<div align="center">
Box Article No. 3
Degree of Inflation Expectations Anchoring in the Philippines[1]
</div>

The BSP's primary mandate is to promote price stability conducive to a balanced and sustainable economic growth. Price stability is achieved when the average annual inflation is within the 2 to 4 percent inflation target range. The inflation expectations channel is a very important transmission channel of monetary policy as it influences the wage- and price-setting behaviors of firms as well as the savings and investment decisions of households. Thus, well-anchored inflation expectations are key to achieving price stability.

Managing inflation expectations is essential as they can influence actual inflation and can serve as a measure of central bank credibility. Thus, like any central bank, the BSP places great importance in monitoring inflation expectations and has, therefore, introduced survey measures based on various economic agents, such as consumers (Consumer Expectations Survey), businesses (Business Expectations Survey), and professional forecasters (BSP's Survey of External Forecasters or BSEF).[2] This box article considers inflation expectations of professional forecasters.

Measuring the degree of anchoring of inflation expectations is usually done by comparing them to the target range. In this box article, we explore a different approach by using the methodology of Naggert, Rich, and Tracy (2023), which considers both the distance of mean expectations from the target and the variability of inflation forecasts. The premise is that well-anchored inflation expectations must fulfill two conditions: (1) inflation expectations would need to be close to the target and (2) disagreement among forecasters should be minimal. As such, a lower value implies a higher degree of anchoring and vice versa. In calculating the anchoring measure, we use current year, next year, and two-year ahead inflation expectations, as well as the midpoint of the inflation target range.[3]

Chart 1 shows the evolution of the anchoring measures wherein inflation expectations are generally well-anchored, except during periods of supply shocks, which led to either the underachievement or overachievement of the inflation target, e.g., 2015 to 2016, 2018, and 2022 to 2024. For example, anchoring measures deteriorated in 2015 and 2016 as the sustained decline in global oil prices led to lower domestic electricity, transport, and oil prices.[4] Meanwhile, the rise in global oil prices, adverse weather conditions, which affected domestic food supply, as well as the direct and indirect effects of the excise tax reforms led to second-round effects, e.g., an increase in transport fares and minimum wages in 2018.[5] There was an improvement in anchoring measures in 2019 as inflation decelerated due in part to the implementation of the Rice Tariffication Law.

The uptrend in international oil prices, which led to higher domestic fuel pump prices, as well as the negative impact of adverse weather conditions on domestic food supply, led to higher food and energy prices in 2022 and 2023.[6] This resulted in a deterioration of the anchoring measures across all time horizons.

Chart 1
Anchoring Measures
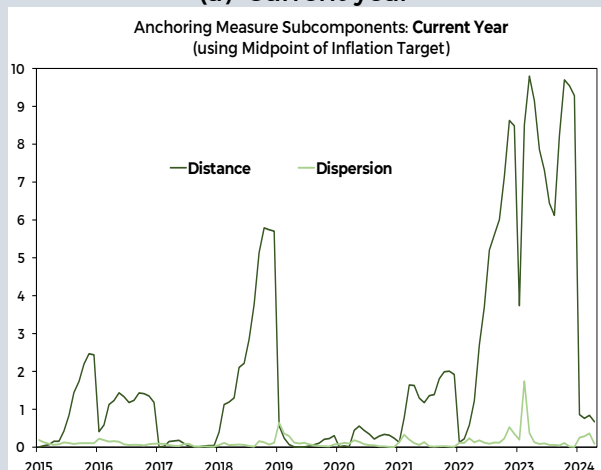in percentage points
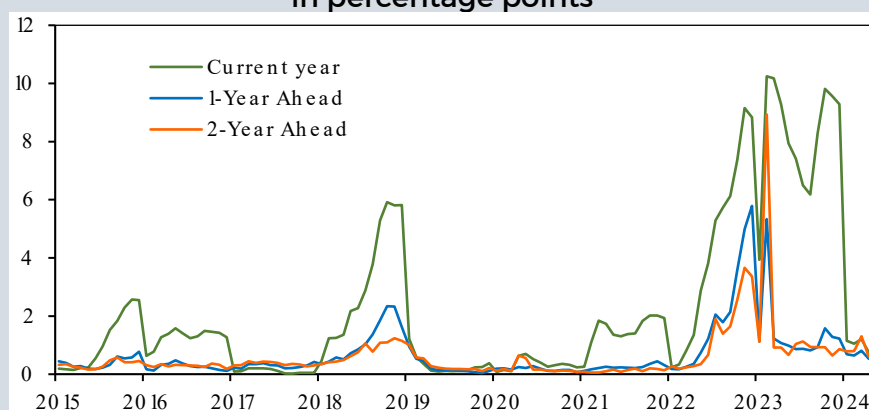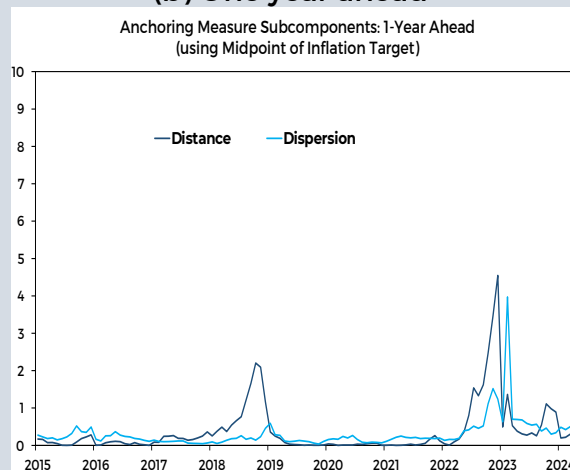

Source: BSP staff calculations

To gain further insights into the anchoring measure behavior, the degree of anchoring measure can be broken down into two components, namely, the *distance* from the midpoint of the target and the level of disagreement or *dispersion* among forecasters. **Chart 2** shows that there appears to be a predominance of distance rather than dispersion for the anchoring measure for the current year's inflation expectation. This is expected given the sensitivity of the current year's inflation expectations to inflation outturns. Nonetheless, the role of dispersion rises for next year and two-year ahead inflation expectations, which could reflect a certain level of uncertainty or differing views among forecasters on the inflation rate path going forward.

Chart 1
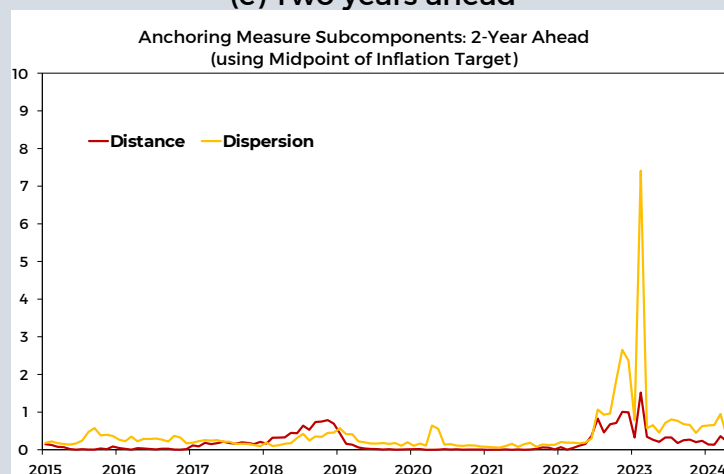**Anchoring Measures Subcomponents**
In percentage points

(a) Current year

Anchoring Measure Subcomponents: **Current Year**
(using Midpoint of Inflation Target)

(b) One year ahead

Anchoring Measure Subcomponents: 1-Year Ahead
(using Midpoint of Inflation Target)

(c) Two years ahead

**Anchoring Measure Subcomponents: 2-Year Ahead
(using Midpoint of Inflation Target)**
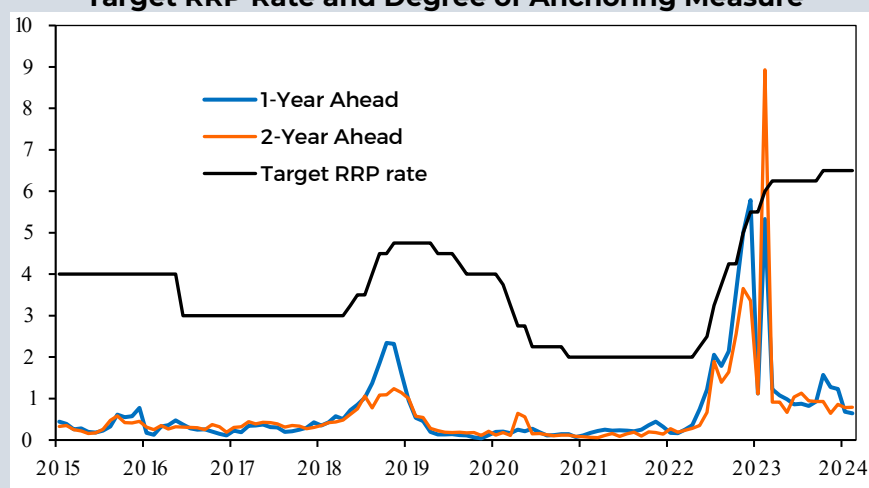

Source: BSP staff calculations

In responding to supply-driven shocks, the BSP typically allows the initial price increases to "pass-through" as these are considered to be only temporary in nature. However, when evidence of second-round effects emerges, the BSP undertakes timely and pre-emptive actions to steer inflation back to within the target range. Given the most recent supply shock episode, which started in 2022, and the broadening out of inflation pressures alongside the de-anchoring of inflation expectations, the BSP decided to tighten its key policy rate (target RRP rate) by a total of 450 bps between May 2022 and October 2023 (**Chart 3**). Nonetheless, the BSP continued to closely monitor evolving conditions in view of persistent upside risks to the inflation outlook and stood ready to undertake follow-through actions as necessary to keep inflation expectations well-anchored and safeguard the BSP's price stability objective.

Chart 2
Target RRP Rate and Degree of Anchoring Measure

Source: BSP staff calculations.

Endnotes

1/ The authors of this box article are Maria Elena G. Ramirez and Vanessa T. Españo.

2/ A more comprehensive discussion on the different inflation expectations used by BSP is available in Box Article No. 3, *"The BSP's Expectations Surveys as Inputs to Forecasting Inflation Including Second-Round Effects."* **Monetary Policy Report, February 2023**.

3/ Since 2015, the inflation target has been set at 2.0-4.0 percent.

4/ Source: BSP Open Letters on 2015 and 2016 Inflation.

5/ Source: BSP Open Letter on 2018 Inflation.

6/ Source: BSP Open Letters on 2022 and 2023 Inflation.

References

Naggert, Kristoph, Robert W. Rich, and Joseph Tracy. 2023. *"The Anchoring of US Inflation Expectations Since 2012."* **Federal Reserve Bank of Cleveland**, Economic Commentary 2023-11. https://doi.org/10.26509/frbc-ec-202311