Inflation expectations are central to the price-setting decision of a forward-looking firm. Because of their role in pricing decisions, they are key to the transmission of monetary policy to inflation, i.e. for the effectiveness of monetary policy.

The macroeconomic literature went from considering expectations primarily as an unobserved model variable, to using financial market prices and then surveys to measure them. In recent years, it has become apparent that the expectations of consumers, professionals, and firms tend to differ in important respects and each deserves separate treatment.

When it comes to pricing, the focus is naturally on firm expectations. In this paper, Federico Di Pace (Bank of England), Giacomo Mangiante (Banca d'Italia) and myself use the Decision Maker Panel survey, a detailed monthly survey of UK firms, to study if and how UK firms revise their pricing plans in response to a monetary policy announcement.

The answer is generally positive, and the response is in line with theoretical predictions: firms reduce their price expectations after a monetary policy tightening, while raising them when rates are cut. There are a couple of important qualifications worth mentioning though.

First, it is important to distinguish monetary policy shocks from monetary policy announcements. A monetary policy shock amounts to the change in policy rates net of any systematic response of the central bank to macroeconomic developments. Estimating the systematic component of monetary policy requires some assumptions and the profession has come up with a number of alternative approaches. We survey the most popular. What we find is that firms and markets respond to different measures of monetary policy shocks. In particular, firms do not respond to so-called "high-frequency" surprises, derived from asset-price variations in a short window around a policy decision. Rather they respond to what we consider simpler/coarser measures of monetary policy shocks, such as rate changes — possibly net of an endogenous component estimated à la Romer and Romer (2004). By using data on the press coverage of monetary policy, we show that rate changes correlate much more closely with news coverage of monetary policy compared to high-frequency surprises. The overall picture is one in which the average firm is not up to date with the tick-by-tick evolution of asset prices, yet it responds to monetary policy decisions as conveyed by the press — hence the stress on announcements, and on communication more broadly.

The second caveat has to do with important nonlinearities. The survey in question only starts after the 2016 Brexit referendum. Yet, we can identify two periods in which firms appeared to be particularly sensitive to monetary policy announcements. The first corresponds to the monetary policy stimulus imparted by the Bank of England in March 2020, at the onset of COVID pandemic. In a time of turmoil and unprecedented uncertainty, firms revised their price expectations up in response to that cut in rates. The second period is a series of consecutive and large (at least 50 basis points each) rate hikes in late 2022 and early 2023. In a period of high inflation, these measures appear to have succeeded at significantly reducing firm price expectations.

Overall, we find that monetary policy can indeed affect firm price expectations, but we also stress the importance of treating firm expectations as separate from those of financial market participants, consumers, and professionals.