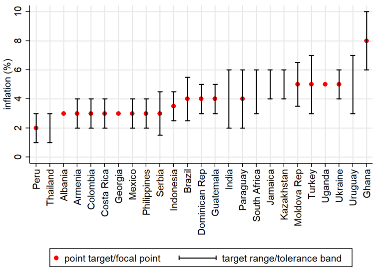
Notes. Summary statistics on the midpoint of the inflation objective for target classifications. Tab. A.1 in the Appendix provides details on the classification for each country in the sample.

Target formulations across countries

Fig. Quantitative inflation targets



(a) AE sample



(b) EME sample

Note: Quantitative targets as of April 2020 of 17 AE countries (panel a) and 25 EME countries (panel b). Switzerland and the United States are the only countries not classified as official inflation targeters. Missing from the AE sample is the Euro area with an inflation objective of below, but close to, 2 percent, which cannot be translated into a specific number without controversy.

Empirical results

Uncond. results: differences between numerical targets

$$X_{it}^{h} = c + \beta_1 d_{it}^{hybrid} + \beta_2 d_{it}^{point} + \delta_1 \sigma_{it}^{\pi 24m} + \delta_2 RQ_{it} + \nu_i + \nu_Y + \varepsilon_{it},$$

d_{it}^{hybrid}: hybrid targets
d_{it}^{point}: pure point target
$\rightarrow$ drop non-numerical IT countries (US$<$2012m3, Euro Area, Japan$<$2012m2)
$\rightarrow$ reference group: **range targets**

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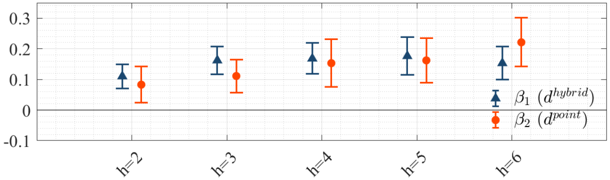
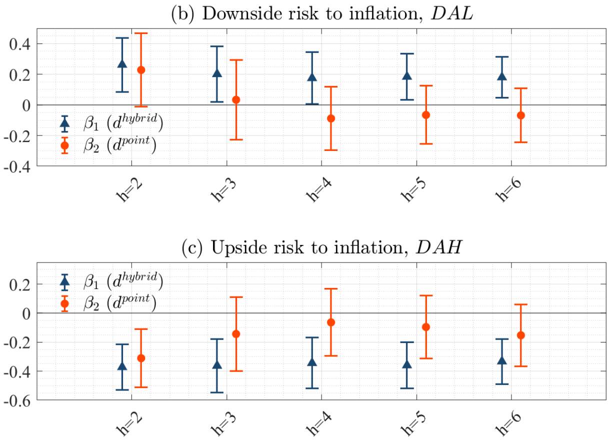
(a) Likelihood being close to target, *probT*



Notes: Point estimates and 90% confidence intervals based on Driscoll and Kraay (1998) standard errors. All equations are estimated separately for each forecast horizon from $h = 2$ to $h = 6$ years based on a fixed-horizon approximation. Sample of 29 countries.

→ Inflation target ranges are associated with less well-anchored π^e

Uncond. results [cont'd] – disanchoring



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→ Point and hybrid targets dampen the risk of disanchoring, but not symmetrically.

Dynamic effect

- So far, stylized fact, but target formulation *causal*?
- Let's look at dynamic effects.

Local projections

$$Y_{h,i,t} - Y_{h,i,t+p} = \nu^{i}_{h,p} + \nu^{Y}_{h,p} + \theta_{h,p} d^{dropRange}_{i,t} + \delta^{1}_{h,p}\sigma^{\pi 24m}_{i,t} + \delta^{2}_{h,p} RQ_{i,t} + \varepsilon_{h,i,t,p},$$

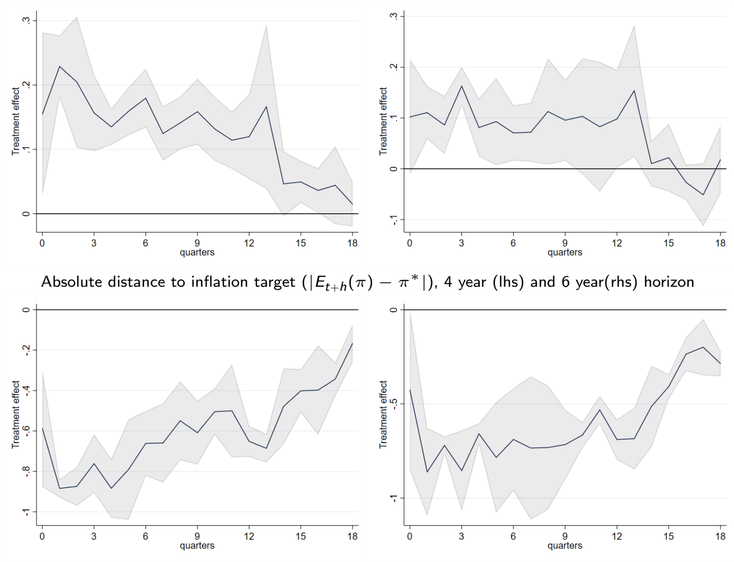
- The dummy $d^{dropRange}$ captures target formulation changes in Czech Republic, Korea, New Zealand and Thailand.

Local projections on dropping a target range

Move to hybrid/point

Likelihood of being close to target (*probT*), 4 year (lhs) and 6 year(rhs) horizon

Absolute distance to inflation target ($|E_{t+h}(\pi) - \pi^*|$), 4 year (lhs) and 6 year(rhs) horizon



Conditioning on persistent deviations from target

Anchoring conditional on track-record

- Indicator CL_{it} based on inflation performance

$$CL_{it} = \frac{1}{T-1} \sum_{s=t-T}^{t-1} (\pi_{is} - \pi^*_{is}) \mid \pi_{is} - \pi^*_{is} \mid$$

- backward-looking, 60 months (Neuenkirch and Tillmann 2014)
- CL_{it} represents multiple things (credibility loss, persistence of shocks, ...)

Net cumulative undershooting/overshooting

$$CL^{(+)}_{it} = \begin{cases} CL_{it}, & \text{if} \quad CL_{it} \geq 0 \\ 0, & \text{otherwise} \end{cases}$$

$$\text{and } CL^{(-)}_{it} = \begin{cases} \mid CL_{it} \mid, & \text{if} \quad CL_{it} \leq 0 \\ 0, & \text{otherwise} \end{cases}$$

Shifts in the fat tails in periods of inflation stress

$$X_{it}^{h} = c + \beta_1 CL_{it}^{+} + \beta_2 CL_{it}^{-} + \gamma_1 \sigma_{it}^{\pi 24m} + \gamma_2 RQ_{it} + \nu_i + \nu_Y + \varepsilon_{it}$$

β_1: cum. overshooting
β_2: cum. undershooting

Tab. 3: Effect of persistent target deviations on expectation anchoring

	(1) $\pi - \pi^*$	(2) probT(4)	(3) probT(6)	(4) DAL(4)	(5) DAL(6)	(6) DAH(4)	(7) DAH(6)	(8) Mean(4)	(9) Mean(6)
$CL^{(-)}$	-0.103	-0.0222**	-0.0301***	0.0632***	0.0850***	-0.0410***	-0.0549***	-0.0407*	-0.0344***
	(0.0831)	(0.0108)	(0.0104)	(0.0146)	(0.0102)	(0.0149)	(0.00858)	(0.0232)	(0.0125)
$CL^{(+)}$	0.722***	-0.00636	-0.00169	-0.00118	-0.0373***	0.00754	0.0389***	0.354***	0.233***
	(0.201)	(0.00848)	(0.00735)	(0.0126)	(0.00891)	(0.0145)	(0.0110)	(0.0561)	(0.0275)
sd infl. (24m)	-0.151	-0.0106	-0.0311	-0.0303	0.0182	0.0409	0.0129	0.0933	0.0236
	(0.260)	(0.0226)	(0.0204)	(0.0258)	(0.0209)	(0.0247)	(0.0179)	(0.0681)	(0.0344)
Regulatory quality	0.307	0.00819	-0.117	0.0930	0.276***	-0.101	-0.160*	-0.919***	-0.761***
	(0.505)	(0.0698)	(0.0842)	(0.0586)	(0.0930)	(0.0749)	(0.0847)	(0.165)	(0.100)
Constant	-0.0425	0.174**	0.353***	0.235***	0.0694	0.592***	0.578***	3.582***	3.359***
	(0.542)	(0.0680)	(0.0780)	(0.0692)	(0.0988)	(0.0758)	(0.0941)	(0.153)	(0.100)
country FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
year dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N.Obs	3978	827	825	827	825	827	825	833	831
N.Countries	28	28	28	28	28	28	28	28	28
adj. R-squared	0.31	0.06	0.06	0.16	0.21	0.19	0.19	0.55	0.51

Notes. Standard errors based on Driscoll and Kraay (1998) in parentheses. ***/**/*/ denote statistical significance at the 1%/5%/10% level.

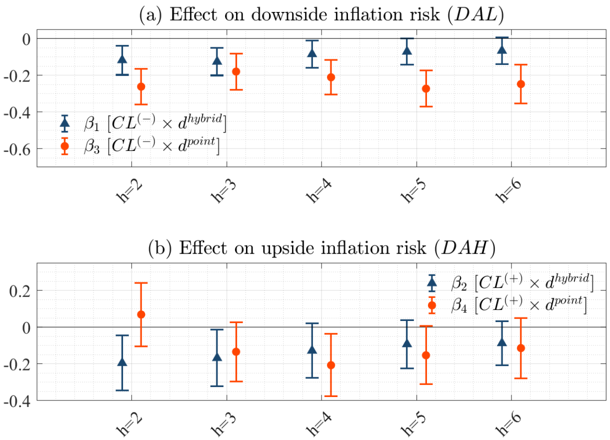
→ Stronger disanchoring from low inflation

Shifts in the fat tails and target formulations

Are movements in the fat tails equal across target formulations?

$$
\begin{aligned}
X_{it}^{h} = & c + \beta_1 \left[CL_{it}^{-} \times d_{it}^{hybrid} \right] + \beta_2 \left[CL_{it}^{+} \times d_{it}^{hybrid} \right] + \delta_1 d_{it}^{hybrid} \\
& + \beta_3 \left[CL_{it}^{-} \times d_{it}^{point} \right] + \beta_4 \left[CL_{it}^{+} \times d_{it}^{point} \right] + \delta_2 d_{it}^{point} \\
& + \gamma_1 CL_{it}^{+} + \gamma_2 CL_{it}^{-} + \gamma_3 \sigma_{it}^{\pi 24m} + \gamma_4 RQ_{it} + \nu_i + \nu_Y + \varepsilon_{it}
\end{aligned}
$$

Shifts in the fat tails and target formulations (results)



Notes: Point estimates and 90% confidence intervals based on Driscoll and Kraay (1998) standard errors. All equations are estimated separately for each forecast horizon from $h = 2$ to $h = 6$ years based on a fixed-horizon approximation. Sample of 29 countries.

$\rightarrow$ Point targets are slightly more effective in limiting shifts in the tails of the distribution.

Robustness

- absolute distance, mean to target
- subsample of AEs only
- subsample w/o Japan, Turkey $(*)$
- No controls $(RQ, \mathit{sdinfl}(24m))$
- No year dummies

Conclusion

- Debate about pros and cons of **inflation target formulations** unsettled, reflected in recurring CB strategy reviews
- **Challenges of disanchoring** remain present
- ... due to persistently low or high inflation, not necessarily *symmetric* or *stable* over time!
  - AE: higher **downside inflation risk** due to expectation bias in the presence of ZLB due to low natural rate
  - EME: higher **upside inflation risk** in emerging market economies
- Inflation target formulations are an important consideration

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3. While further **disinflation and lower target level of inflation** a separate question, there is some overlap
   - Kganyago (2025) indicated MPC could target lower bound of corridor, i.e. 3%
   - Better do proper overhaul of the framework!
   - While possible benefits (EA/symmetric 2% target), should also be aware of risks (US Fed/FAIT).

Thank you.

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