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Abstract

We investigate the extent to which inflation expectations have been more firmly anchored in the United Kingdom—a country with an explicit inflation target—than in the United States—a country with no such target—using the difference between far-ahead forward rates on nominal and inflation-indexed bonds as a measure of compensation for expected inflation and inflation risk at long horizons. We show that far-ahead forward inflation compensation in the U.S. exhibits substantial volatility, especially at low frequencies, and displays a highly significant degree of sensitivity to economic news. Similar patterns are evident in the U.K. prior to 1997, when the Bank of England was not independent, but have been strikingly absent since the Bank of England gained independence in 1997. Our findings are further supported by comparisons of dispersion in longer-run inflation expectations of professional forecasters and by evidence from Sweden, another inflation targeting country with a relatively long history of inflation-indexed bonds. Our results support the view that an explicit and credible inflation target helps to anchor the private sector’s views regarding the distribution of long-run inflation outcomes. (JEL: E31, E52, E58)