INTERNATIONAL MONETARY FUND

WESTERN HEMISPHERE DEPARTMENT

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Evidence from Latin America during the Post-COVID Stress Test

Prepared by Philip Barrett, Federico Duenas, Christopher Evans, Eric Huang, Gonzalo Huertas, and Tannous Kass-Hanna

2026

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Cataloging-in-Publication Data
IMF Library

Names: Barrett, Philip Oliver, author. | Duenas, Federico, author. | Evans, Christopher Michael, author. | Huang, Eric Jincheng, author. | Huertas, Gonzalo, author. | Kass-Hanna, Tannous, author. | International Monetary Fund, publisher.
Title: Anchoring inflation expectations : evidence from Latin America during the post-COVID stress test / Prepared by Philip Barrett, Federico Duenas, Christopher Evans, Eric Huang, Gonzalo Huertas, and Tannous Kass-Hanna.
Other titles: Departmental Paper. | International Monetary Fund. Western Hemisphere Department.
Description: Washington, DC : International Monetary Fund, 2026. | Includes bibliographical references.
Identifiers: ISBN:

9798229041058	(paper)
9798229041157	(ePub)
9798229041126	(Web PDF)

Subjects: LCSH: Inflation (finance)—Latin America. | Monetary policy—Latin America.
Classification: LCC HG229.B3 2026

Publication orders may be placed online or through the mail:
International Monetary Fund, Publication Services
P.O. Box 92780, Washington, DC 20090, USA
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Executive Summary

Long-term inflation expectations play a central role in shaping macroeconomic outcomes, influencing how quickly inflation responds to shocks and how costly it is for monetary policy to restore price stability. The inflation surge that followed the COVID-19 pandemic provided an important stress test for monetary frameworks across Latin America, many of which had shifted toward inflation targeting over the past quarter century. This paper evaluates how well those long-term inflation expectations remained anchored during this episode, what drives differences in anchoring across countries and over time, and how anchoring affects the macroeconomic transmission of shocks. It also examines whether policy actions themselves can strengthen or weaken anchoring and draws lessons from historical transitions to new monetary regimes in the region.

Three key messages emerge. First, long-term inflation expectations remained more resilient than short-term expectations during the recent inflation surge. Although near-term expectations rose—in line with contemporaneous inflation—long-term beliefs generally stayed much closer to monetary policy objectives, even in cases in which fiscal policy was expansionary. This has been a notable success and represents the latest step in a journey that began in a period of very high inflation during the 1970s, 1980s, and 1990s. Over the past two decades, anchoring has improved steadily, supported by clearer policy frameworks, improved communication, and the establishment of inflation-targeting regimes. Nevertheless, expectations remain modestly skewed toward the upside, reflecting persistent concerns likely rooted in historical inflation dynamics and lingering fiscal concerns.

Second, strong anchoring delivers tangible macroeconomic benefits. When expectations are well anchored, adverse external shocks—such as declines in the terms of trade—translate into much smaller and shorter-lived increases in inflation. Economies with weak anchoring, by contrast, experience more pronounced price effects. Evidence on monetary policy shocks is more nuanced: when expectations are strongly anchored, real activity tends to react less to interest rate surprises, consistent with a less sensitive expectations channel.

Third, credibility responds asymmetrically to policy behavior. Unexpectedly tight policy produces only small and delayed gains in anchoring, whereas unexpectedly loose policy leads to sizable and rapid deterioration. This underscores that credibility is difficult to build but easy to lose. Findings from a set of case studies reinforce this point. These show that coherent institutional support, consistent communication, and well-sequenced operational reforms are essential for successful transitions to modern monetary frameworks, even when external conditions are challenging. In contrast, when these supporting elements are absent or when fiscal or political conditions undermine the monetary framework, even otherwise well-designed transitions can fail.

Overall, the findings highlight both the considerable progress and remaining challenges for monetary policy frameworks in Latin America. Reforms introduced over recent decades have enabled economies to navigate the post-pandemic inflation shock with greater credibility than in past episodes. Yet long-term expectations still sit slightly above target in some countries, and institutional credibility—rather than the capability of individual policymakers—remains the principal constraint on achieving fully anchored expectations. The results emphasize the importance of preserving credibility, ensuring policy coherence across institutions, and maintaining frameworks that keep inflation expectations firmly aligned with long-term objectives in the face of future shocks.

1. Introduction

Inflation expectations play a key role in both the theory and the practice of contemporary monetary policy. Expectations of future inflation are a prominent topic of discussion in central bank policy meetings, speeches, and press conferences. Foremost among policymakers' concerns is the possibility that inflation expectations might "de-anchor," a term that describes the case in which long-term inflation expectations deviate from target.

One reason for this concern arises because modern macroeconomics treats economic agents as at least somewhat forward looking. This means that if consumers expect inflation in the future, they try to spend more today when prices are low, boosting aggregate demand and thus causing immediate inflation. As a result, if households expect future inflation to deviate from target, the central bank must act more aggressively to return inflation to target today, inducing larger swings in output and employment. This effect is particularly damaging when *long-term* inflation expectations depart from target, since the central bank must fight against them continuously, keeping interest rates higher and employment lower for longer (see Hazell and others 2022).

Another reason policymakers pay particular attention to long-term expectations is that, over long periods of time, inflation is considered principally a function of monetary policy. Expectations at long horizons are a particularly clear signal of the credibility of the monetary regime, since they reflect the faith that economic agents have in the central bank's ability to meet its objective eventually. In contrast, expectations of short-term inflation are contaminated by the expected effects of other exogenous shocks and therefore do not isolate the contribution of the monetary regime as cleanly.

These issues have been especially pressing in Latin America in recent years. As elsewhere, the region experienced a surge in inflation as it emerged from the COVID-19 pandemic. This served as something of a stress test for monetary frameworks in the region, many of which had been introduced in the drive toward inflation targeting (IT) around the turn of the century. As inflation increased, many central banks across the region responded aggressively by tightening monetary policy. Yet, at the same time, expected inflation rose, including long-term expectations in some places. This gave rise to concerns that, despite policymakers' prompt responses, inflation expectations might remain persistently above target, with the potential to threaten central banks' credibility and increase the costs of returning inflation to target.

In this context, this paper seeks to address the following questions:

- How well-anchored have inflation expectations in Latin America been during the post-pandemic period? Was this anchoring similar to other emerging market and developing economies (EMDEs)?
- How do changes in the distribution of beliefs affect measures of anchoring? Does better anchoring just involve lowering expectations of high inflation, or do beliefs about low inflation also matter? Does weak anchoring reflect forecasters' common beliefs that inflation will miss target, or are beliefs more diffuse? How can we interpret these factors?
- Past work found that better anchoring mitigates transmission of external shocks: does this hold in Latin American countries? What about monetary policy? Does anchoring strengthen monetary transmission?
- How does the conduct of policy affect the anchoring of expectations? Does "acting tough"—implementing extra-hawkish monetary policies—help anchor beliefs that the central bank is committed to its inflation target? Can dovish policies cause de-anchoring?

- How does the choice of monetary regime affect the anchoring of inflation expectations? Do steps toward IT help to anchor long-term expectations? Does the nature of the transition (fast or slow, orderly or not) affect these outcomes? How do political and institutional constraints matter?

The main findings are as follows:

- Although short-term expectations shifted up, longer-term inflation expectations in Latin America generally remained remarkably well anchored during the post-COVID inflation surge. This compared favorably to other EMDEs, where de-anchoring was more significant.
- The distribution of long-term expectations in Latin America is asymmetric. Similarly to other EMDEs, expectations are skewed to the upside. In contrast, expectations in advanced economies (AEs) are weakly skewed to the downside. Improvements in anchoring in the past 20 years have been driven by improvements in both the upper and lower tails of the distribution, a pattern also observed in other EMDEs.
- The distribution of beliefs is tight, but generally off target. Beliefs about future inflation in Latin America are generally less dispersed than in other EMDEs but are dispersed similarly to those in AEs. Yet ***average*** beliefs are further from target than in AEs. As we explain in what follows, this pattern could be evidence of capable policymakers operating in imperfectly credible policy frameworks.
- Better anchoring of inflation expectations has economic benefits. When expectations are anchored, terms-of-trade shocks have smaller inflationary costs. Evidence on monetary transmission is mixed: economic effects of policy shocks are slightly weaker, consistent with a reduced role for the expectations channel.
- Credibility is hard to win but easily lost. Tighter monetary policy can help anchor inflation expectations, but the effects are small and delayed. The evidence on the opposite is clear: surprising markets with extra-loose monetary policy causes more substantial de-anchoring.
- Although experiences vary considerably by country, historical evidence shows that changes in monetary regimes toward more advanced frameworks generally coincide with better-anchored expectations. However, without the proper institutional support, even the most sophisticated frameworks can unravel.

What do these findings imply for the conduct of monetary policy in Latin America going forward? Most obviously, it seems that improvements in macroeconomic management frameworks in the past few decades—coinciding with the introduction of IT regimes some 25 years ago—have left the region much better able to weather major shocks than in the past. Although inflation and short-term expectations rose during the post-COVID inflation surge, credible monetary policy regimes have delivered disinflation in many countries. The findings presented here also suggest that the aggressive policy response itself may have reinforced anchoring.

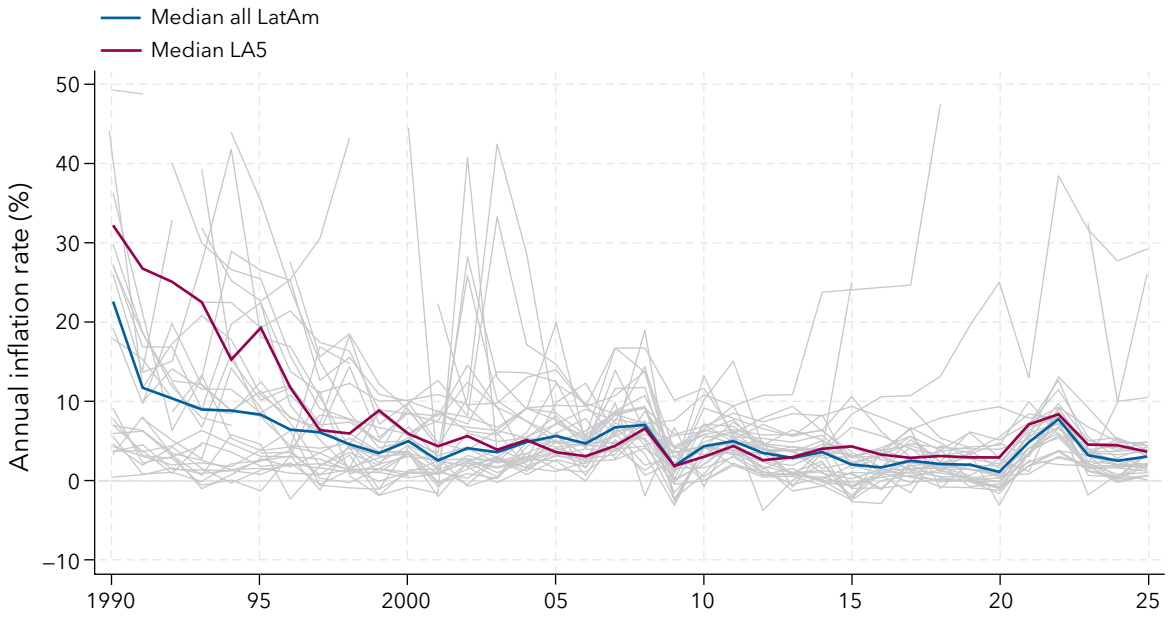
Nevertheless, other findings show that there remains room for improvement. For example, the fact that weak anchoring reflects common beliefs across forecasters rather than idiosyncratic disagreements among them suggests expectations may reflect underlying institutional constraints affecting central banks' ability to meet their inflation targets rather than questions about the competence of individual policymakers. The positive skew in inflation expectations could reflect lingering fiscal concerns or simply that the psychological scars of high inflation may not be fully healed. Determining the specific factors causing this small, persistent departure of long-term expectations from target is left for future work. One possibility is that political or other constraints can impede even the best-designed *de jure* frameworks.

2. Anchoring of Inflation Expectations in Latin America: Recent Experience

A. Inflation in Latin America since the 1990s

Monetary policy in Latin America—and the perspectives of many of the region's central banks—is heavily influenced by the extreme inflation episodes of the 1980s and 1990s. During this time, Argentina, Bolivia, Brazil, Nicaragua, and Peru experienced severe hyperinflationary environments, whereas Chile, Colombia, Mexico, and Uruguay saw lower but still very high and volatile inflation. Stabilization was achieved with the elimination of fiscal dominance, structural reforms, and, in most cases, exchange rate pegs or quasi-pegs.[1]

Figure 1. Annual Inflation Rates in Latin America
(Percent)



Source: IMF World Economic Outlook (WEO). Consumer Price Index (CPI), end-of-period, percent change.

Note: Inflation rates are capped at 50 percent and −10 percent. Sample includes 33 LAC countries: Antigua and Barbuda, Argentina, Aruba, the Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Puerto Rico, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, and Uruguay. LatAm = Latin America; LA5 = Latin America 5.

Once the extreme inflation of the 1990s was overcome, central banks gradually reduced inflation further (see Figure 1) and built credibility as they moved toward more flexible exchange rate regimes. By the early 2000s, the Latin America 5 (Brazil, Chile, Colombia, Mexico, and Peru; LA5) had converged on some version of IT combined with a flexible exchange rate and a more independent central bank. Typically, an inflation objective (explicit or implicit) replaced the exchange rate as the nominal anchor, with targets eventually converging toward 2 to 3 percent with a tolerance band. Monetary frameworks also became more transparent, featuring inflation reports, published targets and ranges, clearer reaction functions, and a greater

[1] See Ayres and others (2019), De Gregorio (2010), and Martinelli and Vega (2019). The case of Peru is a relevant exception: monetary policy in its stabilization plan in the 1990s was much closer to monetary targeting than an exchange rate rule.

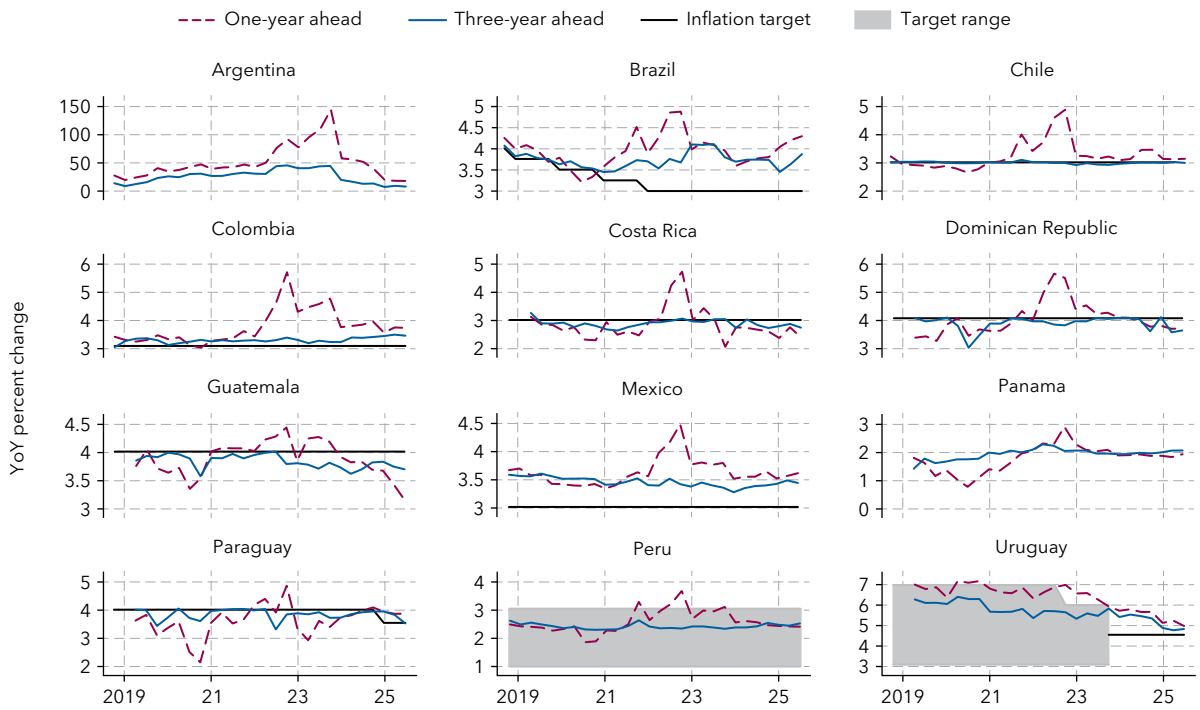
willingness to let the exchange rate respond to shocks. Since then, this new institutional consensus has delivered solid results. Although inflation fluctuated as shocks hit, it has typically remained in the single digits and converged back toward the target over the medium term.

B. The Post-COVID Stress Test and the Role of Well-Anchored Inflation Expectations

The post-COVID inflationary episode was a stress test for this architecture, some 25 years after its initiation. The region was hit by many of the same shocks as other economies: pandemic-related supply disruptions, sizable fiscal and monetary stimulus, and, from 2021 onward, global commodity and transportation shocks. Headline inflation surged, and core inflation followed.

In most countries in Latin America, central banks responded aggressively to these shocks, tightening earlier and more forcefully than the Federal Reserve or the European Central Bank. Nevertheless, the specifics varied. Brazil started hiking in early 2021, as did Uruguay, both with very large cumulative increases; Chile, Colombia, and Peru likewise tightened and were willing to surprise markets with their hawkish actions. Faced with an inflation-output trade-off, the region's central banks showed a clear preference for avoiding any permanent upward shift in inflation.[2] More recent narrative evidence shows that central bankers across the region continue to place a high value on maintaining a reputation for being "hawkish" on inflation, at least in part because of the region's historical experiences with very high inflation.[3]

Figure 2. Inflation Expectations: One-Year Ahead versus Three-Year Ahead
(Percent)



Sources: Inflation expectations and targets from Consensus Economics; and additional inflation targets from the central banks of Guatemala, Costa Rica, Uruguay, Paraguay, and Dominican Republic.

Note: Peru has a target range of 1 to 3 percent. Uruguay had a target range of 3 to 6 percent and transitioned to a point target of 4.5 percent at the end of 2023. YoY = year over year.

[2] See the Regional Economic Outlook (IMF 2023) for a discussion of the monetary policy tightening of the Latin America 5 (Brazil, Chile, Colombia, Mexico, and Peru) countries in response to the rapid increases in headline inflation.

[3] See Huertas (2022); Robitaille, Zhang, and Weisberg (2024); and Jácome and others (2025) for more on the impact of historically high rates of inflation.

The fight against the post-COVID inflation was characterized by generally well-anchored public expectations of inflation in Latin America, even if there was some differentiation across economies. In Chile and Peru, professional forecasters' long-term expectations barely moved in response to higher contemporaneous inflation; their medians stayed around the target or, for Peru, the target range (see Figure 2). Mexico and Brazil saw modest upward shifts in longer-term forecasts, but these were mostly contained. As a result, once the worst of the global supply and commodity shocks had passed and domestic demand cooled, inflation rates in the LA5 started to fall. In many cases, by 2024–25, headline consumer price index (CPI) was back within or near the target bands.

Generally well-anchored expectations likely made for easier policy trade-offs during the post-COVID inflation surge, since well-anchored inflation expectations help mitigate the impact of other shocks. Conversely, when inflation expectations are not anchored, other stabilization policies become more costly. Of course, well-anchored expectations are not a sufficient condition for good policy. In practice, policymakers also have to think about many other immediate concerns, such as short-term price pressures, financial stability, and the trade-off between inflation and output. Nevertheless, well-anchored long-term inflation expectations can ease many of these difficult decisions.

Why might anchoring have these benefits? Modern macroeconomics posits that it is because price and wage setting are at least somewhat foresighted. The idea is that firms set prices based in part on their view of expected future costs. Likewise, workers bargain over wages with some view of how their incomes will be eroded by inflation. If those expectations are well anchored, price and wage setters do not feel compelled to chase price rises today with large and persistent price or wage adjustments in the future. Well-anchored expectations thus act as a dampening mechanism for shocks; with well-anchored expectations, transitory shocks produce transitory outcomes. In contrast, when expectations are poorly anchored, economic agents see higher inflation today as a sign of higher inflation tomorrow, demanding higher future wages or prices. Such a setting amplifies the effect of transitory shocks, resulting in larger and longer-lasting inflationary effects.

These effects have indirect costs too. More persistent shock transmission means that restoring low inflation requires more aggressive systematic monetary tightening, with a commensurately larger output loss. Increased inflation volatility also pushes up interest rates for the government and firms, since investors must be compensated for the higher risk that unexpected inflation erodes the real value of debts.

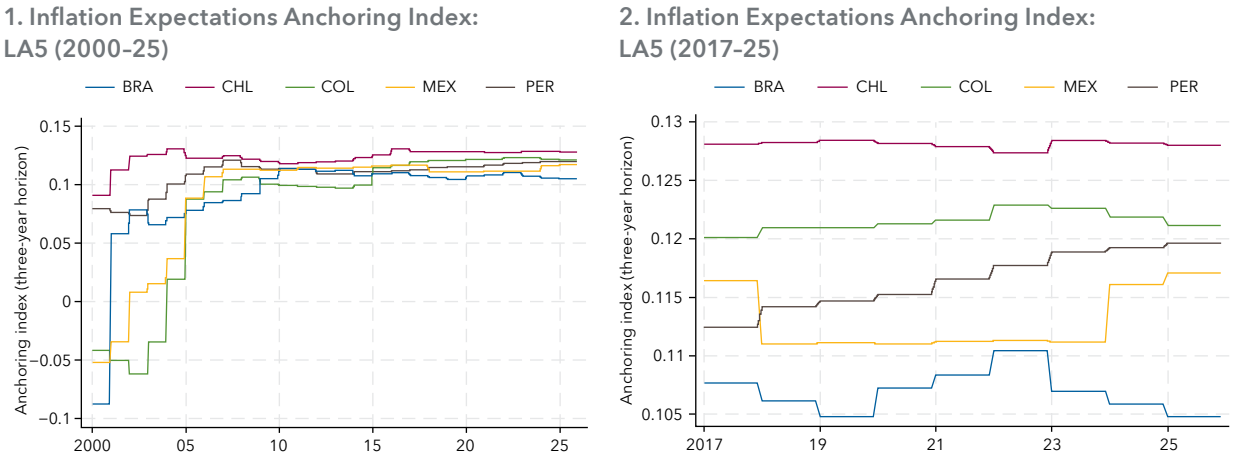
C. Measuring Anchoring

To formalize the otherwise heuristic notion of anchoring, we define inflation expectations anchoring as a measure of how tightly the private sector's long-term inflation forecasts are pinned down around the central bank's target over time. In practice, we measure anchoring using the Bems and others (2021) index, which captures three aspects of anchoring in one summary measure: how close long-term expectations are to the monetary authority's target, how stable long-term expectations are over time, and the extent of agreement across professional forecasters. A country with well-anchored expectations should have long-term forecasts that stay near target over long periods and show little dispersion across forecasters. A country with poor anchoring will fail on one or more of those dimensions.

This is, of course, not the only way that anchoring could be measured. For example, model-based measures infer the degree of forward-looking versus backward-looking expectations from a macroeconomic model and use the weight on the forward-looking component as the anchoring index (Gillitzer and Simon 2018). Another common approach is to use market-based measures, such as the volatility and level of long-term breakeven inflation rates, under the assumption that well-anchored expectations would be reflected in flat, low-volatility term structures (Beechey, Johannsen, and Levin 2011). A third possibility is to focus on the response of long-term forecasts to shocks. Relative to all of these, the Bems and others approach is appealing

because it requires minimal structural assumptions, produces an index that is easy to interpret over time and across countries, and can be implemented consistently across a wide set of AEs and EMDEs: one needs only long-horizon forecasts and a measure of the monetary authority's inflation target. Nevertheless, Consensus forecasts correlate well with alternative measures at many horizons (see, for example, the measure of Albrizio, Dizioli, and Simon 2023).

Figure 3. Inflation Expectations Anchoring Index



Source: Consensus Economics Forecast inflation expectations data and staff calculations.

Note: Metrics constructed following Bems and others (2021) methodology using Consensus Economics Forecast inflation expectations data. The anchoring index is a standardized variable. Data labels in the figure use International Organization for Standardization (ISO) country codes. LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, and Peru).

To construct this anchoring metric, we rely on the same data set as the original authors: Consensus Economics' data on professional forecasters' CPI inflation forecasts at three- and five-year-ahead horizons. For each country and survey date, we observe both the mean long-term forecast and the cross-sectional dispersion around that mean. Using these data, we construct the index following Bems and others (2021) by standardizing and averaging three metrics: (1) the root mean square deviation of long-term forecasts from the inflation target, (2) the time-series standard deviation of forecasts, and (3) the cross-sectional dispersion among forecasters, with higher values indicating stronger anchoring. Coverage runs from the 2000s until 2025 for Argentina, Chile, Brazil, Colombia, Mexico, and Peru. As shown in Figure 3, this measure backs up the narrative evidence that anchoring has improved in major Latin American economies, especially during the early 2000s.

The counterexample to this story of sustained improvement is Argentina (see Annex Figure 1.3). Convertibility in the 1990s delivered a dramatic disinflation, from triple digits to low single digits. But when abandoning the currency board in 2001, the country did not move toward the gradual adoption of an IT regime and an increasingly more flexible exchange rate, with the exception of the 2016–18 experience. Instead, fiscal dominance, and a marked erosion in the independence of monetary policy, led to a resurgence of high inflation. Price and wage indexation also returned, leading to expectations that have been significantly less anchored than in the rest of the region. After reforms in the past few years, however, some measures of anchoring have improved.

D. International Context

The progress of Latin American monetary policy performance shares some similarity with developments in other EMDEs. EMDEs in central and eastern Europe, for example, moved rapidly from very high and volatile inflation in the 1990s to relatively well-anchored expectations in the 2000s (see Annex Figure 1.2). EMDEs in Asia generally followed a more gradual path, with less extreme forms of inflation but nonetheless gradual credibility building around exchange rate management before transitioning to explicit inflation targets.

Even though Latin America stands out for its volatile inflationary history, it has ultimately embraced the same broad institutional architecture that has delivered price stability as elsewhere in the world.

The recent post-COVID inflation surge again underscores how these institutional and expectations differences matter in practice. Many EMDEs, especially in Latin America, reacted quickly by tightening policy as soon as headline inflation began to rise above target. In contrast, AEs reacted more slowly, albeit from a position in which expectations had been well anchored for decades.

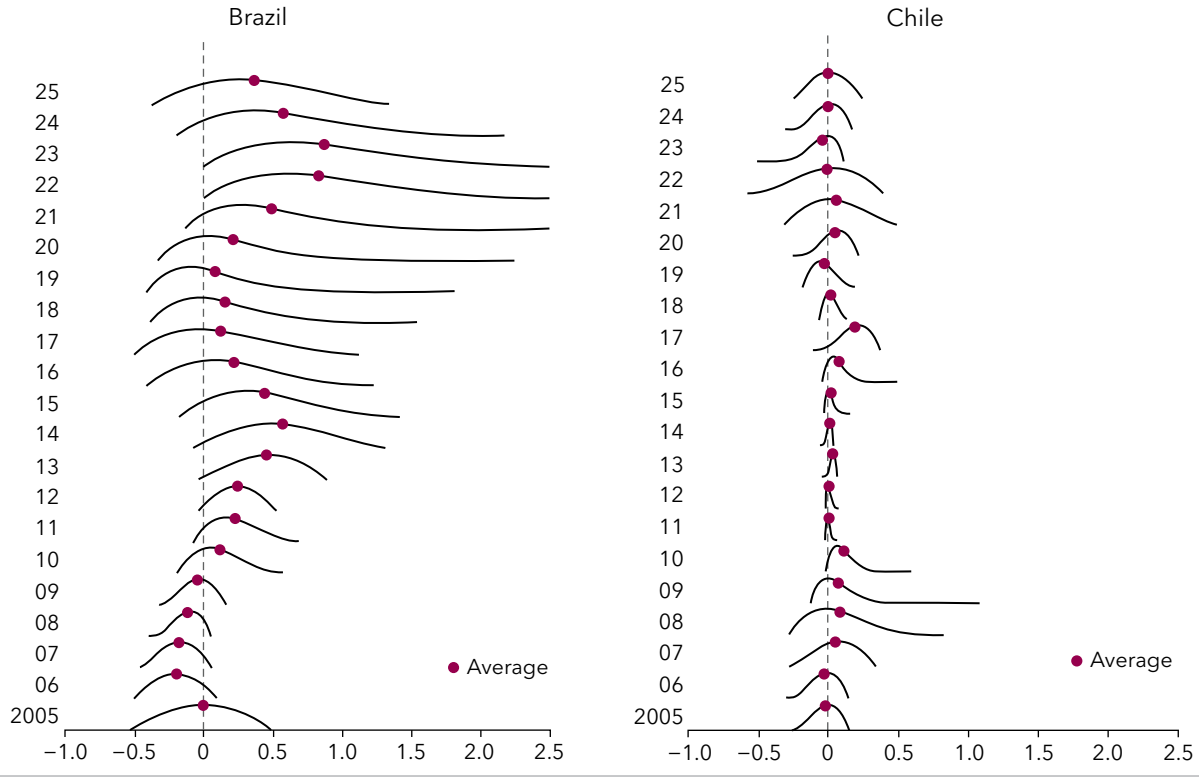
3. Sources of Variation in Anchoring

As shown in the previous section, the degree of anchoring has changed over time and across countries. But measures of anchoring are summary statistics for a whole distribution of beliefs. This raises an obvious question: which aspects of those distributions are driving those changes?

To provide an intuitive understanding of this question, Figure 4 illustrates the distributions of long-term inflation expectations across different countries over time. The Bems and others index compresses this distribution into a single value for each period and country. Ideally, individual-level forecasts should be employed to plot the distributions. However, for long-term expectations (three years and beyond), the Consensus Economics data only provide summary statistics—including the mean, standard deviation, minimum, and maximum—of forecasts by country and month. We thus approximate this distribution, using a beta distribution matching these summary statistics.[4]

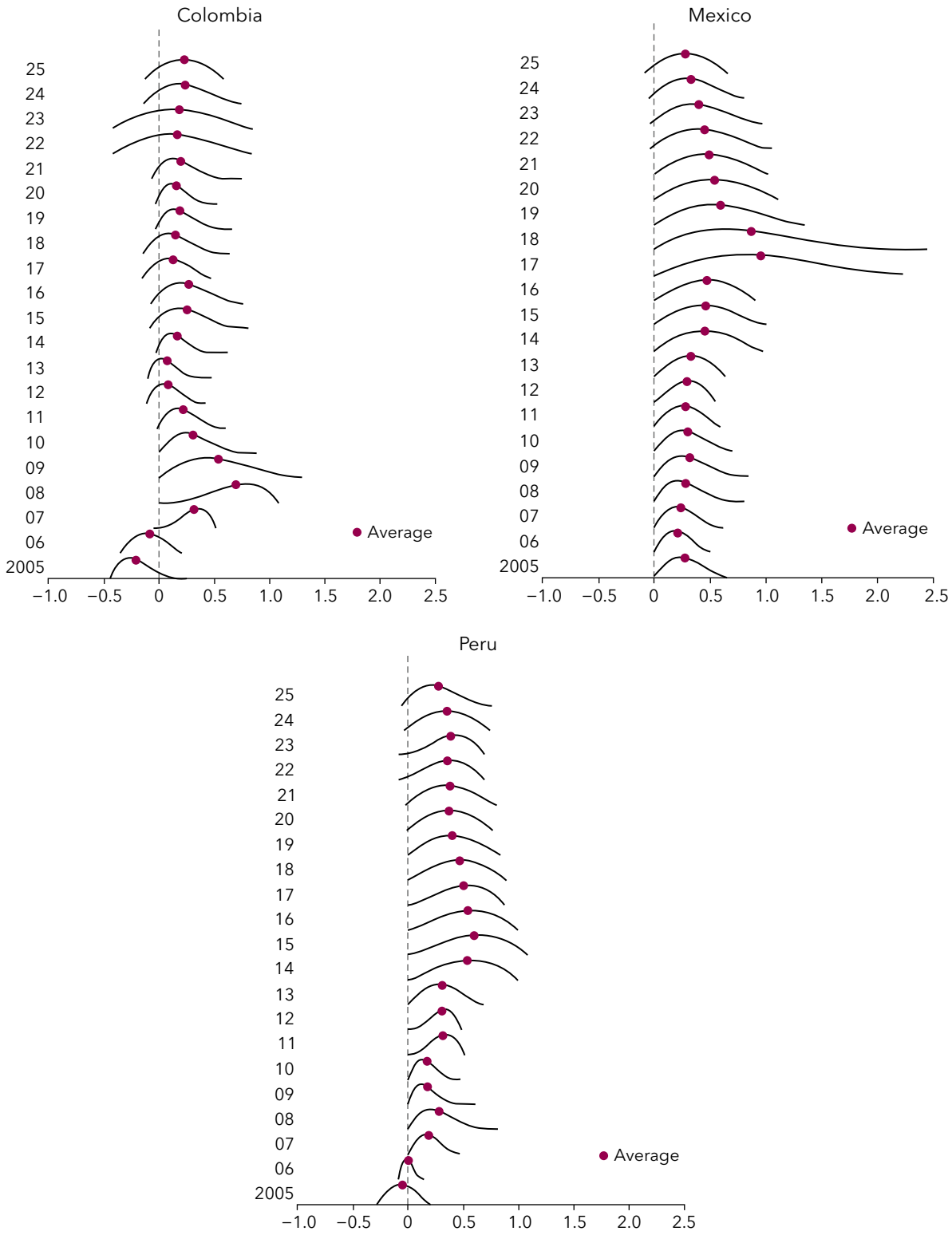
The distributions reveal significant variation in the distribution of inflation expectations both across countries and over time. For instance, the distribution of inflation expectations in Chile remains consistently narrow and centered around its official target. For other countries, there are more persistent deviations both in the center and the spread of long-term beliefs. In some cases, there is evidence of a noticeable weakening in anchoring after the pandemic, as distributions of inflation expectations both shifted higher and became more dispersed. This is particularly notable in Brazil, where this deterioration has partially reversed in recent years. More generally, these patterns demonstrate how inflation anchoring depends not only on the average level of expectations but also on the degree of dispersion and behavior in the tails of the distribution.

Figure 4. Inflation Expectations Distributions across LA5 Countries
(Percentage point deviation from inflation target: three-year-ahead expectations)



[4] A beta distribution is useful because it is bounded, potentially asymmetric, and bell shaped under conventional parameter ranges.

Figure 4. Inflation Expectations Distributions across LA5 Countries (Continued)



Source: Consensus Economics Forecast inflation expectations data.

Note: The distributions are assumed to follow beta distributions, estimated using the mean, standard deviation, minimum, and maximum of inflation expectations. The *x*-axis is percentage point deviations from target; annual averages of quarterly distributions. LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, and Peru).

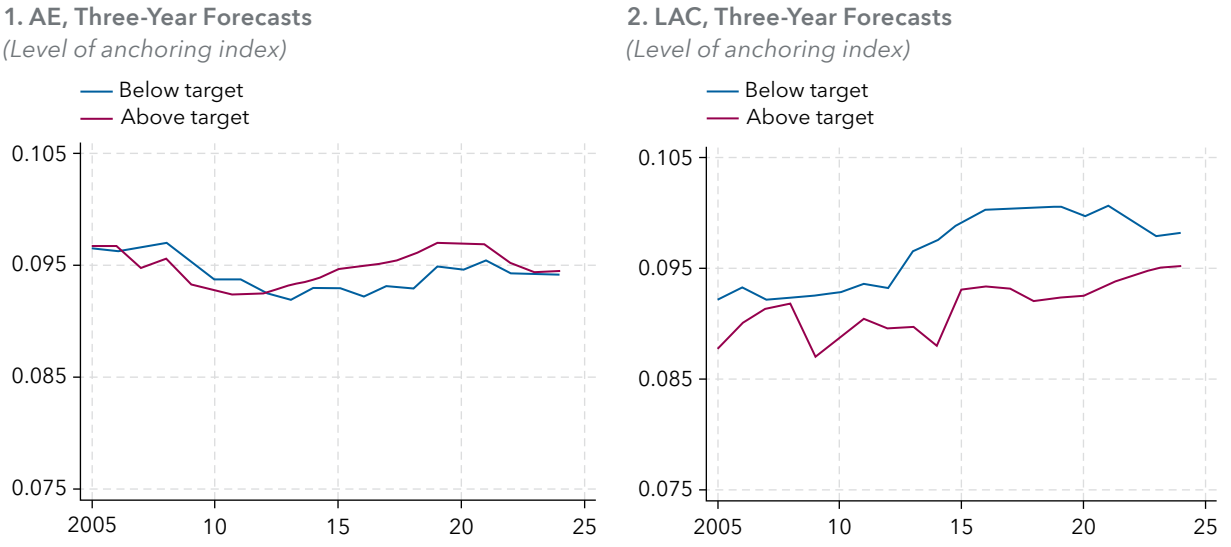
These observations motivate the remainder of this section, in which we present two decompositions of the distribution of beliefs and discuss their connection to aggregate measures of anchoring. The first separates out changes in the upper and lower tails, addressing the extent to which variation in anchoring is separately determined by the distribution of beliefs above and below target. The second decomposes the departure of long-term beliefs from target into a component common to all forecasters and one that captures the spread of forecasters' beliefs.

A. Anchoring Up and Down

We start by looking at the direction of changes in anchoring. Conceptually, the degree of anchoring can improve either because agents who expected above-target inflation revised their beliefs down or because people with below-target expectations revised them up. Any deterioration in anchoring can similarly be due either to de-anchoring up or down. To explore this further, we reconstruct one component of the Bems and others (2021) inflation anchoring index separately for two subsamples.[5] Using the equivalent fitted distributions shown in Figure 4, we recalculate the Bems index for a larger sample of countries, splitting it into two parts: the measure of anchoring conditional on beliefs being above and below target. This gives us two measures of anchoring, which are directly comparable to that in Figure 3 but that split out the variation into that driven by changes in the upper and lower tails of the distribution of beliefs.

Figure 5 presents how the median inflation anchoring index across country groups has changed in each direction. Lower values indicate worse anchoring (that is, further from target) for each tail of the distribution.

Figure 5. Inflation Expectations Anchoring Index: Up versus Down

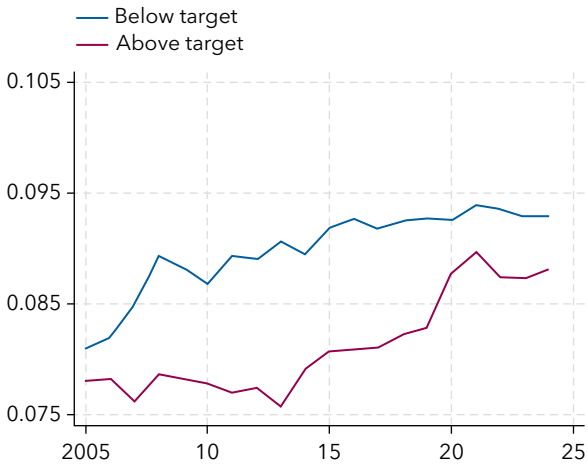


[5] The sample includes 20 advanced economies, 5 Latin America and the Caribbean countries, and 11 other emerging market and developing economies in the period shown in Figure 4.

Figure 5. Inflation Expectations Anchoring Index: Up versus Down (Continued)

3. Other EMDEs, Three-Year Forecasts

(Level of anchoring index)



Source: Consensus Economics Forecast inflation expectations data.

Note: Subindices are constructed following Bems and others (2021), based on subsamples above and below the inflation target. AE = advanced economy; EMDEs = emerging market and developing economies; LAC = Latin America and the Caribbean.

From this evidence, three key conclusions emerge. First, in Latin America and the Caribbean (LAC), de-anchoring is asymmetric: it is more strongly driven by expectations of above-target inflation than below-target inflation. Figure 5 illustrates this point, with the "above target" line showing a weaker degree of anchoring than the "below target" line. For other EMDEs, the degree of asymmetry is even larger than for Latin America between 2008 and 2019. In contrast, de-anchoring in AEs is, on average, more symmetric (the two lines are closer), although below-target de-anchoring became more prominent after the onset of the period of low inflation that followed the European debt crisis in 2012. Second, in LAC, both lines show improvement over time, meaning that anchoring has strengthened in Latin America because of ***both*** above-target expectations falling and below-target expectations increasing. This pattern is repeated in EMDEs more broadly, with improvements in both types of de-anchoring, albeit starting from worse-anchored beliefs than in LAC. Finally, in both Latin America and EMDEs more generally, improvements in anchoring began with better-anchored beliefs from below; only later did improvements come in the upper tail (the blue line increases earlier than the red line).

B. Common versus Individual Beliefs

Although de-anchoring can be measured in many ways, few policymakers would disagree about their preferred distribution of long-term beliefs. Ideally, they should be centered on the inflation target, with little dispersion across individuals. The distribution of beliefs in Chile during 2011–14 was close to this ideal (see Figure 4).

This observation suggests a natural way to think about the components of de-anchoring, since it implies that the distribution of beliefs can depart from this ideal in two ways. The distribution of beliefs can become either less anchored by shifting away from the target without a change in its shape or more spread out while remaining centered on the target. Of course, in practice, both changes will occur at once. Splitting out the contributions of these two types of change is potentially useful, since the former represents *common* beliefs about the (in)ability of the central bank to deliver the inflation target. In contrast, the latter represents the degree of *idiosyncratic* disagreement among forecasters about long-term inflation.

To disentangle these two channels of de-anchoring, we compute two summary measures of the distribution of beliefs corresponding to the common and idiosyncratic components: the root mean square error relative to the target and the standard deviation of the distribution.[6]

Figure 6 presents these two components across countries by region over 2005–24. Several patterns stand out. The first is that, in LAC, the common component of beliefs contributes more to the de-anchoring of expectations than the individual one does (the red bars are generally larger in the panel 1 than in the panel 2). This finding implies that market participants generally agree on how much future inflation will depart from target. Indeed, the extent of disagreement across forecasters in LAC is remarkably small, with the variance of beliefs similar to that in AEs.

The second observation is that both components of this decomposition have historically been better in Latin America than in the rest of EMDEs (the red bars are generally lower for LAC than for EMDEs). This difference has gradually narrowed in recent years for the common component, with forecasters in EMDEs, on average, expecting smaller deviations from target. However, the difference between LAC and EMDEs has persisted for the idiosyncratic component of de-anchoring (the red bars have remained lower than the green bars), highlighting that the extent of disagreement in EMDEs remains much broader in other EMDEs than in LAC.

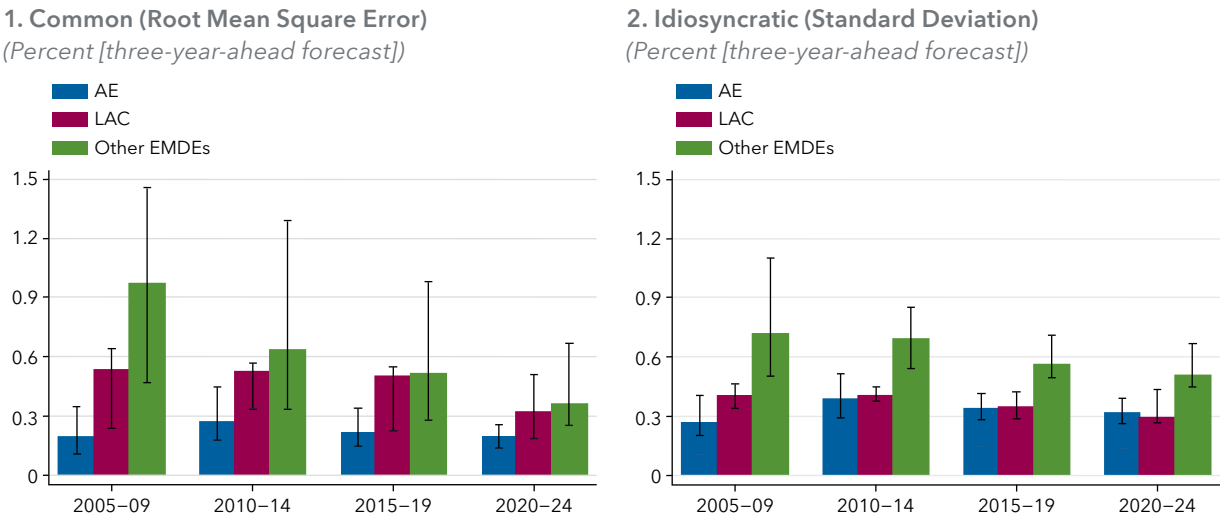
There are many ways to interpret these changes. For example, changes in the idiosyncratic component (forecast dispersion) could reflect changing incentives for forecasters to "follow the herd" or variation in the quality of forecasters' predictions.

However, these results can shed light on two policy-related sources of de-anchoring. First, the common component can indicate a long-standing and generalized lack of faith in monetary policy and its inflation target. Such a lack of institutional credibility could show up as a systemic departure of average beliefs from target (the common component). Second, the idiosyncratic component can indicate de-anchoring resulting from concerns about the ability (or desire) of individual policymakers to respond to specific shocks within a reasonable time frame, resulting in increased variation in beliefs about future paths of inflation. Put differently, this decomposition can split the departure of inflation expectations from target into components because of the credibility of the framework versus the capability of individual policymakers.

This interpretation permits some sharper policy conclusions to be drawn from Figure 6, albeit at the cost of some extra assumptions. In particular, the fact that the dispersion of forecasters' beliefs—the idiosyncratic component—has been similar to levels in AEs (the red and blue bars are similar) is consistent with high-quality individual policymakers, with strong personal credibility. In contrast, regarding the common component, the fact that average perceptions of future inflation have remained further from target than in AEs suggests that broader institutional credibility may be the main aspect hindering full anchoring of expectations to target. Although the evidence from Figure 6 suggests that this common aspect has improved in recent years, it is still consistent with the notion that the credibility of institutional frameworks in the region has not yet fully converged with that in AEs.

[6] When squared, these sum to the square error of the distribution relative to the inflation target. See Annex 1 for an algebraic description of these different components. Data for Latin America and the Caribbean include studies from Brazil, Chile, Colombia, Mexico, and Peru. The two components are reported for periods in which either an explicit inflation target is available or an implicit target can be inferred, proxied by long-term (10-year) inflation expectations, limiting the sample to start in 2005. See Naggert, Rich, and Tracy (2023) for a similar exercise on US inflation expectations.

Figure 6. Sources of Anchoring: Common versus Idiosyncratic Components



Source: Consensus Economics Forecast inflation expectations data.

Note: Panel 1 illustrates the root mean square deviation of average forecasts from the target, and panel 2 illustrates the standard deviation of forecasts among forecasters. AE = advanced economy; EMDEs = emerging market and developing economies; LAC = Latin America and the Caribbean.

4. How Does Anchoring Affect Shock Transmission?

What are the actual effects of better-anchored inflation expectations? This section presents evidence on how the propagation of macroeconomic shocks depends on the degree of anchoring. It focuses on two shocks for which there are well-identified extant data sets, covering a range of AEs and EMDEs: a terms-of-trade shock and a monetary policy shock. These shocks are interesting to study together because they are so different. A terms-of-trade shock is exogenous and largely independent of policy. In contrast, a monetary policy shock is a choice for domestic policymakers. Indeed, when used well, it can be a countervailing shock, offsetting the effect of other shocks, such as those affecting the terms of trade.

A. Terms-of-Trade Shocks

We begin by estimating the impact of a negative terms-of-trade shock on the CPI of a panel of EMDEs. In general, terms-of-trade shocks are thought of as inflationary, since a worsening of the terms of trade increases the price of imports (which are consumed domestically) relative to exports (which are not). The degree of anchoring could affect this transmission either through the dynamics of expected price changes (weak anchoring may mean that higher prices now persist longer) or through differences in wealth effects (if better anchoring induces more domestic savings).[7]

We follow Bems and others (2021) in estimating the cumulative impulse response function of the CPI to a decrease in the Gruss and Kebhaj (2019) terms-of-trade index over a 12-month horizon. Estimation is conducted through local projections using the following specification:

$$p_{i,t+h-1} - p_{i,t-1} = \alpha^h + \beta_1^h\, anchor_{i,t-1} + \beta_2^h\, flex_{i,t} + \beta_3^h\, \Delta ctot_{i,t} + \beta_4^h\, flex_{i,t} \times \Delta ctot_{i,t} + \beta_5^h\, anchor_{i,t-1} \times \Delta ctot_{i,t}$$

$$+ \beta_6^h\, flex_{i,t} \times anchor_{i,t-1} \times \Delta ctot_{i,t} + \beta_7^h\, flex_{i,t} \times anchor_{i,t-1} + \sum_{j=1}^{J} \rho_j^h\, \Delta\, p_{i,t-j}$$

$$+ \sum_{s}^{S} \gamma_s^h\, \Delta ctot_{i,t-s} + \mu_i^h + v_t^h + \epsilon_{i,t+h-1}, \qquad \text{with } h=1,\ldots\ldots,12,$$

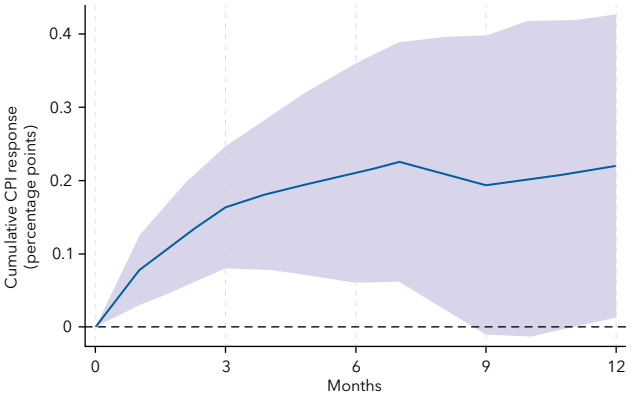
where $p_{i,t}$ is the CPI (in logs) for country i in period t; *anchor* is the inflation expectations anchoring index; *flex* is a dummy variable for flexible exchange rate regime countries;[8] *ctot* is the country terms-of-trade index; and μ_i and v_t indicate country and time fixed effects, respectively. The specification uses 12 lags of inflation and 2 lags of the terms-of-trade shock. Our panel database of EMDE countries includes Argentina, Brazil, Bulgaria, Chile, Colombia, Croatia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, Thailand, Türkiye, and Ukraine, over a period spanning January 1998 to June 2025. This specification means that the variation that identifies the estimates comes from countries that move from an unanchored to an anchored regime.

[7] Changes in a country's terms of trade may capture very different types of shocks (global demand versus commodity-specific productivity, for example). In turn, different types of shocks carry different implications for the role played by the anchoring of inflation expectations, since monetary authorities do not necessarily "see through" every kind of shock. See Di Pace, Juvenal, and Petrella (2025) and Jääskelä and Smith (2013).

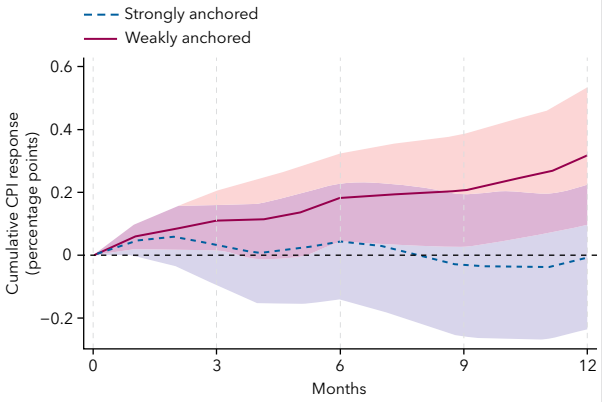
[8] Specifically, observations with an exchange rate regime classification of 3 or 4 in Ilzetzki, Reinhart, and Rogoff (2019) coarse category.

Figure 7. Impact of a Terms-of-Trade Shock
(Percentage points)

1. Inflation Response to ToT Shock at Average Anchoring Level
A deteriorating terms of trade leads to higher prices on average . . .



2. Inflation Response to ToT Shock by Anchoring Level
. . . but the effect is concentrated only in countries with weakly anchored expectations.



Note: Shaded area indicates a confidence interval at the 90 percent level. EMDEs include Argentina, Brazil, Bulgaria, Chile, Colombia, Croatia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, Thailand, Türkiye, and Ukraine. Period: 1998–2025. Results show the cumulative inflation response to a 1 percentage point month-on-month deterioration in commodity terms of trade. Strongly (weakly) anchored corresponds to the 75th (25th) percentile of the anchoring index. CPI = consumer price index; EMDEs = emerging market and developing economies.

Conducting the estimation for the entire panel of countries, we find that a 1 percent decrease in a country's terms of trade leads to a gradual rise in the CPI, reaching an increase of about 0.2 percent after one year on average (Figure 7). However, splitting out the sample between strongly and weakly anchored countries (defined as those observations falling above the 75th percentile or below the 25th percentile of the anchoring index, respectively) shows a clear distinction: when the terms of trade worsen, prices tend to rise only for those countries in which inflation expectations are not well anchored. The difference between these two responses is not only statistically significant but also economically meaningful.

B. Monetary Policy Shocks

We now turn to the question of how monetary inflation anchoring affects the transmission of monetary policy shocks. This is potentially interesting not only because monetary policy is the main tool used to offset other shocks but also because it is not obvious *a priori* how anchoring affects the transmission of policy.

On the one hand, better anchoring could make monetary policy more powerful. The monetary authority may find that it can control inflation with smaller movements in output if households and firms believe that inflation will return to target after an unexpected shock (Bernanke 2007; Mishkin 2007). However, better anchoring—with inflation expectations relatively unresponsive to economic developments—could also weaken the transmission of monetary policy by limiting the expectations channel of monetary policy. In this case, better anchoring of inflation expectations means that future expected inflation reacts *less* to policy, dampening the impact of this channel.[9] Historically, empirical evidence on the transmission of monetary policy in EMDEs has been hindered by a lack of well-identified monetary policy shocks. However, recent advances (Bolhuis, Das, and Yao 2024; Checo, Grigoli, and Sandri 2024) using forecast errors as monetary

[9] Monetary tightening works because a higher nominal interest rate increases the real interest rate, slowing the economy and lowering inflation. Lower future inflation also means lower expected inflation. This is the expectations channel of monetary policy: lower expected inflation boosts the increase in the real rate, amplifying the effects of policy. Note that a finding of weaker monetary policy transmission when expectations are anchored would not mean that anchoring is undesirable. If the impact of other shocks is smaller, improved anchoring may still be welfare improving: policy might do less but also need to do less.

policy shocks find that policy typically operates similarly in EMDEs and AEs. That is, an unexpected increase in interest rates causes bond yields to increase, which slows economic activity.

We extend this analysis by distinguishing between the impact of monetary policy shocks when inflation anchoring is strong versus when it is weak. As discussed earlier, we use an empirical framework similar to Bems and others (2021) but are now using monetary policy shocks identified in Checo, Grigoli, and Sandri (2024) as the independent variable.[10]

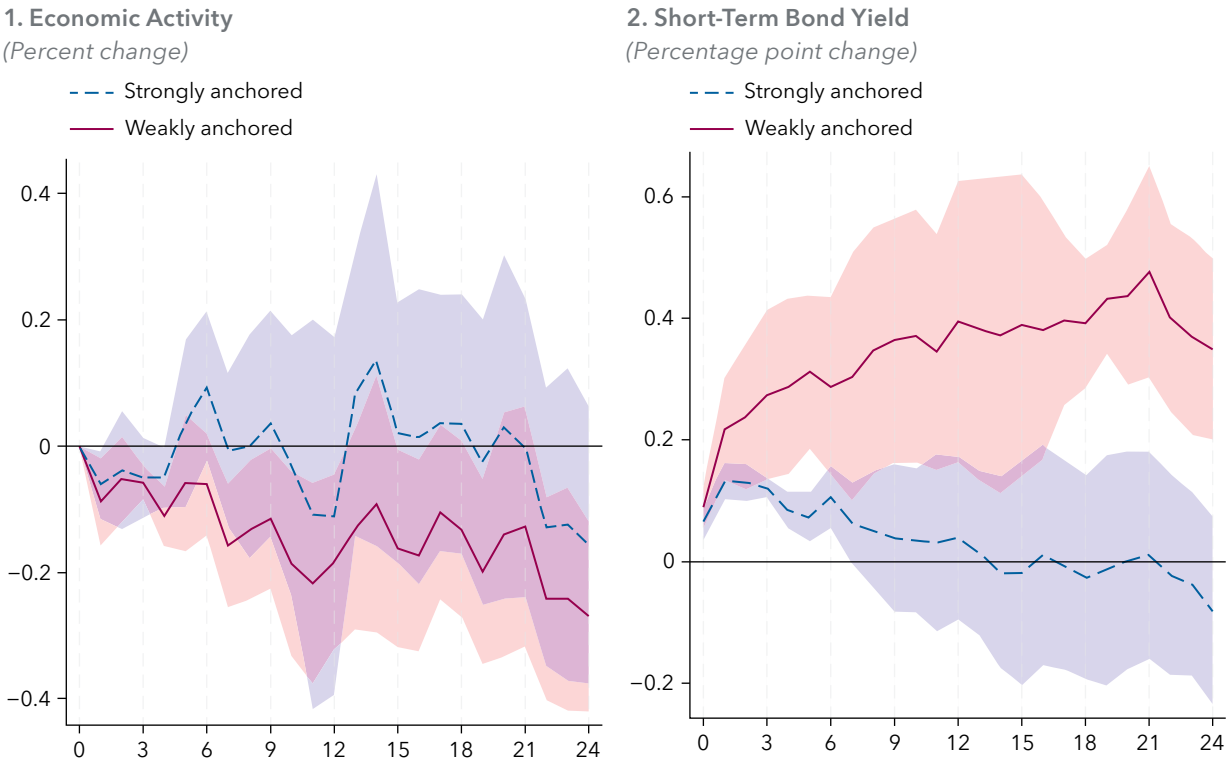
We estimate the response of our variable of interest (bond yield, consumer price inflation, or economic activity) using local projections (Jordà 2005). The specification echoes that for the terms-of-trade shock, with country and time fixed effects and a dummy for fixed exchange rate regimes. The shock is interacted with an indicator for whether anchoring is strong (in the top 25 percent of observations) or weak (in the bottom 25 percent):

$$y_{i,t+h-1} - y_{i,t-1} = \alpha^h + \beta_1^h\, anchor_{i,t-1} + \beta_2^h\, flex_{i,t} + \beta_3^h\, MP_{i,t} + \beta_4^h\, flex_{i,t} \times MP_{i,t} + \beta_5^h\, anchor_{i,t-1} \times MP_{i,t}$$

$$+ \beta_6^h\, flex_{i,t} \times anchor_{i,t-1} \times MP_{i,t} + \beta_7^h\, flex_{i,t} \times anchor_{i,t-1} + \sum_{j=1}^{12} \rho_j^h\, \Delta\, \Pi_{i,t-j}$$

$$+ \sum_{j=1}^{2} \gamma_s^h\, MP_{i,t-j} + \mu_i^h + v_t^h + \epsilon_{i,t+h-1}, \qquad \text{with } h=1,\ldots\ldots,12.$$

Figure 8. Response of Economic Activity and Short-Term Bond Yield to Monetary Policy Shock



Sources: Anchoring index from Bems and others (2021); macroeconomic data from Haver; monetary policy shocks from Checo, Grigoli, and Sandri (2024); and IMF staff calculations.

Note: Ninety percent confidence interval. Monthly data from 2002 to 2022 for LA5 countries. Monetary policy shock is standardized to one standard deviation. Strongly (weakly) anchored corresponds to the 75th (25th) percentile of the anchoring index. LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, and Peru).

[10] These monetary policy shocks are constructed using forecast errors of policy rate decisions using financial analysts' forecasts collected by Bloomberg from the early 2000s. Following Bauer and Swanson (2023), the Checo and others shocks further purge the monetary policy surprises of macroeconomic information by orthogonalizing these surprises with respect to a broad range of macroeconomic and financial variables available before the monetary policy meetings.

For this exercise, the sample covers the LA5 countries. This differs from the sample considered in the previous section, which included all EMDEs. However, there are two benefits of looking at the LA5 here. The most obvious is that these countries all have monthly broad activity indices, analogous to GDP, which typically offer a more precise measure of activity than the alternative, industrial production. The other advantage is that these are a more homogeneous set of economies and are more likely to be relevant to the rest of the region. In these countries, we find that tighter monetary policy reduces real activity and increases bond yields. However, the magnitude of these responses varies with the extent of anchoring. The changes are *smaller* when inflation expectations are strongly anchored (see Figure 8). This difference is statistically significant and is consistent with the importance of the expectations channel of monetary policy. The expectations channel of monetary policy and the asymmetrical response of the economy to positive versus negative monetary policy shocks are explored in Annex 2. There, we show that short-term inflation expectations decrease following tighter monetary policy when long-term anchoring is weaker, consistent with a stronger expectations channel of policy in this case. We also show that output responds more strongly to monetary loosening when long-term expectations are weakly anchored, but that monetary tightening has broadly similar effects regardless of the extent of anchoring.

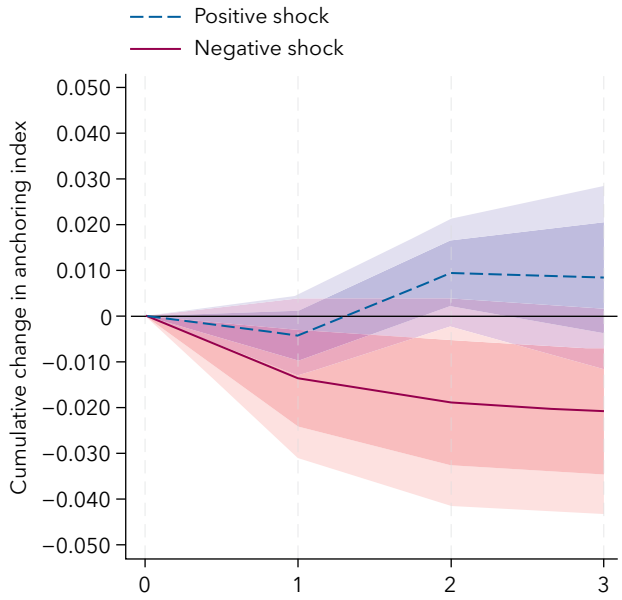
When looking at the response of consumer prices, however, we find statistically insignificant responses to a monetary policy shock in the LA5 in general, and a price puzzle (that is, prices rise after a monetary tightening) when we separate by anchoring level. This is a common challenge in such empirical settings, made more difficult by the relatively small sample size. To address this concern, we conduct the same exercise for a larger sample of EMDEs, including additional controls. There, we find that a monetary policy tightening induces a statistically significant drop in inflation over three years when inflation expectations are well anchored, and a more muted response in prices when inflation expectations are only weakly anchored (see Annex 2). To the extent that these results apply to Latin American economies, they suggest that better anchoring improves the sacrifice ratio for monetary policy.

Overall, these findings imply that the anchoring of inflation expectations has a nuanced effect on the transmission of monetary policy. Although the transmission of monetary policy to real activity seems weaker, broader evidence from EMDEs suggests that the power of policy to reduce inflation remains.

5. Can Policy Conduct Help Anchor Inflation?

This section investigates how policymakers can improve the anchoring of long-term inflation expectations. Although institutional arrangements certainly play a central role, these change infrequently and often in response to other developments. It is therefore hard to isolate and quantify the effect of these changes (this is also why the next section takes a narrative approach to this issue). However, another possibility is that the routine actions of policymakers help to shape long-term beliefs. For example, monetary policymakers may be able to convince forecasters that they will not tolerate future deviations of inflation from target simply by "acting tough," that is, running extra-tight policy today. Evidence and the importance of this reputation channel are shown in Bocola and others (2025). Conversely, they might risk losing a reputation for stable inflation by being surprisingly dovish. This is a particularly pertinent question given that the rationale for such aggressive monetary policy responses in the region included the need to anchor expectations.

Figure 9. Response of Anchoring Index to a Positive or Negative Monetary Policy Shock
(Cumulative change in anchoring index)



Sources: Anchoring index from Bems and others (2021); macroeconomic data from Haver; monetary policy shocks from Checo, Grigoli, and Sandri (2024); and IMF staff calculations.

Note: Dark bands are at the 68 percent confidence interval, and lighter bands are at the 90 percent confidence interval. Annual data for 2000–22 for LA5 countries. Monetary policy shock is standardized to one standard deviation. Strongly (weakly) anchored corresponds to the 75th (25th) percentile of the anchoring index. LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, and Peru).

To investigate this issue, we use a local projections regression with the change in the anchoring index as the dependent variable and monetary policy shocks from Checo, Grigoli, and Sandri (2024) as the principal exogenous variable. As the anchoring index is slow moving and evolves only each year, we estimate our local projections on an annual basis from the early 2000s. The monthly monetary policy shocks are aggregated to produce annual shocks. We include country and time fixed effects. We also split the shock by its sign, allowing us to separate out the effects of tighter versus looser monetary policies on anchoring.

We find that positive (that is, more hawkish) policy surprises lead to improvements in anchoring, although the effects are small, delayed, and weakly significant (see Figure 9). However, negative policy surprises lead to much larger deteriorations in anchoring. Putting this into perspective, when the

anchoring variable increased for the LA5 countries after the global financial crisis of 2007–09, it did so, on average, by 0.01 per year. This is approximately the deterioration resulting from a negative monetary policy surprise of a standard size (one standard deviation) after one year. That is, such a negative policy surprise wipes out around one year's worth of gains in anchoring, on average. The contrast between positive and negative surprises is evidence that the credibility of monetary policy is hard to gain, but easy to lose.

6. Monetary Regime and Anchoring: Narrative Evidence from Latin America

How does the choice of monetary regime affect the anchoring of inflation expectations? A key challenge in addressing this question is that changes in monetary policy regimes are rare and diverse events. This limits the usefulness of quantitative methods, which typically rely on averaging across comparable episodes to average out event-specific shocks and draw generalizable conclusions. Consequently, cross-country metrics or group comparisons not only suffer from limited statistical power but also risk obscuring the nuances embedded in individual country experiences. Furthermore, monetary regime changes are often endogenous to domestic economic circumstances, making it hard to systematically identify the effects of monetary policy regime change per se from those stemming from the conditions that precipitated the regime change.

This section therefore presents narrative evidence from three main case studies of monetary regime changes and their effects on inflation anchoring, complemented by insights from a number of additional cases in LAC. This approach allows for a richer understanding of the motivations, sequencing, and outcomes of regime changes—insights that are critical for understanding the challenges facing the process of inflation anchoring and how credibility is built or eroded over time.

A. Conceptual Framework

Despite the diversity of experiences, it is useful to classify transitions to new monetary policy frameworks along three key dimensions:

1. **Monetary policy regime.** What is the nominal anchor for monetary policy? Examples include monetary aggregate targeting, IT, or exchange rate targeting.
2. **Pace and nature of the transition.** Is it gradual or rapid? Orderly or disorderly?
3. **Underlying institutional capacity and initial conditions.** This includes the operational capacity of the central bank, political and fiscal constraints, and prevailing macroeconomic conditions.

This framework[11] helps structure the comparison between episodes, offering some insight into why some transitions succeed in anchoring expectations, the preconditions for success, and the associated trade-offs.

B. Illustrative Case Studies

Gradual and Orderly Transition to IT: Chile 1989–99[12]

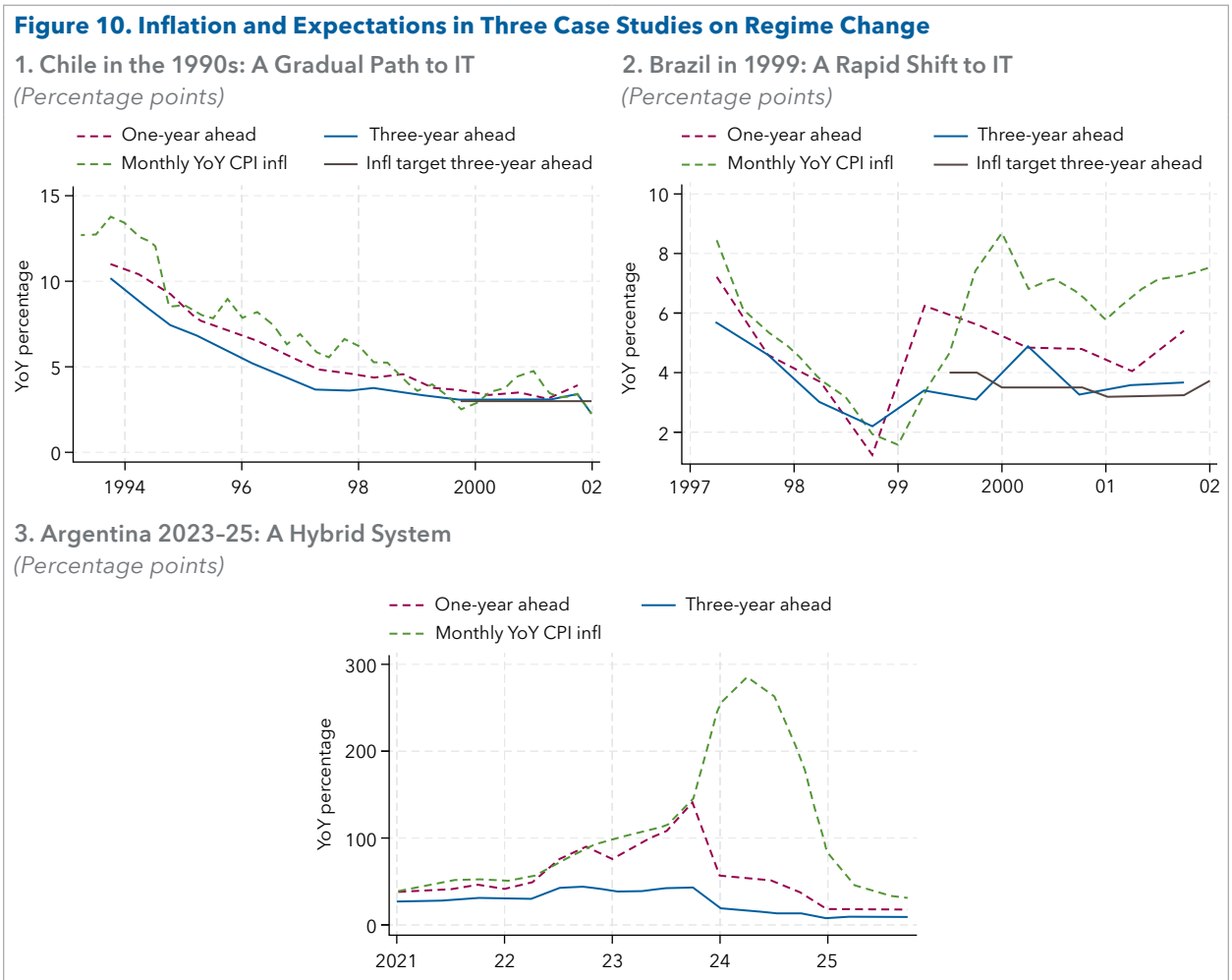
Chile's move toward IT occurred through a phased strategy combining a gradual move to greater exchange rate flexibility, institutional reform, operational modernization, and credibility building.

In common with a number of other Latin American countries, prior to IT, Chile had a history of very high inflation, peaking at several hundred percent per year in the mid-1970s. The transition to IT began in the late 1980s, shortly after the Central Bank of Chile (BCCh) gained legal independence and price stability was

[11] Loosely based on that developed in Ötker-Robe (2007).
[12] See De Gregorio, Tokman, and Valdés (2005); Costa (2023); Morandé (2001); and Ötker-Robe and others (2007).

formally established as its primary mandate. Against a backdrop of high inflation and pervasive indexation, the authorities chose gradual disinflation over rapid stabilization. Throughout the early and mid-1990s, BCCh used a crawling exchange rate band as a nominal anchor while introducing explicit inflation targets—initially communicated as multiyear targets and published as ranges, consistent with the view that credibility had to be earned and uncertainty around inflation forecasts had to be acknowledged. During this phase, the central bank focused heavily on enhancing transparency, forward guidance, and systematic communication, aiming to align private sector expectations with the disinflation path.

Figure 10. Inflation and Expectations in Three Case Studies on Regime Change



Sources: Consensus Economics Forecasts; and national statistical agencies.
Note: CPI = consumer price index; IT = inflation targeting; YoY = year over year.

A key turning point was the modernization of monetary operations. Between 1995 and 1999, BCCh progressively reoriented its operating framework toward the interbank interest rate as the main policy instrument—moving away from quantity-based instruments. This modernization supported a clearer transmission mechanism and improved control over short-term rates.

Credibility strengthened further as inflation converged to single digits and the exchange rate band became increasingly flexible. In 1999, amid a global financial shock, Chile completed the transition by abandoning the band and allowing full exchange rate flexibility, formally adopting a full-fledged IT regime with a point target (3 percent) and a symmetric tolerance band. The ability to let the exchange rate float—without compromising inflation control—reflected how expectations had become adequately anchored.

The results were gradual yet definitive. Inflation fell from above 20 percent in the late 1980s to low single digits by the early 2000s; inflation expectations became tightly aligned with the target and remained so even through external shocks. Anchored expectations, a credible institutional framework, and a transparent communication strategy allowed the floating exchange rate to act as a shock absorber without undermining the nominal anchor. As a result, Chile saw a much earlier improvement in measures of anchoring (see Figure 10). Indeed, long-term inflation expectations in Chile barely budged from the 3 percent target during the post-COVID period, even when inflation itself reached double digits.

Overall, Chile's transition to IT was remarkably successful, delivering consistently low inflation and well-anchored expectations in a country with a history of very high inflation. As a result, it is often considered the archetype for monetary policy reform. The experience shows that a gradual, transparent, and institutionally grounded transition—supported by the modernization of operational tools and consistent policy implementation—can anchor expectations and deliver lasting macroeconomic stability, even in a context of deep indexation and past instability. Crucially, a supportive fiscal stance—characterized by sustained budget surpluses throughout the 1990s—ensured that disinflation under the transition to IT was not undermined by fiscal imbalances and that central bank credibility and independence were preserved by insulating monetary policy from financing pressures and fiscal dominance.

A case that shares some similarities with Chile is that of Peru, which also moved toward IT during the 1990s, albeit from much more adverse initial conditions. After the 1988–90 hyperinflation crisis, the government undertook sweeping reforms—eliminating price controls and multiple exchange rates, ending central bank financing of the budget, liberalizing the capital account, and restoring convertibility—while committing to strict fiscal discipline and debt renegotiation to end fiscal dominance. The 1993 Constitution and the new central bank law granted the BCRP full autonomy and made monetary stability its core mandate, with base money targets used as the initial nominal anchor. Through the 1990s, Peru operated a managed float, accumulated reserves, and used money-based stabilization to bring inflation down, even as high dollarization and uncertainty about the government's commitment slowed the disinflation process. By the early 2000s, however, inflation was steadily converging to international levels, financial conditions had normalized, and credibility had improved enough for Peru to formally adopt an IT regime in 2002—one tailored to its dollarized financial system through continued use of foreign exchange (FX) intervention and carefully calibrated reserve requirement tools to contain currency mismatch risks.

Rapid but Sustainable Move to IT Regime: Brazil 1999[13]

Brazil's shift to IT is a canonical emerging market case of rapid framework adoption paired with swift institution building, emerging from a crisis-driven exit from an exchange rate anchor.

By the late 1990s, the Real Plan, which had been essential to tackling extremely high inflation earlier in the decade, was coming under increasing pressure. The Plan's crawling band regime became increasingly strained by widening current account deficits, sterilized inflows, and rising vulnerability to external shocks. Contagion from the Russian crisis precipitated the unwinding of the crawling band in January 1999.

Brazil entered the float without many of the elements that might be associated with an orderly exit from a peg and a successful gradual transition to IT, including deep FX markets, strong prudential tools, or a fully articulated nominal anchor. The authorities pivoted quickly within months to formalize a comprehensive IT regime in June 1999, anchoring policy in a transparent, rules-based regime with three-year-ahead annual targets and symmetric tolerance bands suited to a floating exchange rate. Initial central targets for inflation were 8 percent (1999), 6 percent (2000), and 4 percent (2001), with ±2 percentage point tolerance bands.

[13] See Bogdanski and others (2001); Minella and others (2003); Mishkin (2004); and Arestis, de Paula and Ferrari-Filho (2007).

From the inception of the IT regime, Brazil emphasized transparency and accountability: quarterly inflation reports, timely Monetary Policy Committee (COPOM) minutes, and—crucially—an open-letter mechanism requiring the Central Bank of Brazil (BCB) Governor to explain misses, corrective measures, and the expected horizon back to target. This legal–institutional commitment—activated during early overshoots around 2001–04 in the face of external shocks—underpinned credibility in the nominal anchor while allowing rule-consistent flexibility acknowledging sizable shocks typical of EMs.

The central bank centered operational control on the Selic interbank rate and adopted a forward-looking reaction to inflation expectations. The regime was tested in the early 2000s by terms-of-trade swings and exchange rate volatility, compounded by a large share of administered or monitored prices with backward-looking adjustment—features that raised pass-through and made it harder to calibrate the monetary policy rate. Even so, evidence from the first years shows that the targets helped stabilize expectations (see Figure 10), as the policy rule reacted strongly to forecast inflation, leading to lower inflation and output volatility relative to pre-IT periods.

The change in monetary regime was also supported by improving fiscal fundamentals. Historically, low global interest rates and a rebound in EM investor sentiment mitigated international pressures on borrowing costs, whereas tighter control over public finances in the context of an IMF-supported program provided reassurance that monetary policy would not be undermined by unsustainable fiscal policies.

After the turbulent start, inflation converged to single digits, and expectations became progressively better anchored around the central target; the framework weathered subsequent external shocks, with the exchange rate functioning as a shock absorber rather than a nominal anchor. Over time, Brazil refined the system further, including by adjusting the width of the symmetric tolerance band (from ±2.5 percentage points starting in 2003 to ±1.5 percentage points starting in 2017) and moving from calendar-year targets to a rolling, long-term framework with a continuous 3 percent target starting in January 2025.

Brazil's experience shows that rapid formal adoption of IT—even on the back of a challenging exit from a crawling exchange rate regime—can succeed if coupled with robust statutory transparency, clear operational tools, and credible communication of trade-offs when shocks hit. The open-letter device, together with forward-looking policy and institutionalized reporting, proved pivotal for expectations management and credibility building in the presence of sizable exchange rate and administered price shocks.

Other Examples of Rapid Transitions to IT

Uruguay's shift to a new monetary framework in 2002 shares many similarities with Brazil's experience just a few years earlier. It emerged from an exit from a crawling band in 2002, when the abandonment of Argentina's convertibility plan triggered escalating withdrawals from domestic banks and, eventually, a broader loss of confidence. However, the institutional and market environment was much more challenging, featuring a severe currency and banking crisis in a highly dollarized system with virtually no FX derivatives or hedging markets in place. As a result, Uruguay relied on a hybrid framework combining monetary and inflation objectives, using the monetary base as its primary policy tool before shifting to the policy rate in 2007.

Although Jamaica began introducing elements of IT as early as 2017—such as forward-looking communication and enhanced operational tools—the formal adoption of a full-fledged IT regime in 2020 occurred rapidly, concurrent with a legislative reform that strengthened central bank independence. As in Brazil, credibility has largely been built after the formal switch: the Bank of Jamaica continued to rely heavily on rules-based FX auctions and surrender requirements to manage persistent market friction (including shallow FX markets, underdeveloped hedging instruments, and high financial dollarization) and reinforced the new anchor through strong, front-loaded monetary tightening during the 2021–23 inflation surge. This was supported by the IMF-backed programs that strengthened fiscal discipline and promoted a clearer, rules-based monetary policy framework.

Argentina's abortive attempt to introduce IT in 2016–18 is an instructive case in which the absence of preconditions contributed to the failure of the transition to an IT regime. At the time, the Argentine economy was marred by persistent fiscal deficits, fiscal dominance concerns, high dollarization, and still elevated inflation and inflation expectations (IMF 2021). Internal inconsistencies in the framework were soon exposed, as debt monetization and perceived fiscal dominance came into conflict with the high real interest rates needed to achieve overly optimistic disinflation targets (Cachanosky and Mazza 2021). This led to a credibility shock in late 2017, when the authorities unexpectedly revised up the subsequent year's inflation target. High interest rates, slowing growth, and questions about fiscal sustainability all eroded the social and political support needed to build credibility in the IT framework. In October 2018, it was replaced by a monetary targeting rule.

Exchange Rate Stabilization Combined with Monetary Targeting: Argentina 2023–25

Argentina's most recent stabilization efforts offer a notable example of a hybrid monetary regime in practice. It features a blend of exchange rate stabilization, tight monetary control, and fiscal consolidation and was used as a bridge between the high inflation environment of late 2023 and a prospective regime involving greater FX flexibility.

At the outset, in December 2023, the authorities enacted a sharp devaluation—effectively overshooting the equilibrium exchange rate—and announced a monthly devaluation schedule (a "crawling peg") of 2 percent per month as part of a broader macroeconomic stabilization plan.

The exchange rate adjustment sought to realign the currency, reduce distortions, and rebuild credibility after years of fiscal and monetary imbalance. Simultaneously, the central bank implemented a tight monetary policy combined with strict control over monetary aggregates and liquidity. Government-backed fiscal consolidation—including deep spending cuts and reduction of quasi-fiscal deficits—helped end chronic monetary financing of the deficit, a prerequisite for restoring nominal stability.

Through this combined strategy, the official and parallel exchange rate gap narrowed dramatically, the currency stabilized, and macroeconomic conditions gradually improved, especially in the second half of 2024. The outcome was sharp disinflation. Monthly inflation, which had surged to over 20 percent in late 2023, began to fall steeply to below 3 percent by late 2024 and early 2025—a trajectory enabled by the exchange rate anchor, tight monetary conditions, and fiscal consolidation.

This hybrid framework allowed the exchange rate to act as a nominal anchor, whereas monetary and fiscal levers curbed liquidity and demand pressures. By early 2025, the crawling peg appeared to have run its course, as sustained real appreciation began to undermine competitiveness and reverse earlier gains in current account balancing and FX reserve accumulation. The official policy stance moved in April 2025 toward greater FX flexibility—allowing the peso to float within a large widening band—combined with a monetary aggregate targeting framework.

The lesson from Argentina's 2023–25 stabilization is that a pragmatic hybrid regime blending exchange rate adjustment, tight monetary and fiscal discipline, and aggregate-money management could be useful for countries starting from a very high inflation environment, which complicates a direct move to IT. This case illustrates that even under severe economic distress, combining exchange rate stabilization with monetary targeting—rather than abrupt adoption of full IT—can help restore nominal stability, narrow currency distortions, curb inflation, and set the stage for longer-term institutional normalization. At the same time, this case illustrates that such a framework may be challenging to sustain in the long term, even if it serves as a bridge toward a more conventional FX and monetary policy framework once annualized inflation is in the low double digits.

A Sustained Hybrid Regime

In contrast to Argentina's recent experience, Nicaragua's crawling peg exchange rate regime, which began in 1993, is one of the world's most durable. Its longevity reflects the fact that the system offers a straightforward and predictable way to anchor the currency in an economy in which domestic capital markets are relatively shallow. By adjusting the exchange rate gradually along a preannounced path—typically one month or two months in advance—the authorities have been able to guide expectations, reduce inflation, and provide a stable reference point for prices. Equally important, the central bank has been able to adjust the rate of crawl when needed—most notably reducing it from 5 percent to 3 percent in 2019, then to 2 percent in 2020, 1 percent in 2023, and finally to 0 percent in 2024. Thus, although the current *de jure* regime remains a crawling peg, in practice, it is equivalent to a stabilized arrangement. This ability to fine-tune the crawl has helped prevent the real exchange rate from becoming overvalued and avoid abrupt corrections. The combination of simplicity, predictability, and policy flexibility, in tandem with ample and adequate reserve coverage and fiscal discipline, has allowed the crawling peg to remain workable for more than three decades, even in the face of recurrent external shocks. This has resulted in deeper local currency financial markets that, although the degree of dollarization remains high, lay the groundwork for stronger domestic monetary policy transmission in the future.

C. Lessons Learned from Narrative Evidence

The case studies presented here invite three main conclusions. First, the appropriate choice of monetary regime is highly context dependent: no single framework is suitable across all countries and conditions. In particular, in episodes of exceptionally high inflation (high double digits or above), regimes such as monetary targets, exchange rate pegs, or hybrid arrangements may prove better suited than formal IT. Second, although a gradual introduction under stable macroeconomic conditions may seem ideal, IT can help anchor inflation expectations even when adopted rapidly in a challenging economic environment. In such conditions, transparency and accountability can go a long way toward building confidence in the central bank's policy objectives. Third, broad institutional support is essential: IT regimes are unlikely to succeed when fiscal or other policies undermine the central bank's stated objective (see IMF 2025), or if broader political support is lacking.

7. Lessons for Policy

The experience of the past quarter century of IT in Latin America has come with important successes:

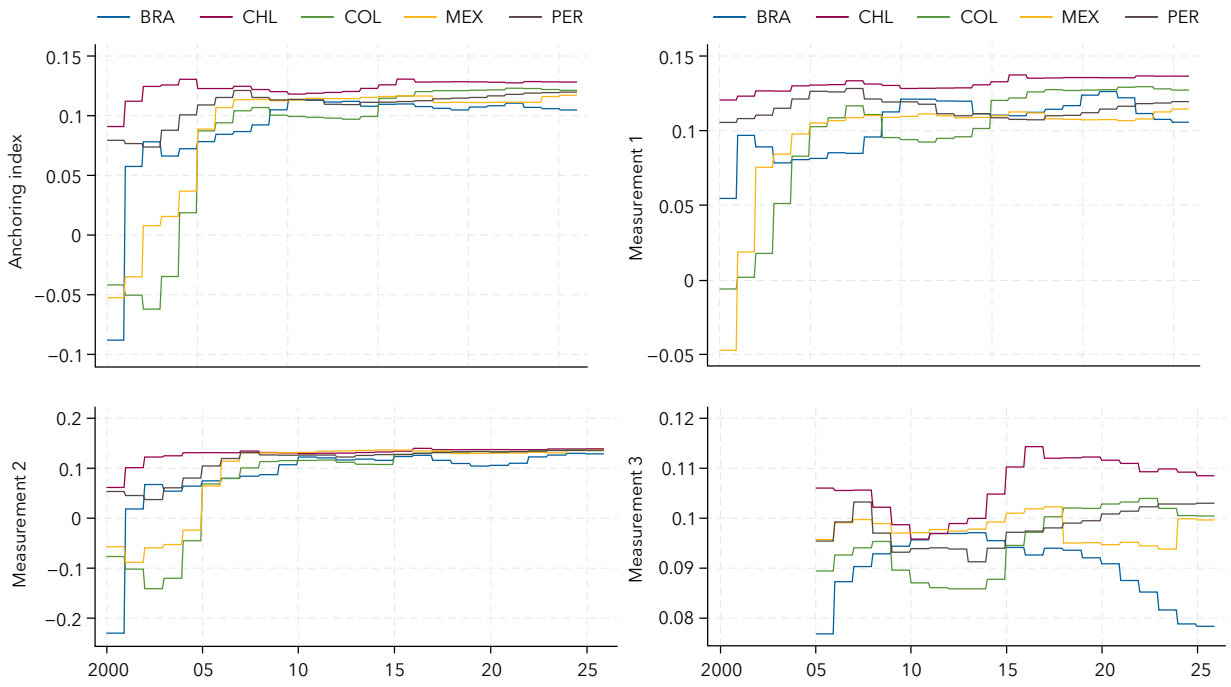
- The recent inflationary surge has been a test of monetary frameworks in Latin America, many of which date from the transition toward IT at the turn of the century. Broadly speaking, this is a test that the region has passed. Even though short-term inflation expectations naturally rose in response to higher prices, beliefs about the long term typically remained anchored. In some cases (Chile, Costa Rica), long-term beliefs barely moved even as inflation rose. But even in cases in which long-term beliefs were not quite well anchored (most notably Brazil), the departures from target have been very small relative to the historically high levels of inflation experienced by the region.
- Inflation expectations have improved over time and are better anchored than in other EMDEs but are still not as well anchored as in AEs. This difference has historically been principally because of the skew in inflation expectations: the upper tail of the distribution of beliefs has typically been further above target than in AEs.
- Decomposing the cross-sectional distribution of beliefs shows that a common component shared by forecasters, rather than the spread of beliefs across them, drives the departure of expectations from target. We interpret this as meaning that economies in the region have policymakers with personal credibility similar to those in AEs and that strengthening institutional arrangements could contribute to narrowing the gap further.

The experience also offers lessons for the conduct of monetary policy in the future—both in the region and beyond:

- The empirical evidence is clear that better anchoring of inflation expectations helps mitigate the impact of external shocks. By providing a clear nominal anchor, the pass-through of terms-of-trade shocks in well-anchored countries is statistically indistinguishable from zero, even though the average response is positive. Better anchoring thus improves the trade-off for policymakers when responding to shocks.
- In contrast, the evidence on how anchoring affects the transmission of monetary policy is more mixed. When anchoring is weaker, interest rates remain higher for longer, and output declines by more when monetary policy tightens. Although perhaps counterintuitive, this is not inconsistent with theory, since better anchoring can have offsetting effects through different channels. But even if stronger anchoring moderates the transmission of monetary policy, this need not be a concern for policymakers: the greater macroeconomic stability afforded by strongly anchored expectations can—at least in principle—imply less need for monetary policy adjustments when anchoring is stronger.
- Anchoring is slowly built but quickly lost. The evidence that anchoring responds asymmetrically to unexpected monetary tightening and loosening underscores the need to safeguard central bank credibility: reanchoring expectations is harder to achieve than de-anchoring.
- The success of IT in recent years confirms its status as a highly effective long-term nominal anchor, but wider institutional support—beyond monetary policy—is critical. In particular, fiscal discipline and political backing are central prerequisites. This broader institutional and policy support can safeguard the transition to and continued success of IT, including in relatively challenging economic environments.

Annex 1. Extra Charts and Tables

Annex Figure 1.1. Measurement Composition of Inflation Anchoring Index



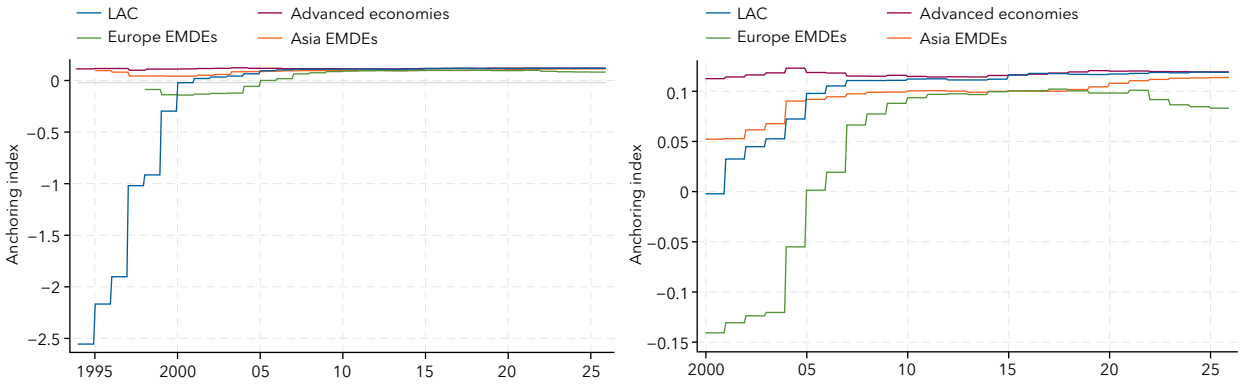
Source: Consensus Economics Forecast inflation expectations data.

Note: Anchoring index based on three metrics: (1) deviation from target, (2) variability over time, and (3) cross-forecaster dispersion. Data labels in the figure use International Organization for Standardization (ISO) country codes.

Annex Figure 1.2. Inflation Anchoring Index by Country Group

1. Anchoring Index by Country Group, 1995–2025

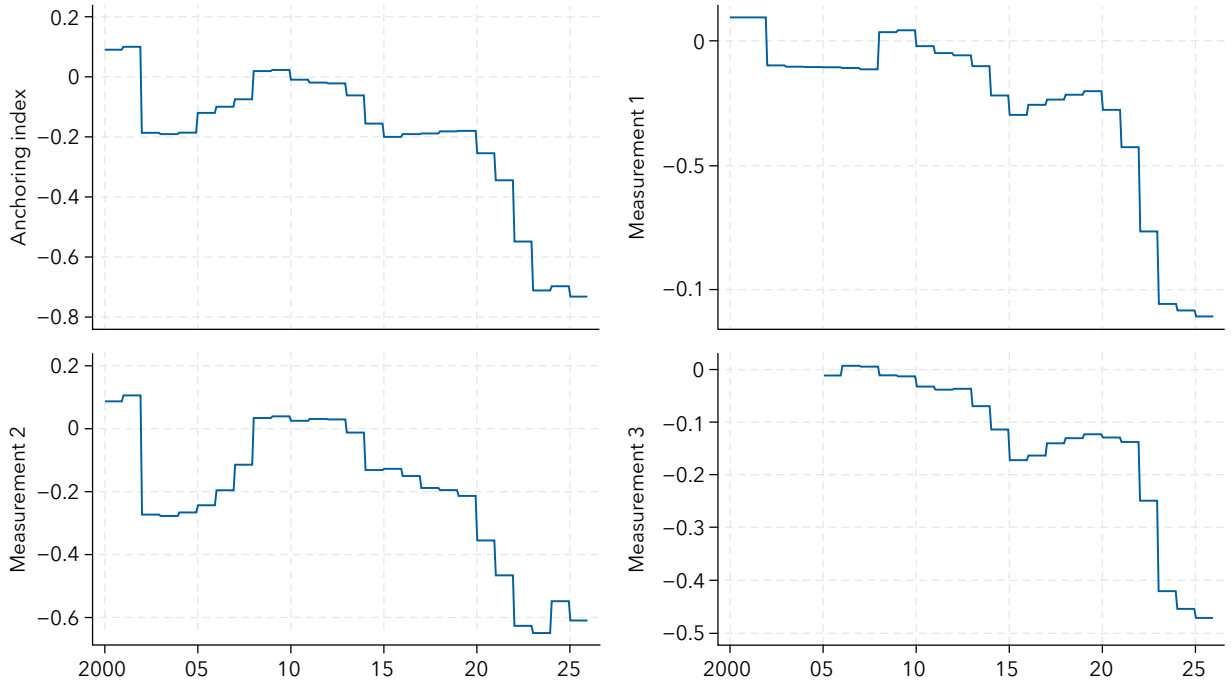
2. Anchoring Index by Country Group, 2000–25



Source: Consensus Economics Forecast inflation expectations data.

Note: LAC includes Brazil, Chile, Colombia, Mexico, and Peru. Advanced economies include Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong Special Administrative Region (SAR), Ireland, Italy, Japan, Korea, Latvia, Lithuania, The Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, the United Kingdom, and the United States. Europe EMDEs include Bulgaria, Croatia, Hungary, Poland, Romania, Russia, Türkiye, and Ukraine. Asia EMDEs include China, India, Indonesia, Malaysia, Philippines, and Thailand. Metrics constructed following Bems and others (2021) methodology using Consensus Economics Forecast inflation expectations data. The anchoring index is a standardized variable. LAC = Latin America and the Caribbean; EMDEs = emerging market and developing economies.

Annex Figure 1.3. Measurement Composition of Inflation Anchoring Index: Argentina



Source: Consensus Economics Forecast inflation expectations data.

Note: Anchoring index based on three metrics: (1) deviation from target, (2) variability over time, and (3) cross-forecaster dispersion.

Annex Table 1.1. Data Availability

	CPI			Anchoring Index			Flex			Shock		
Country	**Start**	**End**	**nobs**	**Start**	**End**	**nobs**	**Start**	**End**	**nobs**	**Start**	**End**	**nobs**
Argentina	1/1997	10/2025	346	1/1994	10/2025	382	1/1994	11/2015	251	2/1994	12/2021	335
Brazil	1/1994	10/2025	382	1/1994	10/2025	382	7/1994	10/2025	369	2/1994	12/2021	335
Bulgaria	1/1994	10/2025	382	1/2007	10/2025	226	1/1997	10/2025	346	2/1994	12/2021	335
Chile	1/1994	10/2025	382	1/1994	10/2025	382	1/1994	10/2025	382	2/1994	12/2021	335
Colombia	1/1994	10/2025	382	1/1997	10/2025	346	1/1994	10/2025	382	2/1994	12/2021	335
Croatia	1/1994	10/2025	382	1/2007	10/2025	226	10/1994	10/2025	373	2/1994	12/2021	335
Hungary	1/1994	10/2025	382	1/1998	10/2025	334	1/1994	10/2025	382	2/1994	12/2021	335
India	1/1994	10/2025	382	1/1995	10/2025	370	1/1994	10/2025	382	2/1994	12/2021	335
Indonesia	1/1994	10/2025	382	1/1995	10/2025	370	1/1994	10/2025	361	2/1994	12/2021	335
Malaysia	1/1994	3/2018	291	1/1995	10/2025	370	1/1994	10/2025	382	2/1994	12/2021	335
Mexico	1/1994	10/2025	382	1/1994	10/2025	382	1/1994	10/2025	367	2/1994	12/2021	335
Peru	1/1994	10/2025	382	1/1997	10/2025	346	1/1994	10/2025	382	2/1994	12/2021	335
Philippines	1/1994	10/2025	382	1/2009	10/2025	202	1/1994	10/2025	376	2/1994	12/2021	335
Poland	1/1994	10/2025	382	1/1998	10/2025	334	6/1995	10/2025	365	2/1994	12/2021	335
Romania	1/1994	10/2025	382	1/1998	10/2025	334	4/2001	10/2025	295	2/1994	12/2021	335
Russia	1/1994	10/2025	382	1/1998	10/2025	334	12/1999	10/2025	295	2/1994	12/2021	335
Thailand	1/1994	10/2025	382	1/1995	10/2025	370	1/1994	10/2025	376	2/1994	12/2021	335
Türkiye	1/1994	10/2025	382	1/1998	10/2025	334	2/1998	7/2018	220	2/1994	12/2021	335
Ukraine	1/1994	12/2019	312	1/1998	12/2019	264	9/1998	1/2014	185	2/1994	12/2019	311

Source: Haver Analytics (CPI); Consensus Economics and staff calculations (Anchoring Index); Gruss and Kebhaj (2019) (Terms-of-Trade shocks); Ilzetzki, Reinhart, and Rogoff exchange rate classification (Exchange rate regime).

Note: CPI = consumer price index. nobs = number of observations.

Annex 2. More Details on Monetary Policy Shocks

We now delve deeper into the response of the economy to monetary policy shocks. Following the same econometric framework as in the main body of the paper, we investigate whether there is an asymmetric response of economic activity to monetary policy shocks dependent on the anchoring level. In other words, we assess whether an economy reacts differently to a positive or negative monetary policy shock and whether this reaction varies depending on the degree of inflation anchoring. To allow comparison with the results in the main body of the paper, we use our Latin American sample.

Symmetry of Responses

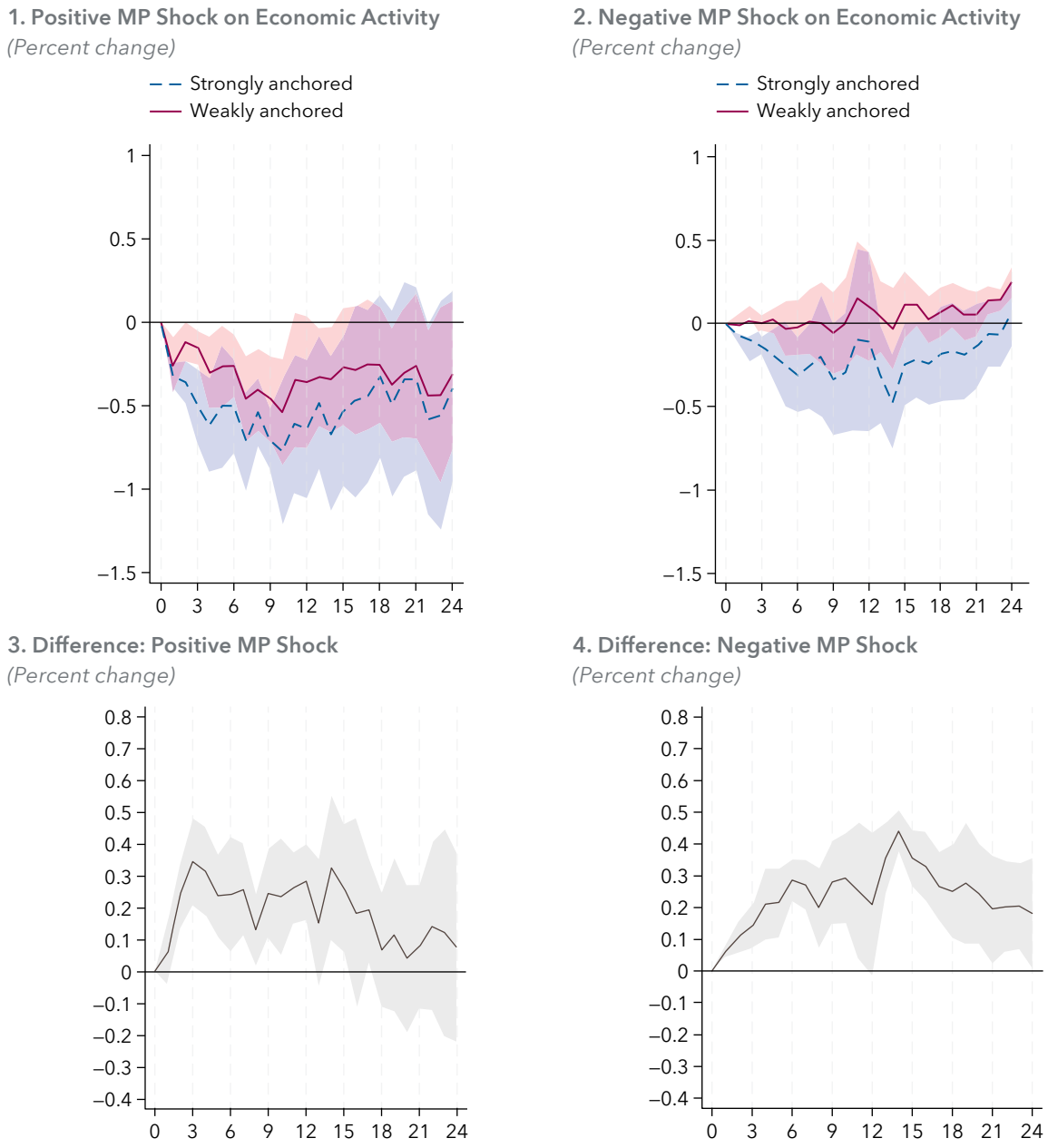
Splitting up the shocks into positive and negative shocks shows that a tightening of monetary policy reduces economic activity regardless of the degree of inflation anchoring. A negative monetary policy shock, or loosening, has an insignificant effect on economic activity when inflation is strongly anchored but a weakly stimulative effect when inflation is weakly anchored. The difference in response from a negative monetary policy shock on economic activity between strongly and weakly anchored cases is significantly different from zero.

The asymmetric response of the economy to monetary policy shocks has been shown before (Tenreyro and Thwaites 2016; Barnichon and Matthes 2018; Debortoli and others 2025). The asymmetric response that we find is that negative (loosening) monetary shocks have smaller output responses than positive ones. This is akin to Barnichon and Matthes (2018), in which a contractionary monetary shock increases unemployment, whereas an expansionary monetary shock has little effect on unemployment. We also find that when long-term expectations are weakly anchored, the stimulative effect of a monetary loosening has a persistently more expansionary effect than when expectations are well anchored. In contrast, tighter monetary policy has similar effects whether expectations are strongly or weakly anchored.

One potential explanation for this asymmetric response of economic activity because of anchoring could be the information channel of monetary policy detailed by Jarociński and Karadi (2020). For example, if inflation is strongly anchored, and the central bank is therefore deemed more credible, a loosening of monetary policy may signal to firms and households that the central bank expects a larger slowdown in economic activity than predicted by private agents, leading them to revise down their output expectations and act accordingly. By contrast, if inflation is weakly anchored, and the central bank is therefore deemed less credible, this information channel may be weaker, and the classic monetary policy transmission channel may prevail by lowering interest rates to stimulate the economy.

On the other hand, if the information channel is the principal driver of the difference in the response of positive and negative monetary policy shocks on economic activity, we would expect to see this phenomenon also occur for a tightening of monetary policy. Such that, for strongly anchored or more credible central banks, a monetary policy tightening shock would signal to private agents that the economy is likely to expand and therefore economic activity should increase. Since we do not find evidence for this, further research is warranted to understand these results.

Annex Figure 2.1. Response of Economic Activity to Positive and Negative MP Shocks by Anchoring Level



Sources: Anchoring index from Bems and others (2021); macroeconomic data from Haver; monetary policy shocks from Checo, Grigoli, and Sandri (2024); and IMF staff calculations.

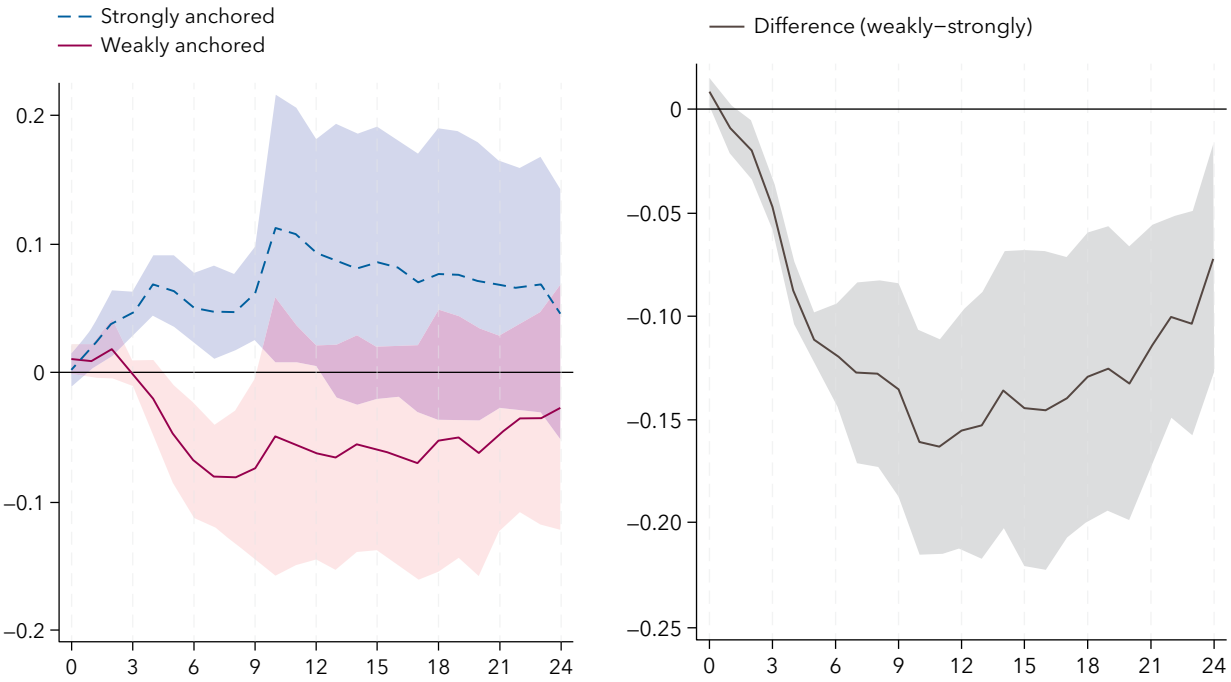
Note: Ninety percent confidence interval. Monthly data from 2002 to 2022 for LA5 countries. MP shock is standardized to one standard deviation. Strongly (weakly) anchored corresponds to the 75th (25th) percentile of the anchoring index. LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, and Peru); MP = monetary policy.

Response of Inflation Expectations to Monetary Policy Shocks

To further assess whether the strength of the information channel of monetary policy differs when inflation expectations are strongly or weakly anchored, we analyze the response of inflation expectations to monetary policy shocks. We use the Latin America 5 sample, consistent with earlier results on monetary shocks, and

employ as the dependent variable the 12-month-ahead year-over-year consumer price inflation expectations from surveys conducted by the countries' central banks.[14]

Annex Figure 2.2. Response of Inflation Expectations to Monetary Policy Shock



Sources: Anchoring index from Bems and others (2021); macroeconomic data from Haver; monetary policy shocks from Checo, Grigoli, and Sandri (2024); and IMF staff calculations.

Note: Ninety percent confidence interval. Monthly data from 2002 to 2022 for LA5 countries. Monetary policy shock is standardized to one standard deviation. Strongly (weakly) anchored corresponds to the 75th (25th) percentile of the anchoring index. Twelve-month-ahead inflation expectations for Brazil, Colombia, Mexico, and Peru, with 11-month-ahead inflation expectations for Chile. Inflation expectation data are from respective central bank surveys. LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, and Peru).

We find that if inflation expectations are strongly anchored, a tightening of monetary policy raises inflation expectations over a one-year horizon, providing evidence that analysts are learning about the state of the economy from central bank actions. By contrast, when inflation expectations are weakly anchored, a similar tightening of monetary policy causes inflation expectations to fall, which is consistent with the expectations channel of monetary policy. The difference in response across anchoring levels, which is statistically significant, provides evidence that when inflation expectations are strongly anchored, central banks have the ability to transmit information through their actions.

Response of Prices to Monetary Policy Shocks

The response of prices to monetary policy shocks has been covered extensively in other studies for AE and EM economies alike (see Checo, Grigoli, and Sandri [2024] and Carella and others [2024] for recent results). Therefore, the focus of this section is to analyze the impact of monetary policy shocks on prices depending on how well inflation expectations are anchored. To provide more power to our

[14] For Chile, we use the 11-month-ahead year-over-year inflation expectations.

results, we expand our sample to a broader set of emerging market and developing economies (Brazil, Chile, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, Thailand, and Türkiye). Since our sample has expanded, and we have additional observations, we include additional controls, akin to Checo, Grigoli, and Sandri (2024), to further isolate the impact of monetary policy on domestic consumer prices. $\Delta C_{i,t}$ is a vector containing consumer price inflation, the short-term bond yield, the domestic exchange rate relative to the US dollar, industrial production, and the unemployment rate. We include six months of lagged controls, and the dependent variable is the log of the consumer price index for each country:

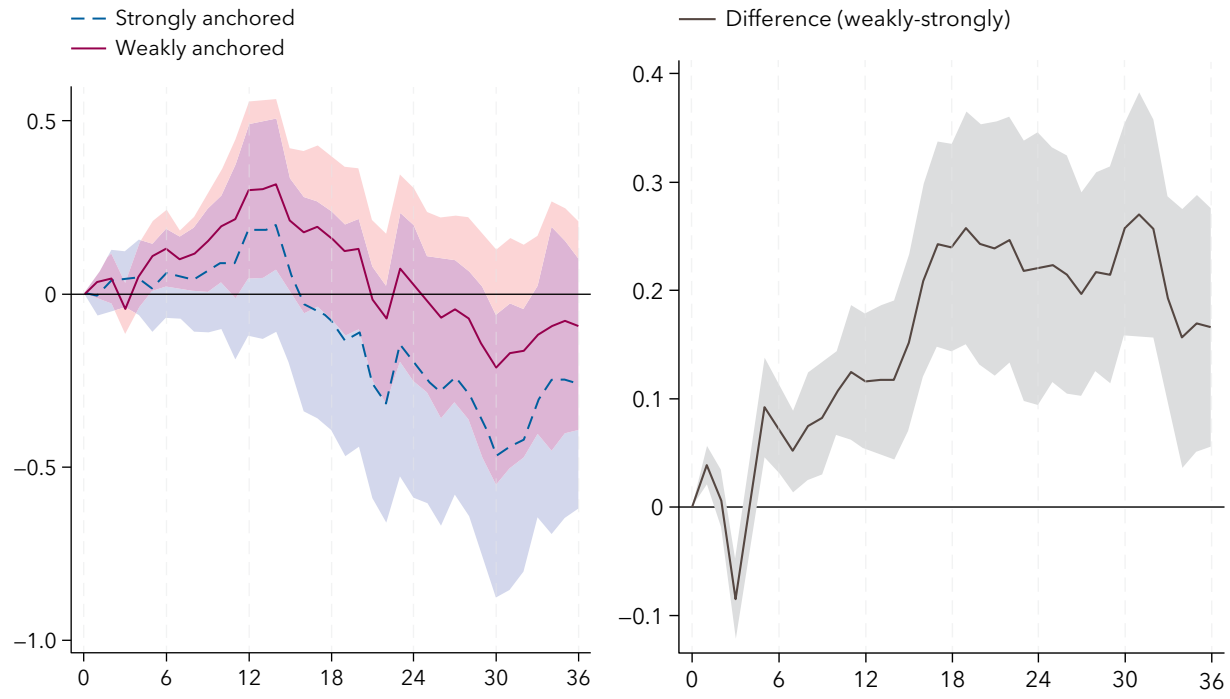
$$p_{i,t+h-1} - p_{i,t-1} = \alpha^h + \beta_1^h\, anchor_{i,t-1} + \beta_2^h\, flex_{i,t} + \beta_3^h\, MP_{i,t} + \beta_4^h\, flex_{i,t} \times MP_{i,t} + \beta_5^h\, anchor_{i,t-1} \times MP_{i,t}$$

$$+ \beta_6^h\, flex_{i,t} \times anchor_{i,t-1} \times MP_{i,t} + \beta_7^h\, flex_{i,t} \times anchor_{i,t-1} + \sum_{j=0}^{6} \rho_j^h\, \Delta C_{i,t-j}$$

$$\sum_{j=1}^{6} \gamma_j^h\, MP_{i,t-j} + \mu_i^h + \nu_t^h + \epsilon_{i,t+h-1}, \qquad \text{with } h = 1,\ldots\ldots,6.$$

Annex Figure 2.3 shows that inflation falls more following a contractionary monetary policy shock if inflation expectations are well anchored. The decrease in inflation is statistically significant between years 2 and 3 for the well-anchored case. Although the confidence intervals for weakly (red line) and strongly (blue line) anchored inflation expectations overlap, the difference between them is statistically significant. This result provides further evidence of the potential gains from anchoring inflation expectations.

Annex Figure 2.3. Response of Consumer Price Index to Monetary Policy Shock



Sources: Anchoring index from Bems and others (2021); monetary policy shocks from Checo, Grigoli, and Sandri (2024); macroeconomic data from Haver; and IMF staff calculations.

Note: Ninety percent confidence interval. Monthly data from 2002 to 2022 for EMDEs: Brazil, Chile, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, Thailand, and Türkiye. Monetary policy shock is standardized to one standard deviation. Strongly (weakly) anchored corresponds to the 75th (25th) percentile of the anchoring index. The difference shown in panel 2 is calculated as the percentage point difference between the weakly anchored (red) and the strongly anchored (blue). EMDEs = emerging market and developing economies.

Annex 3. Cross-Sectional Decomposition

In the text, we use the following decomposition of cross-sectional inflation expectations:

$$\frac{1}{T}\sum_{t=1}^{T}\frac{1}{N}\sum_{i=1}^{N}(\Pi_{it}-\Pi_t^*)^2 = \frac{1}{T}\sum_{t=1}^{T}\frac{1}{N}\sum_{i=1}^{N}(\Pi_{it}-\overline{\Pi}_t+\overline{\Pi}_t-\Pi_t^*)^2$$

$$= \frac{1}{T}\sum_{t=1}^{T}\frac{1}{N}\sum_{i=1}^{N}(\Pi_{it}-\overline{\Pi}_t)^2 + \frac{1}{T}\sum_{t=1}^{T}(\overline{\Pi}_t-\Pi_t^*)^2 + \frac{1}{T}\sum_{t=1}^{T}\underbrace{\frac{1}{N}\sum_{i=1}^{N}2\,(\Pi_{it}-\overline{\Pi}_t)\,(\overline{\Pi}_t-\Pi_t^*)}_{=0\;\forall t}$$

$$= E_{i,t}(\Pi_{it}-\overline{\Pi}_t)^2 + E_t\,(\overline{\Pi}_t-\Pi_t^*)^2,$$

where π_{it} denotes the inflation expectation of individual i at time t, $\overline{\pi}_t$ is the average inflation expectation, and π_t^* is the inflation target. The left-hand side, representing the mean squared deviation of inflation expectations relative to the target averaged over a period of length T, provides a summary measure of inflation anchoring during that period. The right-hand side decomposes this measure into two components: the first term captures the dispersion of individual forecasts, while the second term reflects the deviation of inflation forecasts from the target.

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Anchoring Inflation Expectations

Evidence from Latin America during the Post-COVID Stress Test

ISBN 9798229041058