

Anchored expectations

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Abstract

What anchoring means, why Friedman and Phelps made expectations central, and how anchoring is detected in the data.

“Well anchored” is the phrase central bankers use most about inflation expectations. It has a precise meaning: long-run expectations do not move in response to short-run inflation surprises. This lesson explains why that property is the whole point of a target and how it is measured.

Expectations enter the Phillips curve

Friedman and Phelps independently argued in the late 1960s that the trade-off between inflation and unemployment exists only for *unexpected* inflation (Friedman, 1968; Phelps, 1967). Workers and firms set wages and prices in advance on the basis of expected inflation; if actual inflation exceeds it, real wages fall and employment rises, but only until expectations catch up. In the long run unemployment returns to its natural rate at any steady inflation rate.

$$\pi_t = \pi_t^e - \alpha(u_t - u^n) + \varepsilon_t, \quad \alpha > 0. \quad (1)$$

Equation (1) is the expectations-augmented Phillips curve. Its policy content is that whatever expectations π_t^e are, that is where inflation goes when the economy is at the natural rate. A central bank that controls expectations controls inflation; one that does not is chasing a moving target. The Phillips curve takes up the modern version.

Definition 1 (Anchored expectations). Long-run inflation expectations are anchored when they are (1) close to the target and (2) insensitive to news about current inflation and activity. The second condition is the operative one: anchoring is about the *response* of expectations, not their level.

What anchoring buys

With anchored expectations, a supply shock that raises inflation for a year does not feed into wage demands and prices for the next, so the central bank can look through it without a recession. With unanchored expectations, the same shock raises π^e , and (1) says inflation stays higher until the central bank pushes unemployment above the natural rate to bring it down. The difference between the two cases is the difference between the 1970s and the 2010s.

The mechanism also runs in the helpful direction. When expectations are anchored at 2 percent and inflation is below it, firms expect prices to rise and set their own prices accordingly, which pulls inflation back up without policy action. A credible target is partly self-enforcing.

Detecting anchoring

Long-horizon expectations. Surveys of professional forecasters and market prices for inflation five to ten years ahead should be flat near the target. In the United States the median five-to-ten-year expectation in the Survey of Professional Forecasters has sat within a few tenths of 2 percent since the late 1990s.

Sensitivity to news. Gürkaynak, Sack and Swanson tested the second condition directly: if expectations are anchored, long-term forward rates should not react to data surprises about current inflation and activity. They found that US far-forward rates *did* react in the years before 2004, evidence of imperfect anchoring, while UK forward rates stopped reacting after the Bank of England became independent in 1997 (Gürkaynak et al., 2005). This event-study design is the standard test.

Dispersion and tails. Anchoring also shows in the cross-section: when the distribution of expectations across forecasters narrows and the probability assigned to inflation far from target falls, the anchor is holding. Reis used these features to argue in 2021 that the US anchor was starting to slip (Reis, 2021), a question The 2021–2023 test returns to.

Whose expectations?

The Phillips curve in (1) is about the expectations of the people who set prices and wages: firms and workers. The measures above are mostly about professional forecasters and financial markets, whose expectations are better behaved and less relevant. Measuring expectations shows how large the gap is, and why household and firm expectations are the ones central banks worry about when they use the word “anchored”.

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