

Learning from Inflation Experiences*

Ulrike Malmendier[†]
UC Berkeley, NBER and CEPR

Stefan Nagel[‡]
Stanford University, NBER and CEPR

October 2011

Abstract

How do individuals form expectations about future inflation rates? We propose that personal life-time experiences play a significant role in expectation formation. Differently from existing models of adaptive learning, individuals put a higher weight on realizations experienced over their life-times than on other “available” historical data. Averaged across cohorts, expectations resemble those obtained from constant-gain learning algorithms common in macroeconomics, but the experience model also predicts variations in learning speed based on cross-sectional heterogeneity between cohorts.

Using 54 years of microdata on inflation expectations from the Reuters/Michigan Survey of Consumers, we show that differences in life-time experiences strongly correlate with differences in subjective expectations. Young individuals place more weight on recently experienced inflation than older individuals, consistent with recent experiences making up a larger part of their lifetimes so far. The experience effect explains why there is substantial disagreement between young and old individuals about future inflation rates in periods of high surprise inflation, such as the 1970s. The experience effect also helps to predict the time-series of forecast errors in the Reuters/Michigan survey and the Survey of Professional Forecasters, and the excess returns on nominal long-term bonds.

*We thank Ralph Koijen, Monika Piazzesi, Christina Romer, and workshop participants at the European Central Bank, Federal Reserve Board, Harvard, University of Mannheim, Ohio State, Pompeu Fabra, Stanford, and the American Economic Association meetings for helpful comments and Sith Chaisurote for excellent research assistance.

[†]Department of Economics, University of California, Berkeley, ulrike@econ.berkeley.edu

[‡]Stanford University, Graduate School of Business, 518 Memorial Way, Stanford, CA 94305, e-mail: Nagel.Stefan@gsb.stanford.edu

1 Introduction

How do individuals form expectations about future inflation rates? Despite being at the core of macroeconomics and finance, the answer to this question is still debated.

That macroeconomic outcomes and asset prices depend in crucial ways on expectations of economic actors is well understood at least since Keynes (1936). But we know little about how economic agents form their subjective beliefs about the future. The literature on adaptive learning (see Bray (1982); Sargent (1993); Evans and Honkapohja (2001)) views individual agents as econometricians who make forecasts based on simple forecasting rules estimated on historical data, but there is yet little direct empirical evidence on the actual forecasting rules employed by individuals, even though understanding the formation of inflation expectations, and macroeconomic expectations more generally, is likely to be of first-order importance for macroeconomic policy (Bernanke (2007)).

In this paper we examine to what extent individuals' expectations are particularly strongly influenced by their own "experiences," by which we mean the macroeconomic data that individuals experienced during their life time. This *learning-from-experience* hypothesis is related to the adaptive learning approach in macroeconomics, but it differs in one key respect. Suppose that individuals perceive inflation rates to be *iid*. According to the least-squares learning rules popular in the adaptive learning literature, these individuals would form their subjective expectations as a simple average of past inflation realizations, using all available historical data (whatever "all available" might actually mean in practice). In contrast, our learning-from-experience hypothesis posits that individuals are more strongly influenced by data realized during their life-times than by other historical data. This hypothesis carries a rich set of implications: First, beliefs are heterogeneous. In this simple example, individuals who lived through periods of high inflation forecast higher future inflation than individuals who experienced low inflation on average during their life times. Second, learning dynamics are perpetual. Beliefs keep fluctuating and never converge in the long-run, as memories of historical data get lost when old generations disappear and new generations emerge. Third,

the heterogeneity in subjective expectations between individuals contains information that can be used to estimate the learning rules used by individuals without necessarily using time-series information about the average level of expectations.

We show that the learning-from-experience hypothesis helps explain many empirical regularities in individuals' inflation expectations. We use microdata on inflation expectations of individuals from the Reuters/Michigan Survey of Consumers (*MSC*) covering a time span of more than 50 years. We examine how subjective beliefs about future inflation are influenced by individuals' life-time experiences of inflation.

Our empirical framework employs linear regression-based forecasting rules similar to those used in the adaptive learning literature, in particular Marcet and Sargent (1989), but with the twist that we allow individuals to learn only from data realized during their life-time. We consider two models of individuals' expectations formation. In the first, individuals forecast inflation by forming a weighted average of inflation rates experienced in the past, in the second they use the experienced data to recursively estimate an AR(1) model. The learning-from-experience mechanism is implemented by making the gain, i.e., the strength of updating in response to surprise inflation, decreasing in age. As a result, young individuals react more strongly to an inflation surprise than older individuals who have more data accumulated in their life-time histories. A gain parameter determines how fast these gains decrease with age as more data accumulates. We estimate this gain parameter by fitting the learning rule to individuals' reported inflation expectations in the *MSC*. The estimate of this gain parameter reveals how people weight their inflation experiences when forming their beliefs about future inflation.

The availability of microdata is crucial for our purpose, as it allows us to identify the experience effect from cross-sectional heterogeneity. Moreover, relying on cross-sectional heterogeneity allows us to employ time dummies in the estimation, which makes it possible separate experience effects from other, potentially unobserved, influences on expectations. For example, we do not need to assume that past inflation experiences are the only influence

on people's subjective beliefs about future inflation. The time dummies absorb any other variation in inflation expectations that is common to all individuals. For example, all individuals might rely, to some extent, on the published forecasts of professional forecasters, which could contain additional information over and above the univariate history of inflation rates. With time dummies in the regression we can also accommodate the case in which all individuals draw, to some extent, on the full inflation history, so that life-time experiences only exert a partial influence on individuals' expectations. Thus, we do not need to assume that data realized prior to an individuals' life-time is completely ignored. Instead, our estimation isolates the incremental explanatory power of life-time experiences over and above any effects that are common to all individuals.

Our estimation results show that learning from experience has an economically important effect on inflation expectations. Individuals of different ages often differ substantially in their inflation expectations, and these differences are well explained by differences in their inflation experiences. This heterogeneity is particularly pronounced following periods of high surprise inflation. For example, in the late 1970s and early 1980s, the average inflation expectations of individuals under the age of 40 exceeded those of older individuals above age 60 by several percentage points, consistent with the fact that the experience of younger individuals was dominated by the high inflation years of the 1970s, while the experience of older individuals also included the low inflation years in the 1950s and 1960s. Our estimated AR(1) learning-from-experience rule attributes part of this difference in expectations also to a higher perceived persistence of inflation among younger individuals at the time, not only a higher perceived mean rate of inflation. This heterogeneity in inflation expectations only slowly faded away until the 1990s after a many years of moderate inflation.

The estimates of the gain parameter reveal how much weight people put on recently experienced inflation rates relative to inflation experienced earlier in life. Our estimates imply that recent inflation experiences receive relatively higher weight, but for older individuals experiences from 20 to 30 years ago can still have some long-run effect.

While our estimation exploits cross-sectional differences between cohorts, we also explore the implications of learning from experience for the time series of average inflation expectations. We show that if one averages across cohorts at each point in time, the average weighting of past inflation data implied by our estimates of the learning-from-experience rule from cross-sectional *heterogeneity* can be approximated very well with constant-gain learning algorithms that are popular in macroeconomics applied to *aggregate* data. The value for the gain parameter in a constant-gain algorithm that best matches the learning-from-experience weights is quantitatively similar to the gain that Orphanides and Williams (2005) and Milani (2007) have estimated from macroeconomic data and aggregate survey expectations. This similarity is a remarkable result, because our estimation utilized only information about cross-sectional differences between cohorts, and we did not calibrate learning-from-experience rule to match the average level of inflation expectations or any macroeconomic data. Learning from experience helps to simultaneously understand both the cross-section and time-series of inflation expectations.

Learning, and learning in boundedly rational fashion in particular, implies that forecast errors should be predictable, at least in sample, but possibly also out of sample. Consistent with this implication, we find that the learning-from-experience forecasts contain information that can be used to predict forecast errors in the level of average *MSC* inflation expectations in sample as well as out of sample. Furthermore, we show that the same predictor variable also helps predict forecast errors in the Survey of Professional Forecasters and the excess returns on nominal long-term bonds (which could reflect the inflation forecast errors of bond market investors). The forecast error predictability is thus not limited to the non-professional forecasters in the *MSC*.

Our paper connects to a number of works in the literature. Conceptually, our approach is related to Honkapohja and Mitra (2003) who consider a model of bounded memory learning. Bounded memory learning is similar to the learning-from-experience framework in that memory of past data is lost, but in bounded memory learning agents are homogeneous, whereas

in our setting agents' memory differs depending on their age.

There is only a small, but growing literature that looks at heterogeneity in expectations formation with micro data. Building on early work by Cukierman and Wachtel (1979), Mankiw, Reis, and Wolfers (2003) examine the time-variation in dispersion in inflation expectations, and they relate it to models of "sticky" information. Carroll (2003) further investigates the sticky information model, but with aggregate data on inflation expectations. Branch (2004), Branch (2007), and Pfajfar and Santoro (2010) estimate from survey data how individuals choose among competing forecasting models. Piazzesi and Schneider (2010) incorporate data survey data on heterogeneous subjective inflation expectation in asset pricing, while Piazzesi and Schneider (2011) use data on subjective interest rate expectations and a model with adaptive learning. Shiller (1997) and Ehrmann and Tzamourani (2009) examine the relation between cross-country variation in inflation histories and the public's attitudes towards inflation-fighting policies. Our paper contributes to this literature by demonstrating the important role of learning from experience in expectations formation, which produces both heterogeneity in expectations and gradually fading memory over time.

Our analysis is related to earlier empirical findings of Malmendier and Nagel (2011), from data from the Survey of Consumer Finances, that various measures of individuals' risk-taking and portfolio allocations are correlated with individuals' macroeconomic experiences. Their data, however, did not allow to determine whether these effects are driven by beliefs (e.g., experiences of high stock returns make individuals more optimistic) or by endogenous preferences (e.g., experiences of high stock returns make individuals less risk averse or lead to other changes in "tastes" for certain asset classes). In this paper, we use direct data on expectations to focus specifically on the beliefs channel. Interestingly, the weighting of past experienced data that is implied by the estimated learning-from-experience rules in this paper matches very closely the weighting scheme implied by the estimates in Malmendier and Nagel (2011) from a completely different data source.

Evidence consistent with learning-from-experience effects is also presented in Greenwood

and Nagel (2009) and Vissing-Jorgensen (2003), who show that young mutual fund managers and young individual investors in the late 90s were more optimistic about stocks, and in particular technology stocks, than older investors, consistent with young investors being more strongly influenced by their recent good experience with technology stocks. Vissing-Jorgensen also points out that there is age-heterogeneity of inflation expectations in the late 1970s and early 1980s. Kaustia and Knüpfer (2008) and Chiang, Hirshleifer, Qian, and Sherman (2011) find that investors' participation decision and bidding strategies in initial public offerings is influenced by extrapolation from previously experienced IPO returns.

The rest of the paper is organized as follows. Section 2 introduces our analytic framework with learning from experience and our estimation approach. Section 3 discusses the data set on inflation expectations. Section 4 presents our core set of results on learning-from-experience effects in inflation expectations. In Section 5 we look at the implications of our results at the aggregate level. Section 6 concludes with some final thoughts.

2 Learning from experience

Consider two individuals, one is member of the cohort born at time s , and the other belongs to the cohort born at time $s + j$. Suppose that at time $t > s + j$ they form expectations of next period's inflation, π_{t+1} , based on the history of past inflation rates. The essence of the learning-from-experience hypothesis is that when these two individuals forecast π_{t+1} , they draw on inflation histories of different lengths, and they place different weights on recent and distant historical data: The younger individual, born at $s + j$, has experienced a shorter data set, and is therefore more strongly influenced by recent data. As a result, two individuals of different cohorts may produce different forecasts at the same point in time. Our goal is to investigate whether individuals' inflation forecasts do indeed exhibit such experience effects.

To set up an analytical framework, we need to have some prior idea how individuals' forecasting rules might look like. The candidate forecasting rules we examine have close resemblance to those in the adaptive learning literature, in particular Marcet and Sargent

(1989) (see also Sargent (1993) and Evans and Honkapohja (2001)). The key departure from standard adaptive learning models is that we allow individuals to put more weight on data experienced during their lifetimes than on other historical data, which results in cross-sectional heterogeneity in expectations between members of different cohorts. As we explain below, we do not assume that individuals' forecasts of inflation are entirely adaptive and based on the past inflation history alone. Our framework can accommodate additional sources of information. But we hypothesize that forecasts have an adaptive component, and that this adaptive component gives rise to cross-sectional differences in expectations between different cohorts, depending on their life-time inflation experiences.

We consider two specifications of the perceived law of motion that individuals are trying to estimate. The first one is

$$\pi_{t+1} = \mu + \eta_{t+1}, \tag{1}$$

where π_{t+1} denotes the annualized inflation rate from the end of quarter t to the end of quarter $t + 1$ and η_{t+1} is a white noise shock. This specification is not realistic as a model of inflation for most of our sample, but we use it as a first cut to check whether heterogeneity between cohorts in their inflation expectations is correlated with differences in perceived mean inflation rates. We label this model as the simple mean model.

The second specification of the perceived law of motion is an AR(1), as, e.g., in Orphanides and Williams (2004),

$$\pi_{t+1} = \alpha + \phi\pi_t + \eta_{t+1}, \tag{2}$$

which is a more realistic representation of the time-series process of inflation. Here, cross-sectional differences between different cohorts can arise not only from differences individuals perception of the mean, $\mu = \alpha(1 - \phi)^{-1}$, but also from differences in the perception of persistence, ϕ , of deviations of recent inflation from this perceived mean.

Let $x_t \equiv 1$, $b \equiv \mu$ for the simple mean model, and $x_t \equiv (1, \pi_t)'$, $b \equiv (\alpha, \phi)'$ for the AR(1)

model. We assume that individuals estimate b recursively from past data following

$$b_t = b_{t-1} + \gamma_t R_t^{-1} x_{t-1} (\pi_t - b'_{t-1} x_{t-1}) \quad (3)$$

$$R_t = R_{t-1} + \gamma_t (x_{t-1} x'_{t-1} - R_{t-1}), \quad (4)$$

where the recursion is started at some point in the (distant) past. In our specific setting, as we explain below, past data gets downweighted sufficiently fast that initial conditions do not exert any relevant influence. The gain parameter γ_t determines the degree of updating when faced with an inflation surprise. With the gain sequence $\gamma_t = 1/t$, this algorithm represents a recursive formulation of ordinary least squares estimation, using all data available until time t with equal weights (see Evans and Honkapohja (2001)). With γ_t set to a constant, the algorithm becomes a constant-gain learning algorithm. Constant-gain learning implies that past data is weighted with exponentially decaying weights. Structural breaks can be a motivation for constant-gain learning, for example. Past data is down-weighted, because individuals believe that a structural break may have occurred. Alternatively, the parameters of the inflation process may be perceived as time-varying.

Let $\pi_t^h = h^{-1} \sum_{i=0}^{h-1} \pi_{t-i}$ denote the h -period average inflation rate (with both π_t and π_t^h measured at annual rates). We use the subscript $|t$ to denote that a forecast was made using information available to the agent at time t and the superscript h to denote the forecast horizon. Individuals' one-step ahead adaptive learning forecast is obtained as

$$\tau_{t+1|t}^1 = b'_t x_t \quad (5)$$

Multi-period forecasts $\tau_{t+h|t}^h$ are obtained by iterating on the forecasting model at the time- t estimates of the model parameters.

Relatively simple learning algorithms like the ones we just outlined are motivated in the adaptive learning literature by the fact that economic agents face cognitive and computational constraints which limit their ability to use optimal forecasts. The algorithms are viewed as

an approximation of the "rules of thumb" that practitioners and individuals might employ to form their expectations. The focus of much of the adaptive learning literature is on the conditions under which such simple learning rules can lead to convergence to rational expectations. Our objective is different. We use this simple recursive least-squares learning framework as a starting point for an empirical investigation of individuals' actual forecasting rules, and we depart from the standard adaptive learning algorithms in some ways to allow for learning-from-experience effects.

Our key modification of the standard recursive least-squares learning framework is that we let the gain parameter depend on the age $t - s$ of the members of the cohort s , instead of the calendar time t . As a result, individuals of different age can be heterogeneous in their forecasts and they adjust their forecasts to different degrees in response to surprise inflation. Specifically, we consider the following decreasing-gain specification,

$$\gamma_{t,s} = \begin{cases} \frac{\theta}{t-s} & \text{if } t - s \geq \theta \\ 1 & \text{if } t - s < \theta, \end{cases} \quad (6)$$

where θ is a constant parameter that determines the shape of the implied function of weights on past experienced inflation observations. We let the recursion start with $\gamma_{t,s} = 1$ for $t - s < \theta$, which implies that data before birth is ignored. (As will become clear below, though, our econometric specification does allow for all available historical data to affect the forecast. We do not assume that individuals only use data realized during their life-times, but rather isolate its effect on expectation formation.) Our gain specification resembles the one in Marcet and Sargent (1989), but with the difference that the gain here is decreasing in age, not in time, and individuals use only data realized during their life-times, as opposed to all historical data. That the gain decreases with age is a sensible assumption in context of the learning-from-experience hypothesis. Young individuals, who have experienced only a small set of historical data, should presumably have a higher gain than older individuals, who have experienced a longer data history, and for whom a single inflation surprise observation should

have a weaker marginal impact on their estimates of the the inflation process parameters.

To illustrate the role of the parameter θ , Figure 1 presents the sequences of gains (in the top graph) as a function of the age of the individual and the implied weights (in the bottom graph) on past inflation observations as a function of the time lag relative to current time t . In this example, we consider a 50-year (200 quarters) old individual. Focusing on the top graph first, it is apparent that gains decrease with age at a slower rate when θ is higher. This means that less weight is given to observations that are more distant in the past, as shown in the bottom graph. For $\theta = 1$, for example, all historical observations since birth are weighted equally. For $\theta > 1$ weights on earlier observations are lower than those on more recent observations. With $\theta = 3$ very little weight is put on observations in the first 50 quarters since birth towards the right of the bottom graph.

We show in Appendix D that the decreasing-gain specification in Eq. (6) produces weight sequences that are virtually identical to those produced by the weighting scheme in Malmendier and Nagel (2011) for appropriate choices of the weighting parameters. This allows us to easily compare the weights implied by our estimates of θ from inflation expectations data, with the earlier evidence in Malmendier and Nagel where the weighting scheme is estimated from data on portfolio allocations.

It would not be realistic to assume that individuals' expectations formation is influenced *only* by past inflation data and *only* by data realized during their life-times, and so in setting up our econometric specification we allow the adaptive learning-from-experience forecast to be complemented by other information sources. Letting $\pi_{t+h|t,s}^h$ denote the forecast of the average (annualized) inflation rate over the next h periods made by cohort s at time t , we assume

$$\pi_{t+h|t,s}^h = \beta \tau_{t+h|t,s}^h + (1 - \beta) f_t^h, \quad (7)$$

The subjective expectation is a weighted average of the learning-from-experience component $\tau_{t+h|t,s}^h$ and an unobserved common component f_t^h of individuals' h -period forecasts.

This unobserved component f_t^h could represent any kind of forecast based on common

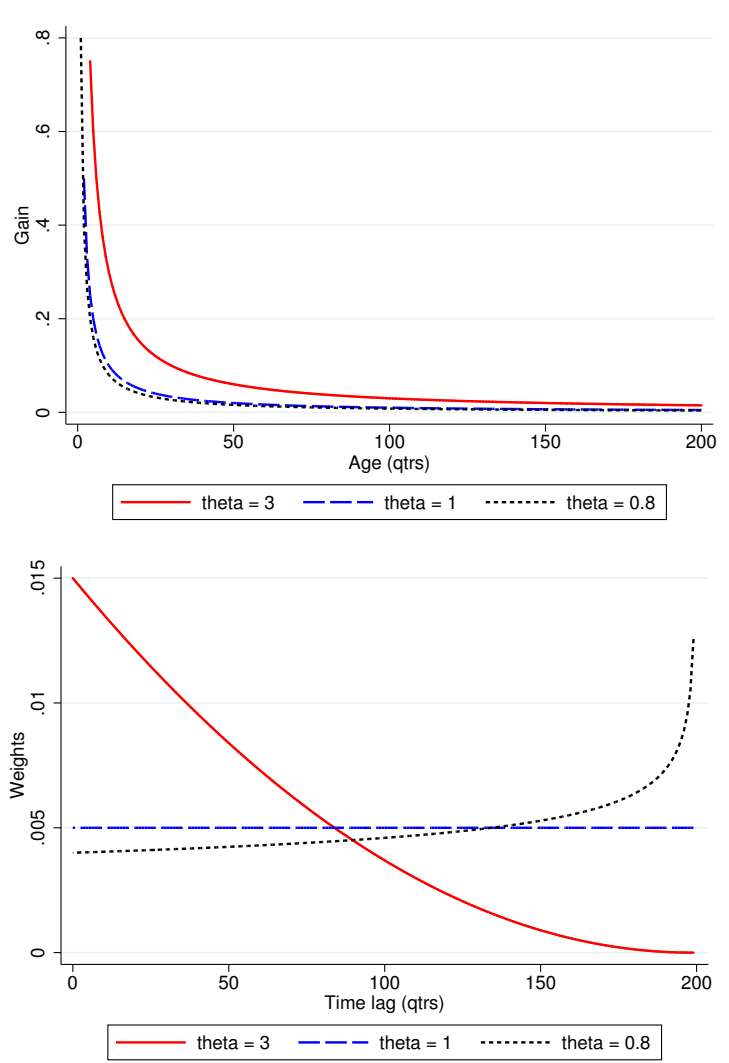


Figure 1: Examples of gain sequences (top) and associated implied weighting of past data (bottom)

information available to all individuals at time t . For example, individuals might rely, to some extent, on the opinion of professional forecasters, and the representation of their opinions in the news media (e.g., as in Carroll (2003)). The learning-from-experience effect might only make an incremental contribution over and above the influence of professional forecasters on individuals' opinions. Alternatively, f_t^h could capture a common component of individual forecasts that is driven by all available historical data, as opposed to their life-time experiences. Again, β then only captures the incremental contribution of life-time experiences $\tau_{t+h|t,s}^h$ to $\pi_{t+h|t,s}^h$ over and above this common component. Thus, we do not assume that individuals *only* use data realized during their life-times, but our goal is to empirically isolate the incremental effect of life-time experiences of inflation on expectations formation.

We estimate the following modification of Eq. (7):

$$\tilde{\pi}_{t+h|t,s}^h = \beta \tau_{t+h|t,s}^h + \delta^{h'} D_t + \varepsilon_{t,s}^h, \quad (8)$$

where $\tilde{\pi}_{t+h|t,s}^h$ denotes measured inflation expectations from survey data. In this estimating equation, we absorb the unobserved f_t^h with a vector of time dummies D_t . We also add the disturbance $\varepsilon_{t,s}^h$, which we assume to be uncorrelated with $\tau_{t+h|t,s}^h$, but which is allowed to be correlated over time within cohorts and between cohorts within the same time period. It captures, for example, measurement error in the survey data and idiosyncratic factors influencing expectations beyond those explicitly considered here. We use this specification to jointly estimate θ and β with non-linear least squares (recall that $\tau_{t+h|t,s}^h$ is a non-linear function of θ).

The presence of time dummies in Eq. (8) implies that we identify β and θ , and hence the learning-from-experience effect on expectations, from cross-sectional differences between the subjective inflation expectations of individuals of different age, and from the evolution of those cross-sectional differences over time. This has a number of advantages over prior work which has estimated adaptive learning rules from aggregate data, e.g., time-series of mean or median inflation expectations. If one finds a time-series relationship between the time- t

level of average inflation expectations and lagged inflation rates, it is difficult to establish whether the formation of expectations is really following adaptive learning rules, or whether the expectations implied by adaptive learning just happen to be highly correlated with the expectations implied by some other formation mechanism (e.g., rational expectations). In contrast, in the case of our learning-from-experience hypothesis, there is a clear prediction about the cross-section: Expectations should be heterogeneous by age, and for young people they should be more closely related to recent data than for older people. We can also estimate the gain parameter θ that determines the learning speed from this cross-sectional heterogeneity. This provides a new source of identification of the learning speed in adaptive learning algorithms.

3 Data

To estimate the learning-from-experience model, we use long-term historical data on the consumer price index (*CPI*). Our survey data starts in 1953, and so, to be able to fully capture experienced inflation for the oldest individuals in the survey sample, we need inflation data stretching back 75 years before that date. We use *CPI* data from Shiller (2005), available (updated until the end of 2009) on Robert Shiller's website. This series starts in 1871, and we use it to calculate annualized quarterly log inflation rates. To illustrate the long-run variation in inflation rates, Figure 2 shows five-year moving averages of this inflation rate series.

The inflation expectations microdata is from the Reuters/Michigan Survey of Consumers (*MSC*), conducted by the Survey Research Center at the University of Michigan. These surveys were administered since the early 1950s, initially three times per year, then quarterly from 1960 through 1977, and monthly since 1978 (see Curtin (1982)). Several questions in these surveys are the basis for the calculation of the University of Michigan Consumer Sentiment Index. We obtain data for surveys conducted from 1953 to 1977 from the Inter-university Consortium for Political and Social Research (*ICPSR*) at the University of Michigan. From 1959 to 1971, the questions of the winter-quarter Survey of Consumer Attitudes were admin-

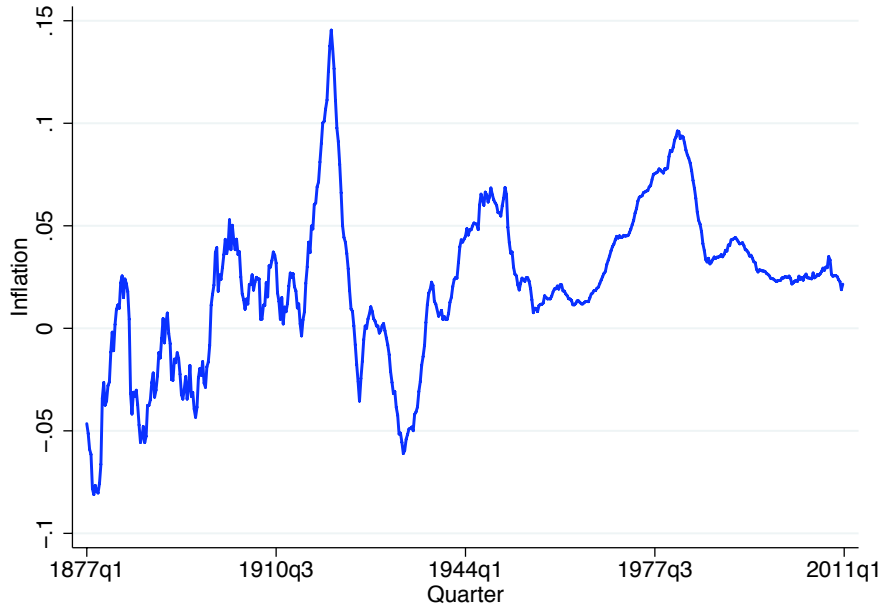


Figure 2: Five-year moving average of annualized CPI inflation rates

istered as part of the Survey of Consumer Finances (*SCF*), and so we obtain those data from the *SCF* files at *ICPSR*. The data from 1978 to 2007 is available in from the University of Michigan Survey Research Center.

In most periods, survey respondents are asked two questions about expected inflation. One about the direction of expected future price changes (“up”, “same”, or “down”) and one about the expected percentage change in prices. Moreover, in many periods, consumers are asked these two questions for both their expectations about price changes at a 1-year horizon and over a 5-10 year horizon.

In our analysis, we focus on percentage expectations about future inflation. Figure 3 highlights the periods in which we have percentage expectations data at a 1-year horizon (top graph) and 5-10 year horizon (bottom graph). The quarters in which percentage expectations data is directly available in the survey data set are shaded in light grey. Those shaded in dark grey are quarters in which respondents in the survey are asked only the categorical question (“up”, “same”, or “down”). In those quarters we impute percentage responses from

the categorical responses. The imputation procedure is described in detail in Appendix B.

Since our learning-from-experience hypothesis predicts that inflation expectations should be heterogeneous across different age groups, we aggregate the data at the cohort level. For each cohort defined by birth year, we compute, each month, the mean inflation expectations of members of this cohort. In the computation of this mean, we apply the sample weights provided by the *MSC*. If multiple surveys are administered within the same quarter, we average the monthly means within each quarter to make the survey data compatible with our quarterly inflation rate series. We restrict our sample to respondents whose age ranges from 25 to 74. This means that for each cohort we obtain a quarterly series of inflation expectations that covers the time during which members of this cohort are from 25 to 74 years old.

To provide some sense of the variation in the data, Figure 3 plots the average inflation expectations of young (averaging across all cohorts that are in the age range from 25 to 39) and old (averaging across cohorts that are in the age range 61 to 75), relative to the full-sample mean expectation at each point in time. Thus, the figure plots cross-sectional differences, which we focus on in the estimation, not the time-variation in aggregate. To better illustrate lower frequency variation, we plot the data as 4-quarter moving averages. For the 1-year expectations in the top graph, the dispersion across age groups widens to almost 3 percentage points (pp) during the high inflation years of the 1970s and early 1980s. The dispersion in expectations is even bigger for the 5-10 year expectations in the bottom graph. The gap between young and old reaches more than 4 pp in the early 1980s. The fact that young individuals at the time expected higher inflation is consistent with the learning-from-experience story: The experience of young individuals around 1980 was dominated by the recent high-inflation years, while older individuals' experience also included the modest inflation rates of earlier decades. For younger individuals, with a smaller set of experienced inflation data points, these recent observations exert a stronger influence on their expectations. As we show below, differences between young and old in their perception of inflation

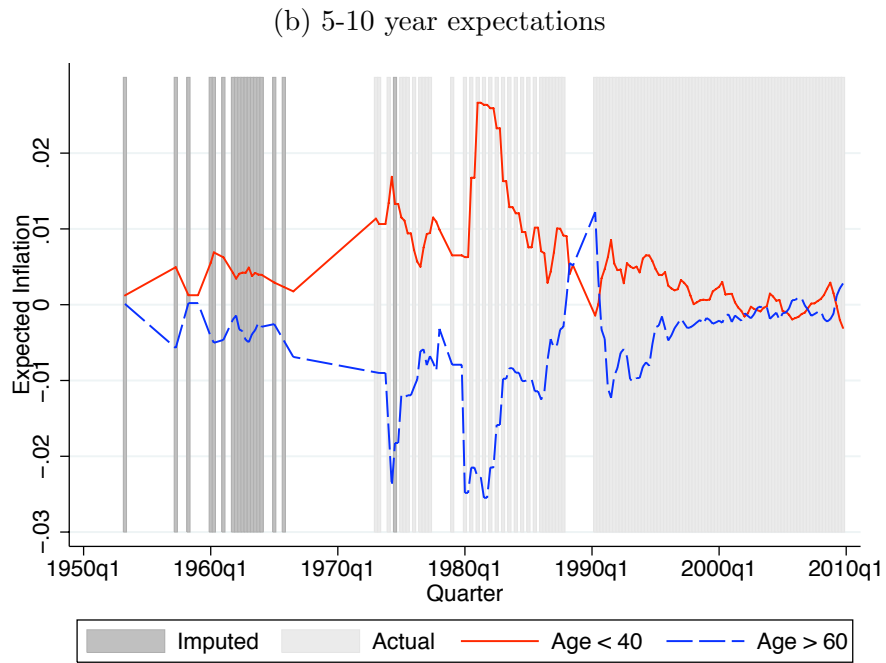
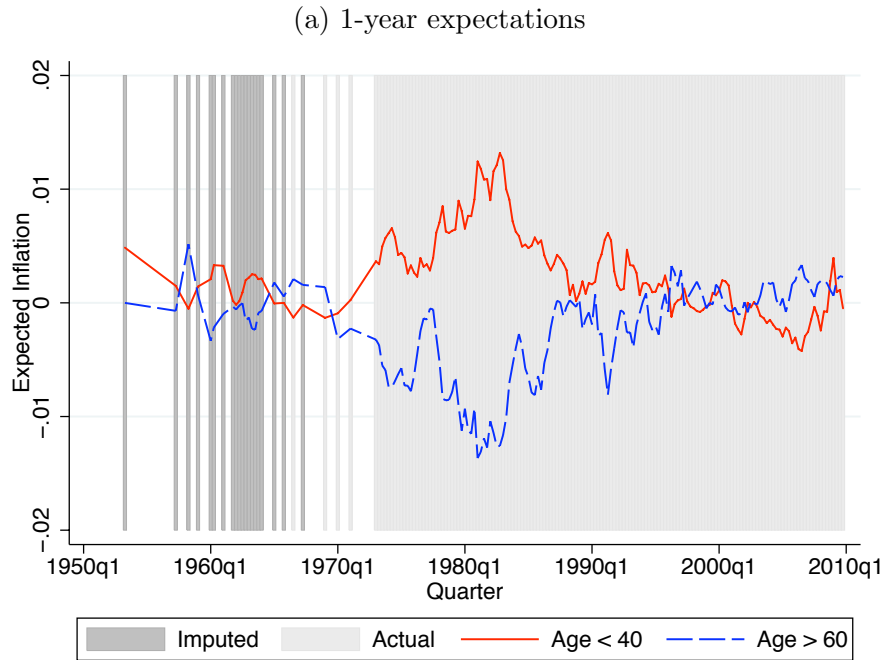


Figure 3: Four-quarter moving averages of mean inflation expectations of young (age < 40) and old (age > 60) in excess of the full-sample mean expectation, with 1-year expectations (top) and 5-10 year expectations (bottom). Percentage forecasts are available in light shaded periods, they are imputed from categorical responses in dark shaded periods, and unavailable in unshaded periods.

persistence matter as well, not just differences in the level of inflation rates they experienced in the past.

4 Estimation of learning-from-experience effects from expectations heterogeneity

We now estimate the learning-from-experience effects by fitting the estimating equation (8) to the *MSC* inflation expectations data, for both the simple mean and the AR(1) model, using nonlinear least squares on the data aggregated at the (birth-year) cohort level. We relate survey expectations measured in quarter t to learning-from-experience forecasts $\tau_{t+h|t,s}^h$, where we assume that the data available to individuals in constructing $\tau_{t+h|t,s}^h$ are quarterly inflation rates until the end of quarter $t - 1$. To account for possible serial correlation of residuals within cohorts and correlation between cohorts within the same time period, we report standard errors that are robust to two-way clustering by cohort and calendar quarter.

Table 1, Panel A, presents the estimation results for 1-year expectations. Using the full sample, our estimate of the gain parameter for the simple mean model in column (1) is $\theta = 2.808$ (s.e. 0.159). Comparing this estimate of θ with the earlier Figure 1 one can see that the estimate implies weights that are declining a bit faster than linearly. The results in Table 1 also show that there is a strong relationship between the learning-from-experience forecast $\tau_{t+h|t,s}^h$ and measured inflation expectations, captured by the sensitivity parameter β , which we estimate to be 0.711 (s.e. 0.070). This magnitude of the β parameter implies that when two individuals differ in the weighted-average inflation experienced during their life time by 1 pp, their one-year inflation expectations differ by 0.711 pp on average.

The presence of the time dummies in these regressions is important to rule out that the estimates might pick up effects unrelated to learning from experience. The fact that β is not equal to zero is direct evidence that differences in experienced inflation histories are correlated with differences in expectations. If differences in expectations between individuals'

Table 1: Explaining heterogeneity inflation expectations with learning from experience

Each cohort is assumed to recursively estimate the simple mean or the AR(1) model with decreasing age-dependent gain using quarterly annualized inflation rate data up to the end of quarter $t - 1$. The table reports the results of non-linear least-squares regressions of 1-year inflation expectations (Panel A) and 5-10 year inflation expectations (expressed in terms of average annual rates) from the *MSC* in quarter t on these learning-from-experience forecasts. Standard errors reported in parentheses are two-way clustered by time and cohort. The sample period runs from 1953 to 2009 (with gaps).

	Simple Mean		AR(1)	
	full sample (1)	w/o imputed data (2)	full sample (3)	w/o imputed data (4)
Panel A: 1-year inflation expectations				
Gain parameter θ	2.808 (0.159)	2.994 (0.184)	3.006 (0.249)	3.097 (0.272)
Sensitivity β	0.711 (0.070)	0.711 (0.069)	0.647 (0.074)	0.650 (0.077)
Time dummies	Yes	Yes	Yes	Yes
Adj. R^2	0.637	0.635	0.636	0.634
#Obs.	8165	7600	8165	7600
Panel B: 5-10 year inflation expectations				
Gain parameter θ	1.860 (0.086)	1.845 (0.090)	1.815 (0.081)	1.796 (0.086)
Sensitivity β	1.167 (0.143)	1.153 (0.147)	1.213 (0.136)	1.201 (0.141)
Time dummies	Yes	Yes	Yes	Yes
Adj. R^2	0.418	0.417	0.421	0.419
#Obs.	6151	5550	6151	5550

with different inflation experiences did not exist (for example, because they all learned from the same historical data set in the same way, applying the same forecasting rules) then β would be zero, because all the effect of historical inflation rates on current forecasts would be picked up by the time dummies. The implication that follows from non-zero β is that recent observations exert a stronger influence on expectations of the young, because their set of experienced historical inflation rates comprises only relatively few observations.

To check whether the imputation of percentage responses from categorical responses has any influence on the results, we also re-run the estimation without the imputed data, using only those time periods in which percentage responses are directly available. The results are presented in column (2). As can be seen, whether or not imputed data is used has little effect on the results.

Columns (3) and (4) present the results for the AR(1) model. The results are very similar to those for the simple mean model in terms of fit and the sensitivity parameter β . At 3.006 (s.e. 0.249), the estimated gain parameter is slightly higher, indicating that the AR(1) model suggests somewhat higher weights on recent data than the simple mean model. But overall, the differences between the simple mean and AR(1) models are minor, which indicates that the cross-sectional differences in expectations produced by the simple mean and AR(1) are largely identical. We discuss this point further below.

Interestingly, the weighting of past inflation experiences implied by the point estimates of θ is similar to the weighting implied by the estimates obtained in Malmendier and Nagel (2011) by relating data on household asset allocation to experienced risky asset returns.¹ This is quite remarkable. Our inflation expectations data here is drawn from a completely different data set, and we look at beliefs about inflation rather than asset allocation choices, but the dependence on life-time macroeconomic history in both cases seems to involve a similar weighting of experienced data. This suggests that that a common expectations-formation

¹The weighting function in Malmendier and Nagel (2011) is controlled by a parameter λ which relates to θ as $\theta \approx \lambda + 1$ (see Appendix D), and which is estimated to be in the range from 1.1 to 1.9 depending on the specification.

mechanism may be driving all of these results.

Panel B reports the same nonlinear least squares regressions, but now with 5-10 year inflation expectations as the dependent variable. The 5-10 year expectations data is available in fewer time periods, and so the number of observations in Panel B is about 2,000 lower than in Panel A. The gain parameter estimates for both the simple mean model in columns (1) and (2) and the AR(1) model in columns (3) and (4) are lower than for 1-year expectations in Panel A, and the β estimates are higher. But broadly speaking, the results are similar to the one-year expectations case. Here, too, the differences in explanatory power between the simple mean and AR(1) models are small. Again, whether we use the full sample or imputed data does not make much difference.

One possible alternative theory for these (time-varying) age-related differences in inflation expectations is that different age groups consume different consumption baskets, and that individuals form inflation expectations based on recent inflation rates they observe on their age-specific consumption baskets. The concern would be that these inflation differentials between age-specific consumption baskets could be correlated with differences in age-specific learning-from-experience forecasts that we construct. In other words, inflation differentials between age-specific consumption baskets could be a correlated omitted variable. To address this issue, we re-run the regressions in Table 1 controlling for differences between inflation rates on consumption baskets of the elderly and overall CPI inflation rates. We measure the inflation rates of the elderly with the experimental CPI for the elderly series (CPI-E) provided by the Bureau of Labor Statistics. The results reported in Appendix C show that this does not affect our results. The cross-sectional differences that we attribute to learning-from-experience effects are not explained by differences in age-specific inflation rates.

Turning back to the main results, the reported R^2 in Panels A and B of Table 1 include the effect of the time dummies, and so they are of limited use in judging the explanatory power of learning-from-experience. To get a better sense of the extent to which learning-from-experience effects explain cross-sectional differences in inflation expectations, Figure 4

and 5 presents some plots of fitted values for different age groups for the simple mean and AR(1) models, respectively.

For the purpose of these plots only, we average inflation expectations and the fitted values within the same young (age < 40) and old (age > 60) categories that we used earlier in Figure 3. Since our estimation with time dummies focuses on cross-sectional differences, we plot the inflation expectations and fitted values of these subgroups after subtracting the full-sample mean each period. Thus, the plots focus on cross-sectional differences, just like the estimation in Table 1. To eliminate high-frequency variation, we show 4-quarter moving averages for both actual and fitted values.

The top graph in Figure 4 plots the fitted values of 1-year expectations, i.e. those corresponding to the estimates in Panel A of Table 1. Fitted values are drawn as lines, raw inflation expectations are shown as triangles (young) or circles (old). The plot shows that the simple mean model does a good job of explaining the differences in inflation expectations between young and old. In particular, it accounts, to a large extent, for the large difference in expectations between young and old in the late 1970s and early 1980s.

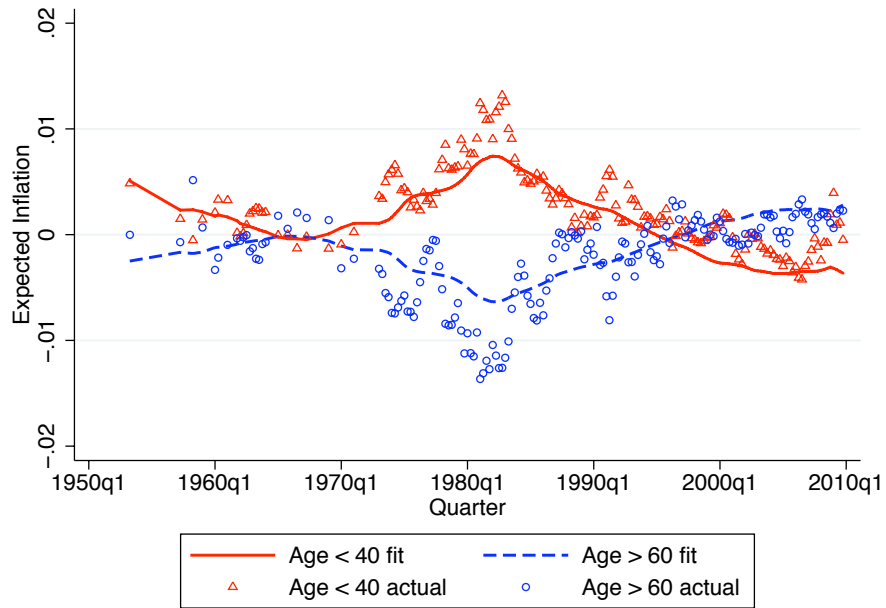
The bottom graph in Figure 4 provides an equivalent plot using 5-10 year inflation expectations and the corresponding fitted values based on the estimates in Panel B of Table 1. Here, too, the simple mean model accounts for much of the difference in inflation expectations between young and old, although it is less successful than for one-year expectations in explaining some of the more extreme differences, such as the big spike in the mid-1970s.

Figure 5 shows that the fit with the AR(1) model looks similar. The AR(1) model does slightly better in capturing the big spike in the difference between young and old in the early 1980s and the convergence in the most recent periods.

4.1 Time-path of parameter estimates

It may seem surprising that the simple mean and AR(1) models do roughly equally well in explaining the cross-sectional heterogeneity between cohorts. To see how this can arise, note

(a) 1-year expectations



(b) 5-10 year expectations

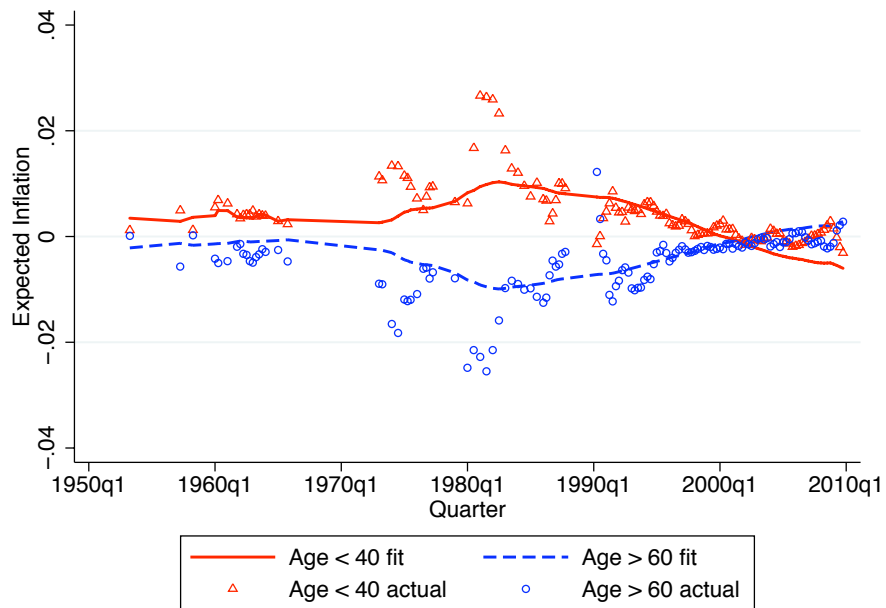
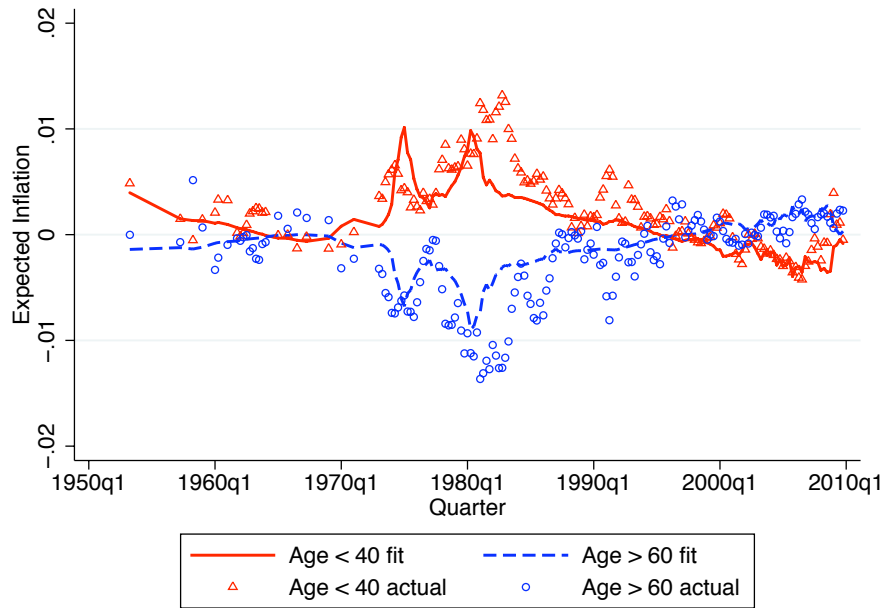


Figure 4: Simple mean model: Comparison of 4-quarter moving averages of actual and fitted 1-year (top) 5-10 year (bottom) inflation expectations of young and old in excess of the full-sample mean expectation.

(a) 1-year expectations



(b) 5-10 year expectations

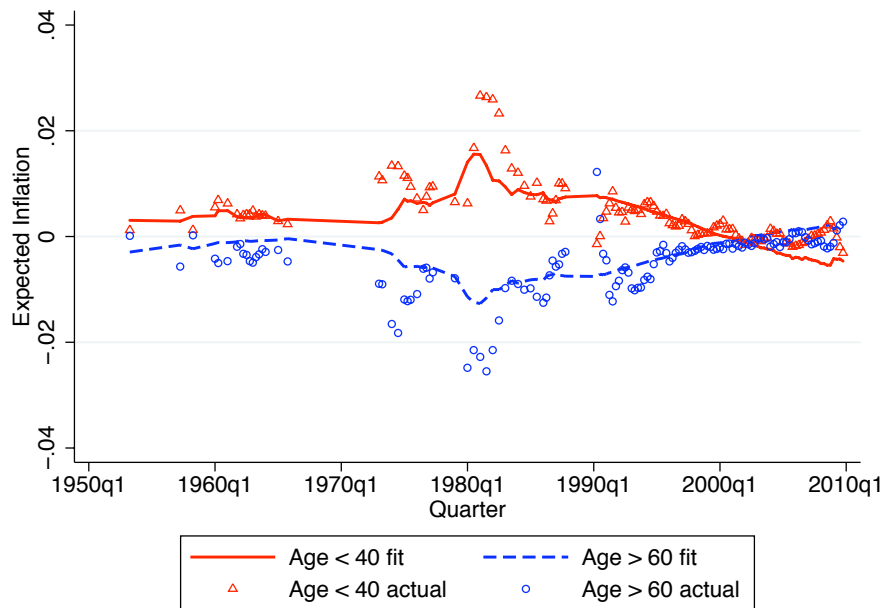


Figure 5: AR(1) model: Comparison of 4-quarter moving averages of actual and fitted 1-year (top) 5-10 year (bottom) inflation expectations for young and old in excess of the full-sample mean expectation.

that we can write the one-step ahead learning-from-experience forecast for cohort s according to the AR(1) model as

$$\tau_{t+1|t,s}^1 = \mu_{|t,s} + \phi_{|t,s}(\pi_t - \mu_{|t,s}), \quad (9)$$

where $\mu_{|t,s}$ and $\phi_{|t,s}$ represent the AR(1) parameter estimates of cohort s at time t . Labelling cohorts of older people with “o” and the young with “y”, the difference in their forecasts can be expressed as

$$\tau_{t+1|t,y}^1 - \tau_{t+1|t,o}^1 = (1 - \phi_{|t})(\mu_{|t,y} - \mu_{|t,o}) + (\phi_{|t,y} - \phi_{|t,o})(\pi_t - \mu_{|t}), \quad (10)$$

where $\phi_{|t}$ and $\mu_{|t}$ denote the average of the respective parameter estimates of young and old.

The above expression, in conjunction with Figure 6, which reports the time-path of the learning-from-experience AR(1) parameter estimates for young and old, helps to understand how the simple mean model and the AR(1) model can produce similar implications for cross-sectional differences in inflation forecasts. In times of high $\phi_{|t}$, when both young and old perceive a high degree of inflation persistence, a situation that applied around 1980 (see top panel of Figure 6), the positive differences in mean $\mu_{|t,y} - \mu_{|t,o}$ (see bottom panel of Figure 6) are heavily downweighted by $(1 - \phi_{|t})$. However, during this period, $\phi_{|t,y} - \phi_{|t,o}$ was positive, and $\pi_t - \mu_{|t}$ was strongly positive, too, which means that the downweighting of $\mu_{|t,y} - \mu_{|t,o}$ was more than offset by the second term in (10). In contrast, in the last 10 years of the sample, $\phi_{|t}$ was much closer to zero, and hence there was little downweighting of $\mu_{|t,y} - \mu_{|t,o}$. Furthermore, the moderate inflation rates at the time stayed relatively close to $\mu_{|t}$, which means that the second term in (10) was close to zero.

Thus, the similarity of the cross-sectional differences implied by the simple mean and AR(1) models are explained by the time-path of the autocorrelation estimates of young and old. However, even though the simple mean and AR(1) models produce similar predictions for cross-sectional differences in inflation expectations, their predictions for the time series of inflation forecast levels are likely to be very different.



Figure 6: Learning-from-experience AR(1) model estimates (with $\theta = 3.006$) of autocorrelation (top) and mean inflation (bottom) for young and old.

Table 2: Explanatory power of learning-from-experience forecasts without time dummies

MSC inflation expectations are regressed on the (horizon-matched) forecasts implied by the learning-from-experience models (simple mean or AR(1)), with θ fixed at the point estimates from Table 1. Unlike those in Table 1, the regressions here do not include time dummies. Standard errors reported in parentheses are two-way clustered by time and cohort. The sample period runs from 1953 to 2009 (with gaps), but it excludes all quarters in which percentage expectations had to be imputed from categorical responses.

	1-year expectations		5-10 year expectations	
	Simple mean (1)	AR(1) (2)	Simple mean (3)	AR(1) (4)
Learning-from-experience forecast	0.627 (0.141)	0.994 (0.079)	0.778 (0.242)	1.227 (0.212)
Intercept	0.020 (0.006)	0.003 (0.003)	0.011 (0.011)	-0.007 (0.009)
Adj. R^2	0.058	0.415	0.053	0.136
#Obs.	7600	7600	5550	5550

4.2 Explanatory power without time dummies

To assess to what extent the estimated learning-from-experience rules help explain not only cross-sectional differences between cohorts, but also the time variation in inflation expectations, we now examine how well the estimated learning rules explain the pooled cross section and times series of survey inflation expectations if we do not absorb the variation in the average level of survey inflation expectations with time dummies. For this purpose, we re-run the regressions from Table 1, but with two modifications. First, we omit the time dummies. Second, we fix the gain parameter θ at the point estimates we obtained in Table 1. In this way, we investigate how much explanatory power we get from a learning rule that we fitted only to cross-sectional heterogeneity, without altering θ to better fit the time series of average survey inflation expectations.

The results are shown in Table 2. Since our imputation method for missing percentage expectations is designed to impute only cross-sectional differences, but not the average level

of inflation expectations each period, these regressions use only data from periods in which percentage expectations are available without imputation from categorical information. Focusing first on the results for 1-year expectations, column (1) shows, not surprisingly, that the explanatory power of the simple-mean model is relatively poor once the model is asked to capture not only cross-sectional heterogeneity, but also the time variation in the average level of inflation expectations. While the simple mean model does a good job in capturing cross-sectional heterogeneity (Table 1), it misses much of the variation in the level of inflation expectations. In contrast, the AR(1) model in column (2) does much better with an adj. R^2 of 41.5%. Evidently, the AR(1) model is not only good at capturing cross-sectional heterogeneity (Table 1), but also the time-variation in the level of inflation expectations. Moreover, with 0.994, the coefficient on the expectation learning-from-experience is almost exactly equal to one, suggesting that observed survey expectations tend to move one-for-one with the expectation implied by the learning-from-experience AR(1) model. This is quite remarkable, as θ is set to the estimate from Table 1 and not fitted to get a good match to the level of average inflation expectations. These results suggest that the AR(1) learning-from-experience model works well as a model of individuals' inflation expectations formation.

For 5-10 year expectations, the explanatory power of the simple mean model in column (3) is quite low, similar to the result for 1-year expectations. But here the explanatory power is relatively poor even for the AR(1) model in column (4). Iterating on the quarterly AR(1) model to produce a forecast at a 5-year horizon eliminates much of the effect of π_t , even in times when the autocorrelation at a quarterly horizon is relatively high. As a result, the 5-year horizon forecasts are driven largely by the $\mu_{|t,s}$, which explains why there is much less of a difference between the simple mean and AR(1) forecasts in the case of 5-10 year expectations. Closer inspection of the data shows that survey respondents perceive a much higher degree of long-run persistence in inflation than the AR(1) model can deliver. The level of 5-10 year survey expectations is generally very close to the 1-year expectations. For example, replacing the 5-year horizon forecast in the regression in column (4) with the 1-year

horizon AR(1) forecast produces a much better fit (adj. $R^2 = 22.5\%$). Survey respondents seem to perceive autocorrelations as decaying roughly consistent with an AR(1) up to a lag of four quarters, but then with very little decay beyond the fourth lag. We have experimented with more complex ARIMA models such as ARMA(1,1), for example, that can accommodate a slow long-run decay in autocorrelations to check if these can help to explain the long-run persistence implicit in the 5-10 year survey expectations, but we found that this is not the case.

5 Implications for the level of average inflation expectations

So far we have focused on understanding to what extent learning from experience can help understand inflation expectations at the cohort level. In our estimation in Table 1, we did not need to assume that the learning-from-experience mechanism is necessarily the only driving force behind inflation expectations formation. The time dummies in our regressions could absorb various other common factors affecting individuals' expectations. However, from a macroeconomic perspective it would also be interesting to see to what extent the learning-from-experience mechanism, based on the estimates of θ from cross-sectional heterogeneity, helps explain inflation expectations in aggregate. In this section we show that the learning-from-experience forecasts at the cohort level aggregate to average forecasts that closely resemble those from constant-gain algorithms that are popular in macroeconomics. We also show that one can extract components from the learning-from-experience forecasts that are useful in predicting forecast errors in the Michigan survey and the Survey of Professional Forecasters (SPF), as well as the returns on long-term bonds. In this section, we focus solely on the AR(1) model, as the simple-mean model, while quite good in explaining cross-sectional heterogeneity, fares poorly in capturing the time-series of average expectations. Like most of the literature, we focus on expectations at a 1-year horizon in this section.²

²As we noted before, the dynamics of 5-10 year survey expectations are (puzzlingly) similar to those at a 1-year horizon. Thus, all results we show in this section would be roughly similar with 5-10 year expectations if one makes the assumption that individuals' apply their 1-year horizon learning-from-experience forecast

5.1 Approximating learning-from-experience with constant-gain learning

In our learning-from-experience framework, individuals update their expectations with *decreasing* gain: as individuals age, their experienced set of data expands and their expectation reacts less to a given inflation surprise than a younger individual would. However, as older individuals leave the population at some point, they are replaced by younger ones. At any given point in time, there is a distribution of gains in the population, but to the extent that the age distribution is relatively stable, the average gain should be approximately constant. Therefore, the average forecast across all age groups can be approximated by a *constant-gain* learning algorithm where updating takes place in the same way as laid out in equations (2) to (4), but with the decreasing gain in (6) replaced by a constant gain, and with a single “representative” agent.

How well this works can be seen by comparing the average weights on past inflation data implied by the cohort-level learning-from-experience rules with the weights implied by constant-gain learning. The solid line in Figure 7 plots the average of implied weights on past inflation with learning from experience, where the average is taken (equal-weighted) across all cohorts alive in the population at a point in time. The implied weights are based on our point estimate of $\theta = 3.006$ from Table 1, column (3). We then look for a constant gain so that the weights on past data implied by this constant-gain algorithm minimize the squared deviations from the average learning-from-experience weights. The result is a constant gain of $\gamma = 0.0175$, with implied weights as shown by the dashed line. The figure shows that the weighting of past data is clearly very similar.

Thus, the implications of learning from experience for expectations formation in aggregate are likely to be very similar to those of the constant-gain learning algorithms that are common in macroeconomics (see, e.g., Orphanides and Williams (2005), Milani (2007), Evans and Honkapohja (2001)).³ There are two important differences, though.

unchanged to the 5-10 year horizon.

³Cross-sectional heterogeneity in expectations between different cohorts could matter for other macroeconomic implications, though; see, e.g., Piazzesi and Schneider (2010).

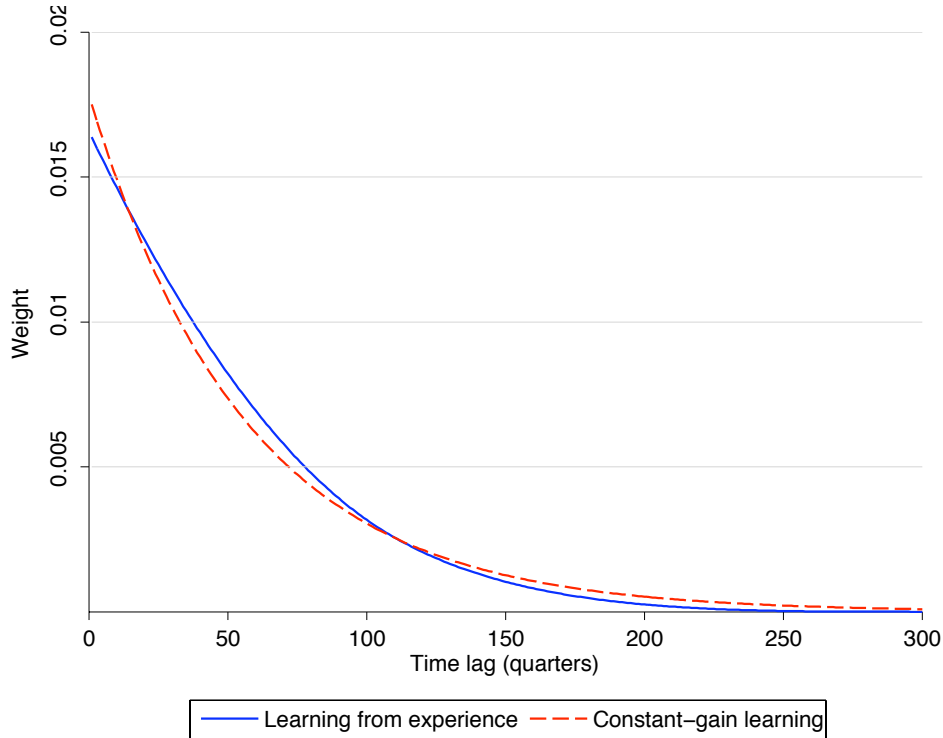


Figure 7: Implied aggregate weights for past inflation observations under learning from experience (equal-weighted average of weights across age groups at point estimate of $\theta = 3.006$ from Table 1, Panel A, column (3)) compared with implied weights under constant-gain learning by a single agent (with gain $\gamma = 0.0175$ that minimizes squared deviations from the aggregated learning-from-experience weights).

First, the motivation for the loss of memory of past data is different. In constant-gain learning, the gradual loss of influence of past data is typically motivated as a concern on part of agents that past data is not relevant anymore to do structural changes and time-variation in the parameters of the perceived law of motion. While these concerns may also be relevant in the learning-from-experience framework and lead to $\theta > 1$ so that recent data receives a higher weight than data realized earlier in life, learning from experience comes with the additional feature that memory of past data is lost as old generations die and new ones are born. In aggregate, data in the distant past would be downweighted even if each individual weighted all life-time experiences equally.

Second, as we demonstrated in the previous section, the gain parameter of the learning-

from-experience rule can be estimated from cross-sectional data. Our estimate of θ is not fitted to aggregate expectations. The time dummies in our estimation absorb all variation in the cross-sectional average expectation, and so θ is identified from cross-sectional information only. In light of the fact that we did not employ aggregate expectations in estimation of θ and we did not calibrate θ to achieve the best fit to realized future inflation, it is remarkable that the constant gain $\gamma = 0.0175$ in Figure 7 that best matches the weights implied by our estimate of θ is virtually the same as the gains that seem to be required to match aggregate expectations and macro time-series data. For example, Milani (2007) estimates a DSGE model with constant-gain learning and obtains an estimate of 0.0183 that results in the best fit of the model to the macro time series employed in estimation. Orphanides and Williams (2005) choose a gain of 0.02 to match the time series of inflation forecasts from the Survey of Professional Forecasters (SPF). Thus, our estimation from cross-sectional heterogeneity between different cohorts brings in new additional data that provides “out-of-sample” support for values of the gain parameter in this range. This is particularly important because the identification of the learning speed in macro models from macro data is econometrically difficult (Chevillon, Massmann, and Mavroeidis (2010)).

5.2 Explaining the level of average inflation expectations

Figure 8 explores how well the average learning-from-experience forecast tracks the average 1-year survey expectations (i.e., the data we used in the estimation in Table 1 is now averaged across all cohorts each quarter). Since our imputation of percentage responses only targeted cross-sectional differences, but not the average level of percentage expectations, we omit all periods from these regressions in which we only have categorical inflation expectations data.

It is apparent that the average learning-from-experience forecast (calculated with $\theta = 3.006$ from Table 1, Panel A, column (3)), shown as the solid line, tracks the average survey expectations closely. It is important to keep in mind that this is by no means a mechanical result. Our estimation of θ used only cross-sectional differences in survey expectations between

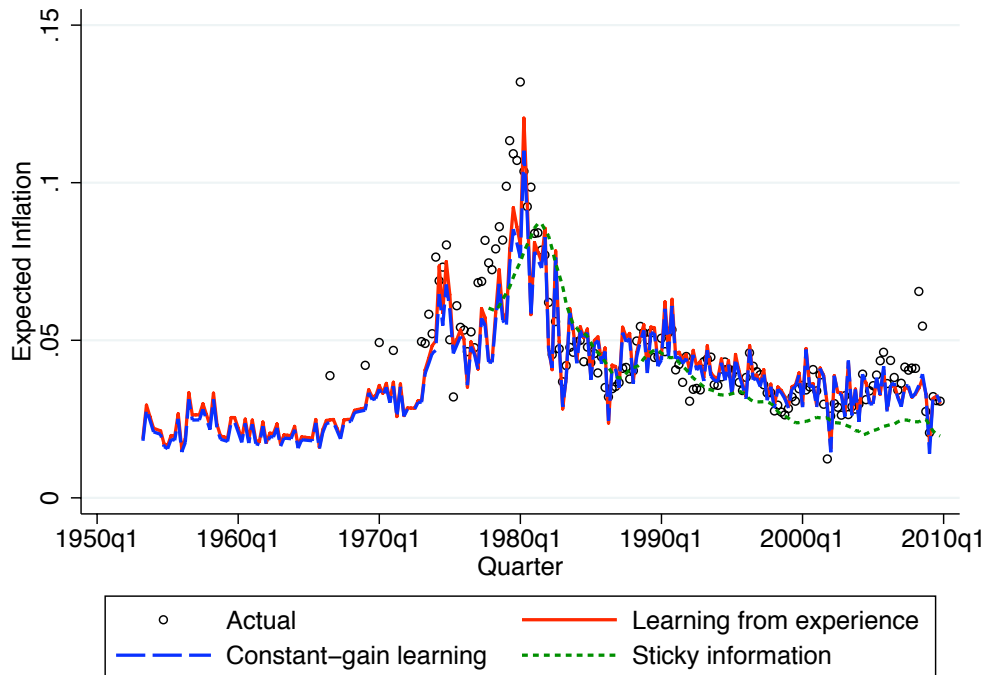


Figure 8: Average 1-year survey expectations (actual) compared with average learning-from-experience forecasts and with constant-gain and sticky-information forecasts.

cohorts. It did not utilize any information about the level of the average survey expectation. Therefore, it could have been possible, in principle, that the θ that fits cross-sectional differences produces average forecasts that fail to match the level of average expectations. As the figure shows, though, we find that the two match well.

We also compare the average learning-from-experience forecast to a constant-gain-learning forecast (with $\gamma = 0.0175$ as in Figure 7), shown as the dashed line. Not surprisingly, given how similar the weights on past inflation data are for the two expectations-formation mechanisms (see Figure 7), the forecasts are almost indistinguishable. This provides further support for the idea that at the aggregate level, the learning-from-experience expectations formation mechanism can be approximated well with constant-gain learning.

Next, we compare the average learning-from-experience forecast to a sticky-information forecast. Sticky information, as in Mankiw and Reis (2002) and Carroll (2003) induces sticki-

Table 3: Explaining mean inflation expectations

OLS regressions with quarterly data from 1973Q1 to 2009Q4 (with gaps). The dependent variable is the forecast of one-year inflation made during quarter t , averaged across all cohorts. Newey-West standard errors (with 5 lags) are shown in parentheses.

	(1)	(2)	(3)	(4)
Learning-from-experience forecast	0.893 (0.124)			0.707 (0.130)
Constant-gain-learning forecast		0.943 (0.144)		
Sticky-information forecast			0.877 (0.202)	0.385 (0.145)
Intercept	0.009 (0.005)	0.008 (0.005)	0.011 (0.006)	-0.001 (0.005)
Adj. R^2	0.570	0.557	0.597	0.713
#Obs.	172	172	129	129

ness in expectations, and it is possible that our estimation of the learning-from-experience rule might be picking up some of this stickiness in expectations. We calculate sticky-information inflation expectations as in Carroll’s model as a geometric distributed lag of current and past quarterly SPF forecasts of one-year inflation rates.⁴ We set the weight parameter $\lambda = 0.25$ as in Mankiw and Reis (2002) (Carroll (2003) estimates $\lambda = 0.27$). The resulting sticky-information forecast is shown as the short-dashed line in Figure 8.

In addition to the informal graphical comparison in Figure 8, Table 3 reports the results from a regression of quarter t average survey expectations on the learning-from-experience forecast in quarter t . Column (1) shows that with 0.893 the coefficient on the learning-from-experience forecast is very close to one, and less than one standard error away from it. With 57.0% the adj. R^2 is high. This is another confirmation of the fact that the learning-from-experience forecast tracks the actual average survey expectations very closely. Not surprisingly, given the similarity of average learning-from-experience forecasts and constant-gain

⁴We use the 1-year inflation forecasts that the SPF constructs from median CPI inflation forecasts for each of the four quarters ahead. Before 1981Q3, when the CPI inflation forecast series is not available, we use the GDP deflator inflation forecast series.

learning forecasts, using the constant-gain learning forecast as explanatory variable in column (2) produces almost identical results. The explanatory power of the sticky-information forecast in column (3) is lower. Adding the sticky-information forecast as an explanatory variable along with the learning-from-experience forecast in column (4) lowers the coefficient on the learning-from-experience forecast a little, but the effect is small. This shows that the learning-from-experience forecast does not just pick up the sticky-information effect of Mankiw and Reis (2002) and Carroll (2003).

5.3 Predictability of forecast errors

Adaptive learning may lead to predictable and persistent forecast errors (from the econometrician's perspective). If such forecast errors do not cancel out in the aggregate, they can influence macroeconomic outcomes. We therefore now turn our attention to the question whether we can link the learning-from-experience behavior to predictability of level of average forecast errors.

That learning-from-experience can lead to predictable and persistent forecast errors can be seen in the following simplified example. Consider first the simple mean model with a time-varying mean, $\pi_{t+1} = \mu_t + \eta_{t+1}$, as the true as well as the perceived model of inflation. The average one-step ahead learning-from-experience forecast results in the forecast error

$$\pi_{t+1|t}^1 - \pi_{t+1} = \mu_{|t} - \mu_t - \eta_{t+1}. \quad (11)$$

Now consider an econometrician who analyzes subjective expectations data ex-post with data available. If μ_t is equal to a constant μ , the econometrician can, with a sufficiently large sample (which is not restricted to the $[s, t]$ interval that learning-from-experience agents in cohort s are learning from), approximately observe the true mean. Any fluctuations of $\mu_{|t}$ around μ translate, predictably and one-to-one, into forecast errors. Regressing $\pi_{t+1|t}^1 - \pi_{t+1}$ on $\mu_{|t}$ would yield a coefficient of one, with the second term in (11) absorbed by the intercept. If μ_t is time-varying, $\mu_{|t}$ is likely to have positive correlation with μ_t which lowers

the regression coefficient. Of course, it is also possible that agents have some biases in their forecasts that influence the coefficient upwards.

In the case of a true and perceived AR(1) model for inflation with time-varying parameters, $\pi_{t+1} = \mu_t + \phi_t(\pi_t - \mu_t) + \eta_{t+1}$, the situation is more complicated. The one-step ahead forecast error in the average learning-from-experience forecast is given by

$$\pi_{t+1|t}^1 - \pi_{t+1} = \mu_{|t}(1 - \phi_{|t}) - \mu_t(1 - \phi_t) + \phi_{|t}\pi_t - \phi_t\pi_t. \quad (12)$$

If μ_t and ϕ_t are constant, regression of $\pi_{t+1|t}^1 - \pi_{t+1}$ on $\mu_{|t}(1 - \phi_{|t})$, $\phi_{|t}\pi_t$, and π_t produces a coefficient of one on the first two variables, and a coefficient of ϕ on the third. The second term in (12) is absorbed by the intercept. If μ_t and ϕ_t are time-varying, this can result in lower coefficients on the first two variables, just like in the simple mean model above, but, in addition, regression coefficients here can also be impacted by correlation between the various terms in (12).

We now run these regressions in our data. We work with 1-year ahead forecasts ($h = 4$ quarters). The multi-period expression corresponding to the right-hand side of equation (12) can be obtained by iterating on the AR(1) model. The three predictors in this multi-period case are $\mu_{|t} \left(1 - \sum_{i=1}^4 i^{-1} \phi_{|t}^i\right)$, which we label as the mean component, $\left(\sum_{i=1}^4 i^{-1} \phi_{|t}^i\right) \pi_t$, which we label as the AR component, and π_t . The $\mu_{|t}$ and $\phi_{|t}$ parameter estimates are averages of the parameter estimates across all cohorts at time t , where we computed the cohort-level estimates from the learning-from-experience rule with $\theta = 3.006$ as in Table 1. In the computation of the average survey expectation on the left-hand side (from which we subtract the realized four-quarter inflation rate π_{t+4}^4), we take care to first align individuals' reported expectations with realized inflation rates by interview month, i.e., we align it with the inflation rates realized over the 12 months following the interview month.

Table 4 presents the results. As column (1) shows, there is a strong positive relationship between the mean component of the learning-from-experience forecast at time t and average inflation forecast errors of the participants in the Michigan survey during the forecast period

Table 4: Predictability of average forecast errors

OLS regressions with quarterly data from 1973Q1 to 2009Q4 (with gaps). The dependent variable is the forecast of 1-year inflation made during quarter t , averaged across all cohorts, minus the inflation rate realized over the 12 months following the interview month. Newey-West standard errors (with 5 lags) are shown in parentheses. Out-of-sample (OOS) forecasts for the OOS tests at the bottom of each panel are constructed recursively, with an initial minimum window size until 1976Q3 (20 observations), except for column (3), where the initial window extends until 1989Q4.

	Full sample		Post-1989	SPF
	(1)	(2)	(3)	(4)
Mean component	2.553 (0.750)	2.432 (0.735)	1.526 (0.864)	3.203 (1.004)
AR component		-0.380 (0.318)	-0.839 (0.648)	-0.049 (0.337)
Lagged inflation		0.090 (0.112)	0.199 (0.098)	-0.062 (0.112)
Intercept	-0.073 (0.023)	-0.068 (0.023)	-0.036 (0.024)	-0.096 (0.031)
Adj. R^2	0.222	0.243	0.158	0.288
#Obs.	152	152	80	148
OOS RMSE with constant only	0.019	0.019	0.018	0.020
OOS RMSE with constant and predictor(s)	0.017	0.017	0.016	0.017
Diebold-Mariano one-tailed p -value	0.019	0.011	0.044	0.052

t to $t + 4$. The coefficient estimate of 2.553 (s.e. 0.750) is greater than one, which suggests that the regression picks up not only forecast errors induced by learning, but also other errors over and above the error induced by learning. The point estimate is just about two standard errors above one, though, so a coefficient of one is still within the likely range of possible values that one might find if one had a larger sample. The adj. R^2 of 22.2% indicates that predictability of forecast errors is substantial. Column (2) adds the AR component and the lagged inflation rate π_{t-1} as predictors,⁵ but both of these are not significant, neither statistically nor in terms of their incremental explanatory power. To check whether all the predictability is driven by the high-inflation periods around 1980, the regression reported in

⁵As before, we assume here that forecasts in quarter t are made with information up to end of quarter $t - 1$, and so $\mu_{|t}$, $\phi_{|t}$, and the lagged inflation rate are also calculated from inflation rates up to quarter $t - 1$.

column (3) is run with the sample restricted to the post-1989 period. The coefficient on the mean component is lower, but the adj. R^2 of 15.8% still indicates substantial predictability. Evidently, the forecast error predictability is not just limited to the high-inflation periods.

Another interesting issue is to what extent inflation expectations of *professional* forecasters mirror the predictability that we find in individuals' forecast errors in the *MSC*. Individuals' forecast errors may be more significant for individuals' decisions (e.g., household investment decisions, labor market choices), while professional forecasts may be more relevant for asset pricing in financial markets. For this reason, column (4) reports results from a regression where we use the forecast error from the *SPF* as dependent variable. The results are similar to those with the *MSC* data in column (2): A large coefficient on the mean component, close-to-zero coefficients on the AR component and lagged inflation, and an adj. R^2 greater than 20%. Thus, the forecasts of professionals exhibit similar forecast error predictability.

Our focus so far has been on tests of in-sample predictability. To check for predictability induced by learning along the lines discussed above, this is the appropriate perspective. Learning does not necessarily induce predictability of forecast errors out-of-sample (OOS), though (although it might, to the extent that rationality is bounded and individuals discard information, as in learning from experience, or use information in suboptimal ways, or work with misspecified models). In addition to shedding light on individuals' expectation formation mechanism, exploring OOS predictability would also have the potential practical implication that it could help to extract better inflation forecasts from the Michigan survey data by removing some predictable errors in real time.

To provide some perspective on the OOS predictability of forecast errors in the Michigan survey, the bottom rows of Table 4 report (pseudo) OOS test results. The prediction for the forecast error in period t to $t + 4$ is constructed from estimates of a regression using data from the start of the sample up to quarter t . We use an initial window until 1976Q3 (20 observations) for the first prediction, with the exception of column (3), where the initial

window extends until 1989Q4. We report the root mean squared error (RMSE) from this OOS prediction exercise for two specifications: one regression with only a constant, and one with the predictors included. In column (1), including the mean component of the learning-from-experience forecast in addition to the constant lowers the OOS RMSE to 0.017 from 0.019. To check the significance of this difference, we calculate the Diebold and Mariano (1995) statistic (with Newey-West adjustment). We obtain a p -value of 0.019, indicating evidence for OOS predictability. Adding additional predictors in column (2) has little effect. Out-of-sample predictability is also evident in the late sample in column (3) and the SPF in column (4).

5.4 Predictability of bond excess returns

As an alternative way of assessing whether the predictability of forecast errors is pervasive among macroeconomic forecasters and financial market participants and not just confined to the individuals in the *MSC* sample, we now examine excess returns on nominal long-term bonds. The tests with bond market returns have the additional benefit that we can use data that extends further back in time, because we only need inflation and return data, but not survey data for these tests.

For default-free bonds, an identity connects realized (log) returns in excess of the one-period risk-free rate from holding an n period bond from t to $t + 1$ as follows (see, e.g., Piazzesi and Schneider (2011)):

$$rx_{t+1}^{(n)} = (n - 1)(f_t^{(n-1,n)} - i_{t+1}^{(n-1)}), \quad (13)$$

where $rx_{t+1}^{(n)}$ denotes the excess return, $f_t^{(n-1,1)}$ is the time- t forward interest rate rate for the period starting at $t + 1$ to $t + n$ and $i_{t+1}^{(n-1)}$ is the time $t + 1$ yield yield of an $n - 1$ period bond. Taking subjective expectations, $\hat{E}_t[\cdot]$, of (13),

$$\hat{E}_t[rx_{t+1}^{(n)}] = (n - 1)(f_t^{(n-1,n)} - \hat{E}_t[i_{t+1}^{(n-1)}]). \quad (14)$$

Taking objective expectations of (13),

$$E_t[rx_{t+1}^{(n)}] = (n-1)(f_t^{(n-1,n)} - E_t[i_{t+1}^{(n-1)}]). \quad (15)$$

If we assume, for simplicity, that investors price bonds with zero risk premia so that the expectations hypothesis holds under investors' subjective beliefs and hence $\hat{E}_t[rx_{t+1}^{(n)}] = 0$, then, substituting this into (14) and then into (15) yields objectively expected excess returns

$$E_t[rx_{t+1}^{(n)}] = (n-1)(\hat{E}_t[i_{t+1}^{(n-1)}] - E_t[i_{t+1}^{(n-1)}]), \quad (16)$$

i.e., objective expected excess returns are driven by deviations of investors' subjective expectations of future n period yields from objective expectations. These subjective expectations of future yields are in turn likely to be driven by subjective expectations of future inflation.⁶ Suppose $\hat{E}_t[i_{t+1}^{(n-1)}] = \psi \hat{E}_t[\pi_{t+1}]$ and $E_t[i_{t+1}^{(n-1)}] = \psi E_t[\pi_{t+1}]$ for some constant ψ . Then,

$$E_t[rx_{t+1}^{(n)}] = \psi(n-1)(\hat{E}_t[\pi_{t+1}] - E_t[\pi_{t+1}]), \quad (17)$$

i.e., the predictability of bond excess returns is linked to the predictable component of inflation forecast errors $\hat{E}_t[\pi_{t+1}] - E_t[\pi_{t+1}]$. The more investors' subjective expectations of higher inflation (and hence higher future bond yields) exceed those under objective expectations, the higher the objectively expected excess returns.

For this reason, we now investigate whether we find predictability patterns in bond returns that are similar to those in survey forecast errors. Since only the mean component of the learning-from-experience forecast emerged as an economically and statistically significant predictor of survey forecast errors in Table 4, we focus on this single predictor here.

To measure long-term bond returns we use a return series of U.S. Treasury Bonds with

⁶One way of making the link between yield expectations and inflation expectations explicit would be to combine a factor model of bond yields, most simply a single-factor model in which all bond yields are linear in the short-term interest rate, with an interest-rate policy rule under which the short-term interest rate is a function of current inflation

Table 5: Predictability of bond excess returns

Quarterly and annual regressions of long-term U.S. Treasury bond returns in excess of 1-month Treasury Bill returns on the mean component of the learning-from-experience forecast (calculated with $\theta = 3.006$). Quarterly and annual bond returns are calculated by compounding monthly returns. The regression with annual returns uses non-overlapping windows. The sample period runs from 1952Q1 to 2010Q4. The table shows OLS estimates along with a 90% Bonferroni confidence interval following Campbell and Yogo (2006) for the coefficient on aggregate experienced inflation.

	Quarterly (1)	Annual (2)
Intercept	-0.019	-0.075
OLS s.e.	(0.008)	(0.033)
Mean component of learning-from-experience forecast	0.891	3.614
OLS s.e.	(0.343)	(1.401)
Campbell-Yogo 90% Bonferroni CI	[0.154, 1.384]	[0.830, 6.624]
Adj. R^2	0.021	0.077
AR order of predictor by BIC	2	1
90% CI for largest AR root	[1.001, 1.008],	[0.935, 1.002]
#Obs.	236	59

maturities between 61 and 120 months from the Fama Bond database at the Center for Research in Security Prices (*CRSP*) and we construct excess returns by subtracting the 1-month T-Bill return (from Ibbotson Associates). We use quarterly returns as well as returns compounded to annual returns in our return-prediction regressions.

The results are presented in Table 5. The OLS coefficient estimate with quarterly returns in column (1) is 0.891 (s.e. 0.343), which yields an adj. R^2 of 2.1%. For return-prediction regressions this is an economically significant and plausible R^2 . With annual returns, the magnitudes of coefficient and standard errors roughly quadruple and the adj. R^2 rises to 7.7%.

The predictor variable in these regressions is highly persistent, and its innovations (which are closely related to innovations in inflation) are contemporaneously correlated with long-term bond returns. Under these circumstances, it is well known that inference based on

conventional OLS t -statistics leads to hypothesis tests that reject the null of no predictability too frequently in finite samples (Stambaugh (1999)). For this reason, we construct confidence intervals using the methods of Campbell and Yogo (2006). Campbell and Yogo use local-to-unity asymptotics to achieve a better approximation of the finite-sample distribution in cases when the predictor variable is persistent. Their construction of the confidence interval uses the Bonferroni method to combine a confidence interval for the largest autoregressive root of the predictor variable with confidence intervals for the predictive coefficient conditional on the largest autoregressive root.

As Table 5 shows, the Campbell-Yogo confidence interval for the regression coefficient of the predictor variable do not include zero, and they are approximately centered around the OLS point estimate.⁷ This indicates that there is statistically reliable evidence in favor of predictability. The mean component of the learning-from-experience forecast thus not only predicts the forecast errors in survey expectations from the *MSC*, but it also helps predict bond excess returns, which indicates that the learning-from-experience expectations-formation mechanism may be relevant for understanding expectations formation of bond market investors, too.

Unlike for the survey expectation forecast errors, there is, however, no evidence of out-of-sample predictability. OOS regressions with a constant (i.e., predicting simply with the past average return) yield a slightly lower OOS RMSE than regressions that include the mean component of learning-from-experience forecasts as a predictor. This suggests that bond market investors might be better than the respondents in the *MSC* and *SPF* in avoiding out-of-sample predictable forecast errors. As a caveat, though, it is difficult to interpret the out-of-sample results in return prediction regressions. Lack of OOS predictability is a common feature of return prediction regressions, and, as discussed in Campbell and Thompson (2008),

⁷At the bottom of the table, we also report the estimated autoregressive lag length for the predictor variable, as determined by the Bayesian Information Criterion (*BIC*), as well as a confidence interval for its largest autoregressive root. These are among the inputs to Campbell and Yogo’s construction of confidence intervals. The confidence intervals for the largest autoregressive root contain an explosive root. This is similar to the dividend-price ratio regressions in Campbell and Yogo (2006), and it underscores the potential importance of accounting for the persistence of the predictor variable in testing for predictability.

OOS tests have low power to detect predictability.

6 Discussion and conclusion

Our empirical analysis shows that individuals' inflation expectations differ depending on the characteristics of the inflation process experienced during their life times. Differences in the experienced mean inflation rate and the persistence of inflation shocks generate (time-varying) differences in inflation expectations between cohorts. Younger individuals' set of experienced data is dominated by recent observations, while older individuals draw on a more extended historical data set in forming their expectations.

This learning-from-experience expectations-formation mechanism can explain, for example, why young individuals forecasted much higher inflation than older individuals following the high inflation years of the late 1970s and early 1980s. This is due to a combination of a high mean rate of inflation and high persistence in the short data set experienced by young individuals at the time. Learning-from-experience also provides an alternative and complementary mechanism to the sticky information hypothesis in Mankiw and Reis (2002) and Carroll (2003) that contributes to the high level of disagreement about inflation expectations around that time noted in Mankiw, Reis, and Wolfers (2003).

For the most recent periods towards the end of our sample in 2010, our results suggest that individuals perception of the persistence of inflation shocks is close to zero, particularly for young individuals. This suggests that unexpected movements in the inflation rate are currently unlikely to move inflation expectations much. As argued in Roberts (1997), Orphanides and Williams (2005), and Milani (2007), these changes in individuals' perceptions of persistence are also likely to influence the persistence of inflation rates.

Even though the learning-from-experience framework is substantially different from more conventional representative-agent applications of learning in that it generates heterogeneity in inflation expectations, its implications for the average level of inflation expectations are similar to those resulting from representative-agent constant-gain learning algorithms that

are popular in macroeconomics (see, e.g., Orphanides and Williams (2005); Milani (2007)). There are, however, two important differences.

First, the learning-from-experience theory provides an alternative motivation for a constant-gain learning at the aggregate level. With learning-from-experience, information in the distant past is discarded not only because individuals believe that structural shifts and parameter drift could occur, but also because individuals' memory is bounded: Memory of macroeconomic history is lost as new generations emerge whose subjective beliefs are shaped by relatively recent experience. This is an additional reason why learning dynamics may be perpetual, without convergence in the long-run.

Second, in the learning-from-experience framework, the heterogeneity between cohorts can be exploited to estimate the parameter controlling the gain in individuals' learning rule, and hence the speed of updating in response to inflation surprises, from cross-sectional differences alone, without using information about the level of average inflation expectations. This is useful, because identifying the gain from macro data seems to be difficult. In light of this, it is remarkable that our estimate of the speed of updating, averaged across cohorts, are quantitatively similar to those obtained in earlier work in macroeconomics that estimated the speed of updating to fit macroeconomic time-series or aggregate survey expectations.

Appendix

A Michigan Survey data

The inflation expectations data is derived from the responses to two questions, the first is categorical, while the second one elicits a percentage response. For example, for 1-year expectations the two questions are:

1. “During the next 12 months, do you think that prices in general will go up, or go down, or stay where they are right now?”
2. “By about what percent do you expect prices to go (up/down) on average during the next 12 months?”

As outlined in Curtin (1996), some adjustments to the raw data are necessary to address some known deficiencies. We follow Curtin’s approach, which is also the approach used by the Michigan Survey in constructing its indices from the survey data:

For respondents who provided a categorical response of “up” (“down”), but not a percentage response, we drew a percentage response from the empirical distribution of percentage responses of those who gave the same categorical response of “up” (“down”) in the same survey period. Prior to the February 1980 survey, respondents were not asked about percentage expectations if they responded (in the categorical first part of the question) that they expected prices to decline. We assign a value of -3% to these cases before February 1980. In most survey periods, they account for less than 2% of observations.

Starting in March 1982 the administrators of the Michigan survey implemented additional probing, which revealed that the categorical response that prices will remain the “same” was often misunderstood as meaning that the inflation rate stays the same. We use the adjustment factors developed in Curtin (1996) to adjust a portion of “same” responses prior to March 1982 to “up”, and we assign a percentage response by drawing from the empirical distribution of those observations in the same survey period with a categorical response of “up”.

B Imputation of percentage expectations from categorical responses

In the early years of the Michigan survey, only categorical responses about prices going “up”, “down”, or stay the “same” were elicited, but no percentage responses. We nevertheless attempt to use the information in those surveys in our analysis of percentage expectations by imputing percentage responses from the categorical information. We do so by estimating the relationship between categorical responses, the dispersion of categorical responses, and percentage responses in those periods in which we have both categorical and percentage response data. We conjecture that the average percentage response of individuals in an age group should be positively related to the proportion of “up” responses and negatively to the proportion of “down” responses.

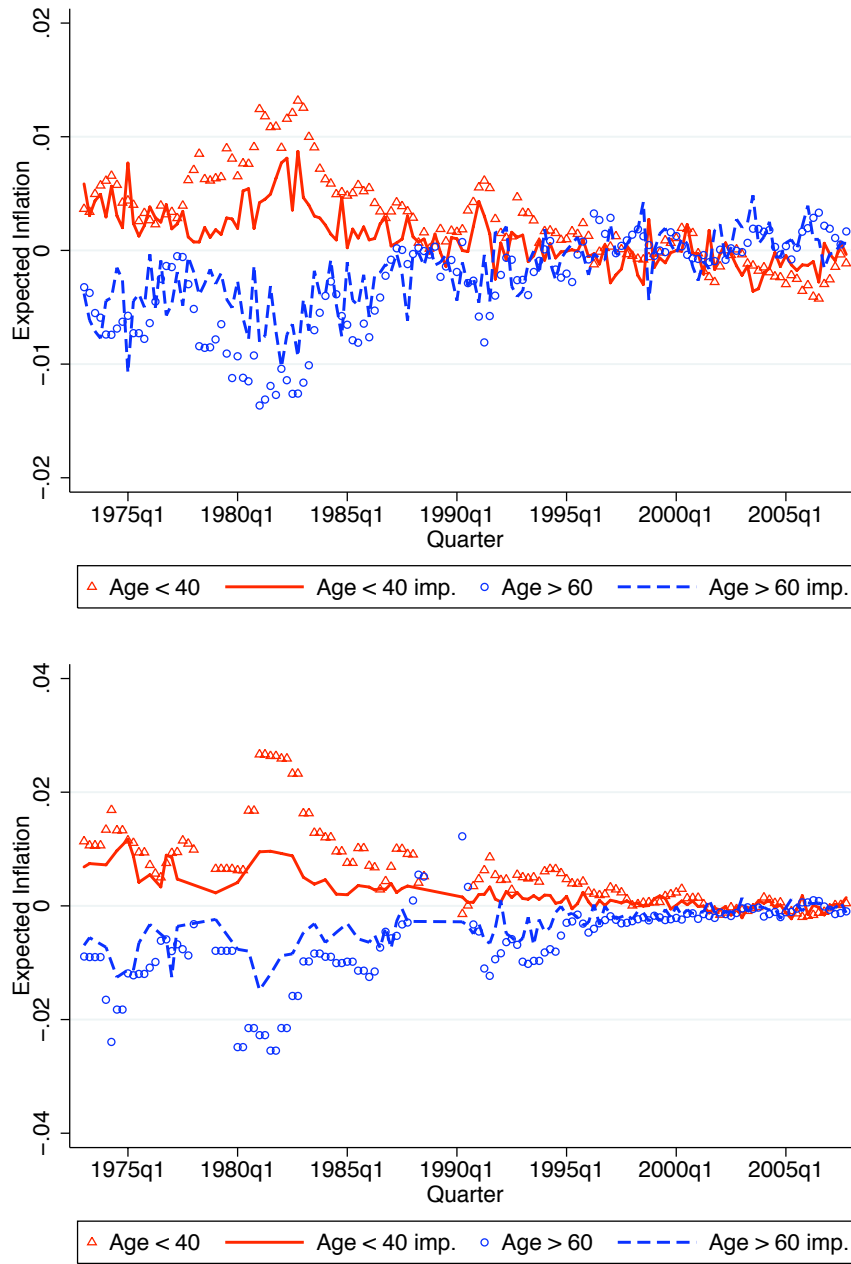


Figure A.1: Actual and imputed one-year (top) and 5-10 year inflation expectations in excess of the full-sample mean.

We first calculate the proportion of “up” and “down” responses, $p_{t,s}^{up}$ and $p_{t,s}^{down}$, within each cohort s at time t (in this case t denotes a calendar month). We then run a pooled regression of measured percentage inflation expectations, $\hat{\pi}_{t+1|t,s}^e$, on $p_{t,s}^{up}$ and $p_{t,s}^{down}$, including a full set of time dummies, and obtain, for one-year expectations, the fitted values

$$\hat{\pi}_{t+1|t,s}^{e,imp} = \dots \text{time dummies} \dots + 0.052 p_{t,s}^{up} - 0.069 p_{t,s}^{down} \quad (R^2 = 35.3\%)$$

(0.001) (0.004)

and for 5-10 year expectations,

$$\hat{\pi}_{t+1|t,s}^{e,imp} = \dots \text{time dummies} \dots + 0.050 p_{t,s}^{up} - 0.047 p_{t,s}^{down} \quad (R^2 = 29.6\%)$$

(0.003) (0.004)

with standard errors in parentheses that are two-way clustered by quarter and cohort.

Because we employ time dummies in our main analysis, our main concern here is whether the imputed expectations track well cross-sectional differences of expectations across age groups, rather than the overall mean over time, and so we also estimate the relationship between percentage expectations and categorical responses with time dummies included in the regression.

Figure A.1 illustrates how the imputed percentage expectations compare with the actual expectations in the time periods in which we have both categorical and percentage expectations data. To focus on cross-sectional differences between age groups, the figure shows the average fitted and actual values (in terms of four-quarter moving averages) for individuals below 40 and above 60 years of age after subtracting the overall mean expectation in each time period.

C Controlling for age-specific inflation rates

We re-run the regressions from Table 1 with controls for age-specific inflation-rates. We measure the inflation rates of the elderly from the experimental CPI for the elderly series (CPI-E) provided by the Bureau of Labor Statistics. We calculate annualized quarterly log inflation rates from the CPI-E, similar to our calculation of overall CPI inflation rates. We then include in our regressions the differential between the CPI-E and CPI inflation rates, $\pi_{t-1}^{Elderly} - \pi_{t-1}$, interacted with age.

Panel A of Table A.1 presents the results for one-year expectations. The inflation series based on the CPI-E is only available from the end of 1983 onwards, and so the sample in this table is restricted to 1984Q1 to 2009Q4. As a basis for comparison, we therefore first re-run the regression without the additional age-dependent inflation control on this shorter sample. The results in column (1) show that the estimate of the gain parameter is similar to the earlier estimate in Table 1, but the sensitivity parameter β is estimated to be lower than before. Its magnitude is still statistically, as well as economically significant, though. In column (2) we add the interaction term between age-related inflation differentials and age, as well as age itself (the $\pi_{t-1}^{Elderly} - \pi_{t-1}$ variable itself without the interaction is absorbed by

Table A.1: Controlling for age-specific inflation rates

The estimation is similar as in Table 1, but with the experimental CPI for the elderly interacted with age included as control variable. The sample runs from 1984Q1 to 2009Q4, the period for which lagged 12-month inflation rates from the experimental CPI for the elderly is available. Standard errors in parentheses are two-way clustered by time and cohort.

	Simple mean		AR(1)	
	(1)	(2)	(3)	(4)
Panel A: One-year inflation expectations				
Gain parameter θ	2.438 (0.213)	3.502 (0.510)	2.702 (0.286)	3.901 (0.633)
Sensitivity β	0.412 (0.068)	0.449 (0.086)	0.455 (0.092)	0.511 (0.105)
Age		0.000 (0.000)		0.000 (0.000)
Age $\times (\pi_{t-1}^{Elderly} - \pi_{t-1})$		-0.003 (0.002)		-0.001 (0.002)
Time dummies	Yes	Yes	Yes	Yes
Adj. R^2	0.245	0.247	0.244	0.245
#Obs.	5350	5350	5350	5350
Panel B: 5-10 year inflation expectations				
Gain parameter θ	1.489 (0.082)	3.127 (0.292)	1.448 (0.083)	3.292 (0.318)
Sensitivity β	0.695 (0.093)	0.731 (0.118)	0.735 (0.109)	0.816 (0.132)
Age		0.000 (0.000)		0.000 (0.000)
Age $\times (\pi_{t-1}^{Elderly} - \pi_{t-1})$		-0.001 (0.003)		0.000 (0.003)
Time dummies	Yes	Yes	Yes	Yes
Adj. R^2	0.297	0.303	0.295	0.302
#Obs.	4600	4600	4600	4600

the time dummies). We obtain a negative coefficient on the interaction term, which is not consistent with the idea that inflation expectations of the elderly may be positively related to the inflation rates on the consumption basket of the elderly. One should not overemphasize this negative coefficient, though, as it is not statistically significant. Including age and the interaction term does, however, have some effect on the estimates for θ . With 3.502, the point estimate is substantially higher than in column (1), and the standard error is much higher as well. For the AR(1) model in columns (3) and (4), the picture is quite similar.

Panel B repeats the same analysis for 5-10 year expectations, and the results are similar, too. The point estimates on the interaction term are again close to zero and statistically not significant, and the inclusion of the interaction term does not drive out the learning-from-experience effect. Overall, the evidence does not support the alternative theory that different consumption baskets could explain the age-related heterogeneity in inflation expectations individuals.

D Implied weighting of past data with learning from experience

The learning-from-experience algorithm in our analysis implicitly weights past observations in almost exactly similar fashion as the (ad-hoc) weighting function in Malmendier and Nagel (2011). Moreover, the parameter θ that controls the strength of updating in the framework here maps into the parameter that controls the weighting function in Malmendier and Nagel (2011). This makes the results easily comparable. For simplicity, we illustrate the connection between the two weighting schemes in the case of the simple mean model, where an agent tries to estimate the mean. But an analogous result applies in the AR(1) case or other regression-based forecasts.

Consider an individual of age $t - s$ making an inflation forecast at time t . The weighting function in Malmendier and Nagel (2011) implies that this individual forms a weighted average of past inflation, where the inflation rate observed at time $t - k$ (with $k \leq t - s$) gets the following weight:

$$\omega_{t,s}(k) = \frac{\left(\frac{t-s-k}{t-s}\right)^\lambda}{\sum_{j=0}^{t-s} \left(\frac{t-s-j}{t-s}\right)^\lambda}. \quad (\text{A.1})$$

This implies that the most recent observation, i.e. time- t inflation, π_t , receives the weight

$$\omega_{t,s}(0) = \frac{1}{\sum_{j=0}^s \left(\frac{t-s-j}{t-s}\right)^\lambda}. \quad (\text{A.2})$$

For comparison, in the learning-from-experience algorithm, the forecast $\tau_{t+1|t,s}^1$ is a weighted average of the prior-period forecast and π_t ,

$$\tau_{t+1|t,s}^1 = (1 - \gamma_{t-s}) \tau_{t|t-1,s}^1 + \gamma_{t,s} \pi_t. \quad (\text{A.3})$$

which implies that the most recent observation carries the weight $\tilde{\omega}_{t,s}(0) = \gamma_{t,s}$. Iterating, one finds that earlier observations receive the weight

$$\tilde{\omega}_{t,s}(k) = \begin{cases} \gamma_{t,s} & \text{for } k = 0 \\ \gamma_{t-k,s} \prod_{j=0}^{k-1} (1 - \gamma_{t-j,s}) & \text{for } k > 0 \end{cases} . \quad (\text{A.4})$$

We now show that both weighting schemes are equivalent if the gain sequence is chosen to be age-dependent in the following way:

$$\gamma_{t,s} = \frac{1}{\sum_{j=0}^{t-s} \left(\frac{t-s-j}{t-s}\right)^\lambda} \quad (\text{A.5})$$

We present a proof by induction. First, the choice of $\gamma_{t,s}$ in (A.5) implies that $\tilde{\omega}_{t,s}(0) = \omega_{t,s}(0)$. It remains to be shown that if $\tilde{\omega}_{t,s}(k) = \omega_{t,s}(k)$, then $\tilde{\omega}_{t,s}(k+1) = \omega_{t,s}(k+1)$ (with $k+1 \leq t-s$). Thus, assume that

$$\tilde{\omega}_{t,s}(k) = \frac{\left(\frac{t-s-k}{t-s}\right)^\lambda}{\sum_{j=0}^{t-s} \left(\frac{t-s-j}{t-s}\right)^\lambda} . \quad (\text{A.6})$$

Then, from Eq. (A.4),

$$\begin{aligned} \tilde{\omega}_{t,s}(k+1) &= \gamma_{t-s-k-1} \frac{(1 - \gamma_{t-s-k})}{\gamma_{t-s-k}} \tilde{\omega}_{t,s}(k) \\ &= \frac{\left[\sum_{j=0}^{t-s-k} \left(\frac{t-s-j}{t-s-k}\right)^\lambda\right] - 1}{\sum_{j=0}^{t-s-k-1} \left(\frac{t-s-j}{t-s-k-1}\right)^\lambda} \frac{\left(\frac{t-s-k}{t-s}\right)^\lambda}{\sum_{j=0}^{t-s} \left(\frac{t-s-j}{t-s}\right)^\lambda} \\ &= \frac{\left[\sum_{j=0}^{t-s-k} \left(\frac{t-s-j}{t-s-k}\right)^\lambda\right] - 1}{\sum_{j=0}^{t-s-k-1} \left(\frac{t-s-j}{t-s-k}\right)^\lambda} \frac{\left(\frac{t-s-k-1}{t-s}\right)^\lambda}{\sum_{j=0}^{t-s} \left(\frac{t-s-j}{t-s}\right)^\lambda} \\ &= \frac{\sum_{j=0}^{t-s-k-1} \left(\frac{t-s-j}{t-s-k}\right)^\lambda}{\sum_{j=0}^{t-s-k-1} \left(\frac{t-s-j}{t-s-k}\right)^\lambda} \frac{\left(\frac{t-s-k-1}{t-s}\right)^\lambda}{\sum_{j=0}^{t-s} \left(\frac{t-s-j}{t-s}\right)^\lambda} \\ &= \frac{\left(\frac{t-s-k-1}{t-s}\right)^\lambda}{\sum_{j=0}^{t-s} \left(\frac{t-s-j}{t-s}\right)^\lambda} \\ &= \omega_{t,s}(k+1) , \end{aligned}$$

where for the third-to-last equality we multiplied numerator and denominator by $\left(\frac{t-s-k-1}{t-s-k}\right)^\lambda$. This concludes the proof.

Finally, we show that the gain sequence (A.5) can be approximated by

$$\gamma_{t,s} \approx \frac{\lambda + 1}{t - s},$$

i.e., by the gain specification in (6) with $\theta = \lambda + 1$. To see this write the gain in (A.5) as

$$\gamma_{t,s} = \frac{(t - s)^\lambda}{\sum_{j=0}^{t-s} (t - s - j)^\lambda}.$$

Focusing on the denominator of this expression, note that if one were to make the increments j infinitesimally small (instead of being discrete steps of 1), the denominator would become $\int_0^{t-s} x^\lambda dx = \frac{1}{\lambda+1}(t - s)^{\lambda+1}$. Therefore, in this limiting case of infinitesimal increments, we get

$$\gamma_{t,s} = \frac{\lambda + 1}{t - s}.$$

In our case with quarterly increments, this approximation is, for all practical purposes, virtually identical with the true gain sequence in (A.5).

References

- Bernanke, B. S. (2007). Inflation Expectations and Inflation Forecasting. Speech at NBER Monetary Economics Workshop, available at <http://www.federalreserve.gov/newsevents/speech/Bernanke20070710a.htm>.
- Branch, W. A. (2004). The Theory of Rationally Heterogeneous Expectations: Evidence from Survey Data on Inflation Expectations. *Economic Journal* 114, 592–621.
- Branch, W. A. (2007). Sticky Information and Model Uncertainty in Survey Data on Inflation Expectations. *Journal of Economic Dynamics and Control* 31, 245–276.
- Bray, M. (1982). Learning, Estimation, and the Stability of Rational Expectations Equilibria. *Journal of Economic Theory* 26, 318–339.
- Campbell, J. Y. and S. B. Thompson (2008). Predicting Excess Stock Returns Out of Sample: Can Anything Beat the Historical Average? *Review of Financial Studies* 21, 1509–1531.
- Campbell, J. Y. and M. Yogo (2006). Efficient Tests of Stock Return Predictability. *Journal of Financial Economics* 81, 27–60.
- Carroll, C. D. (2003). Macroeconomic Expectations of Households and Professional Forecasters. *Quarterly Journal of Economics* 118(1), 269–298.
- Chevillon, G., M. Massmann, and S. Mavroeidis (2010). Inference in Models with Adaptive Learning. *Journal of Monetary Economics* 57, 341–351.
- Chiang, Y.-M., D. Hirshleifer, Y. Qian, and A. E. Sherman (2011). Do Investors Learn from Experience? Evidence from Frequent IPO Investors. *Review of Financial Studies* 24, 1560–1589.
- Cukierman, A. and P. Wachtel (1979). Differential Inflationary Expectations and the Variability of the Rate of Inflation: Theory and Evidence. *American Economic Review* 69(4), 595–609.
- Curtin, R. T. (1982). Indicators of Consumer Behavior: The University of Michigan Surveys of Consumers. *Public Opinion Quarterly* 46(3), 340–352.
- Diebold, F. X. and R. S. Mariano (1995). Comparing Predictive Accuracy. *Journal of Business and Economic Statistics* 13, 253–263.
- Ehrmann, M. and P. Tzamourani (2009). Memories of High Inflation. working paper, European Central Bank.
- Evans, G. W. and S. Honkapohja (2001). *Learning and Expectations in Macroeconomics*. Princeton, NJ: Princeton University Press.
- Greenwood, R. and S. Nagel (2009). Inexperienced Investors and Bubbles. *Journal of Financial Economics* 93, 239–258.
- Honkapohja, S. and K. Mitra (2003). Learning with Bounded Memory in Stochastic Models. *Journal of Economic Dynamics and Control* 27, 1437–1457.

- Kaustia, M. and S. Knüpfer (2008). Do Investors Overweight Personal Experience? Evidence from IPO Subscriptions. *Journal of Finance* 63, 2679–2702.
- Keynes, J. M. (1936). *The General Theory of Employment, Interest, and Money*. London: Macmillan.
- Malmendier, U. and S. Nagel (2011). Depression Babies: Do Macroeconomic Experiences Affect Risk-Taking? *Quarterly Journal of Economics* 126, 373–416.
- Mankiw, G. N. and R. Reis (2002). Sticky Information Versus Sticky Prices: A Proposal to Replace the New Keynesian Phillips Curve. *Quarterly Journal of Economics* 117(4), 1295–1328.
- Mankiw, N. G., R. Reis, and J. Wolfers (2003). Disagreement About Inflation Expectations. In M. Gertler and K. Rogoff (Eds.), *NBER Macroeconomics Annual 2003*.
- Marcet, A. and J. Sargent, Thomas (1989). Convergence of Least Squares Learning Mechanisms in Self-Referential Linear Stochastic Models. *Journal of Economic Theory* 48, 337–368.
- Milani, F. (2007). Expectations, Learning, and Macroeconomic Persistence. *Journal of Monetary Economics* 54, 2065–2082.
- Orphanides, A. and J. C. Williams (2004). Imperfect Knowledge, Inflation Expectations and Monetary Policy. In B. S. Bernanke and M. Woodford (Eds.), *The Inflation Targeting Debate*. Chicago, IL: University of Chicago Press.
- Orphanides, A. and J. C. Williams (2005). The Decline of Activist Stabilization Policy: Natural Rate Misperceptions, Learning, and Expectations. *Journal of Economic Dynamics and Control* 29, 1927–1950.
- Pfajfar, D. and E. Santoro (2010). Heterogeneity, Learning and Information Stickiness in Inflation Expectations. *Journal of Economic Behavior and Organization* 75, 426–444.
- Piazzesi, M. and M. Schneider (2010). Inflation and the Price of Real Assets. working paper, Stanford University.
- Piazzesi, M. and M. Schneider (2011). Trend and Cycle in Bond Premia. working paper, Stanford University.
- Roberts, J. M. (1997). Is Inflation Sticky? *Journal of Monetary Economics* 39, 173–196.
- Sargent, T. J. (1993). *Bounded Rationality in Macroeconomics*. Oxford, UK: Clarendon Press.
- Shiller, R. J. (1997). Why Do People Dislike Inflation? In C. D. Romer and D. H. Romer (Eds.), *Reducing Inflation: Motivation and Strategy*, pp. 13–65. Chicago: University of Chicago Press.
- Shiller, R. J. (2005). *Irrational Exuberance* (second edition). Princeton, NJ: Princeton University Press.
- Stambaugh, R. F. (1999). Predictive Regressions. *Journal of Financial Economics* 54, 375–421.

Vissing-Jorgensen, A. (2003). Perspectives on Behavioral Finance: Does "Irrationality" Disappear with Wealth? Evidence from Expectations and Actions. In *NBER Macroeconomics Annual*.