

On looking through sectoral shocks: The role of (de-)anchored inflation expectations

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How should monetary policy respond to inflationary supply shocks that affect economic sectors differently, such as an energy price shock? Common wisdom suggests that it should "look through" the impact of such shocks on headline inflation and focus on core inflation instead. Does this recommendation still hold if inflation expectations can de-anchor from the inflation target? This study shows that monetary policy should pay close attention to de-anchoring risks, especially on the household side, to calibrate its interest rate policy. However, it also shows that these risks alone do not undermine a looking-through approach to sectoral shocks.

Recent years have seen inflationary pressures driven by supply shocks that affect different sectors unevenly, such as the COVID-19 pandemic and the Russian invasion of Ukraine. These shocks have caused significant increases in overall inflation as well as relative price differences across sectors, raising difficult questions for monetary policy. Should monetary policy "look through" such shocks, focusing on core rather than headline inflation and reduce macroeconomic costs, or act aggressively to prevent inflation expectations from de-anchoring?

To address this dilemma, this study develops a multisector New Keynesian model with sectoral heterogeneity in price stickiness and a network production structure. Importantly, unlike previous work (for example Pasten et al., 2020; Rubbo, 2023), the model allows for endogenous long-run inflation expectations, which evolve through adaptive learning (Preston, 2005) and can deviate from the inflation target.

The model is first studied using a stylised 4-sector calibration (see Chart 1) and later extended to a more granular 72-sector structure. The analysis focuses on the optimal monetary policy response to an adverse productivity shock in the energy sector, leading to an energy price increase akin to that observed after Russia invaded Ukraine in 2022. The model features a closed economy and is calibrated to the United States. For economies that rely on energy imports, like the euro area, an optimal monetary policy analysis would have to involve an open-economy model.

Optimal monetary policy: two competing views?

The paper examines two seemingly competing views. The first view argues that monetary policy should "look through" sectoral shocks, as these reflect necessary relative price adjustments (see Chart 2) that cannot be effectively targeted by controlling aggregate demand via interest rate policy (Aoki, 2001; Rubbo, 2023). The second view, prominently featured in policy discussions, contends that persistent inflationary shocks risk de-anchored inflation expectations, necessitating a more aggressive policy response to prevent second-round effects. By incorporating endogenous long-run inflation expectations into a multisector framework, the authors bridge these perspectives and show that they need not contradict each other: Monetary policy should pay close attention to de-anchoring risks to calibrate its interest rate policy even in the presence of necessary relative price adjustments.

The key findings can be summarised as follows:

- **Risk of de-anchoring requires more aggressive interest rate policy.** When inflation expectations are not perfectly anchored, the optimal monetary policy response to an adverse

sectoral shock involves more aggressive interest rate hikes. This is necessary to counteract the expansionary effects of rising long-run inflation expectations on household demand.

- **Limited impact on inflation and output dynamics.** Despite the more aggressive interest rate response, actual inflation and output dynamics under the optimal policy are similar to those in a world with perfectly anchored expectations.
- **Focus on output gap stabilisation.** In line with previous research, the welfare-maximising policy prioritises stabilising the output gap and inflation in sectors with sticky prices rather than headline inflation. This approach reduces distortions in labour and product markets caused by nominal rigidities. De-anchoring risk does not change this finding.

Conclusion

This study provides a nuanced perspective on the optimal monetary policy response to sectoral shocks in the presence of de-anchored inflation expectations. Its findings suggest that monetary policy should look through sectoral shocks, even when facing de-anchoring risks, in the sense that it should focus on stabilising the output gap and inflation in sectors with sticky prices rather than headline inflation. Nevertheless, monetary policy should closely monitor long-run inflation expectations and the possibility of a de-anchoring, especially on the household side, as the nominal interest rate response needs to be more aggressive in such a case, countering the effect of higher household inflation expectations.

References

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