Inflation Targeting: A crisis of relevance?

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Kyiv, November 2021

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IT adoption is associated with

- Durable disinflation experiences
- Lower inflation and output volatility
- Good shock absorber
- Inflation expectations anchored and low exchange rate pass-through
- Lower nominal and real costs of borrowing
- Lower financial dollarization and development of local financial markets
- Output drop would have been much worse without IT's role in anchoring expectations during the GFC

- Thanks to Great Moderation
- Spurious
- Only for a subset of ITers
- Breaks down the MP transmission mechanism (flat Phillips curve)
- Real rates higher on average to combat inflation
- Thanks to a regulatory environment
- IT made monetary policy too easy before the Crisis and insufficiently so after it

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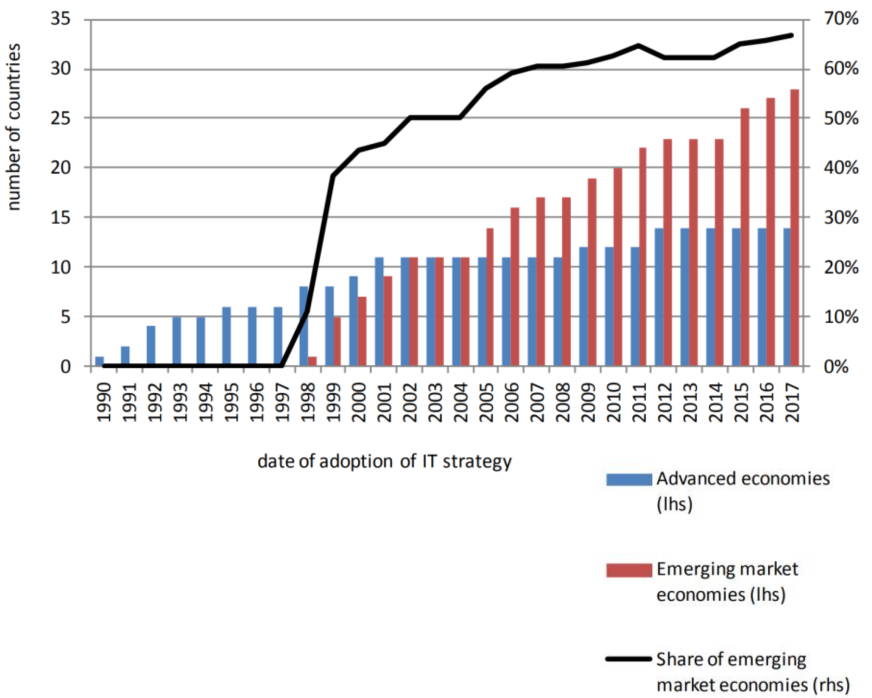
Is IT still relevant?

- Academic doubts over the performance before and during the GFC
- Unconventional balance sheet policies as a practical response to limitations of the ZLB
- Need to account for financial stability and macroprudential policies
- EMDE: Two instruments, two targets
- AEs: price level targeting
- Substitute for fiscal policy in the COVID crisis

But why is IT so popular, at least nominally?



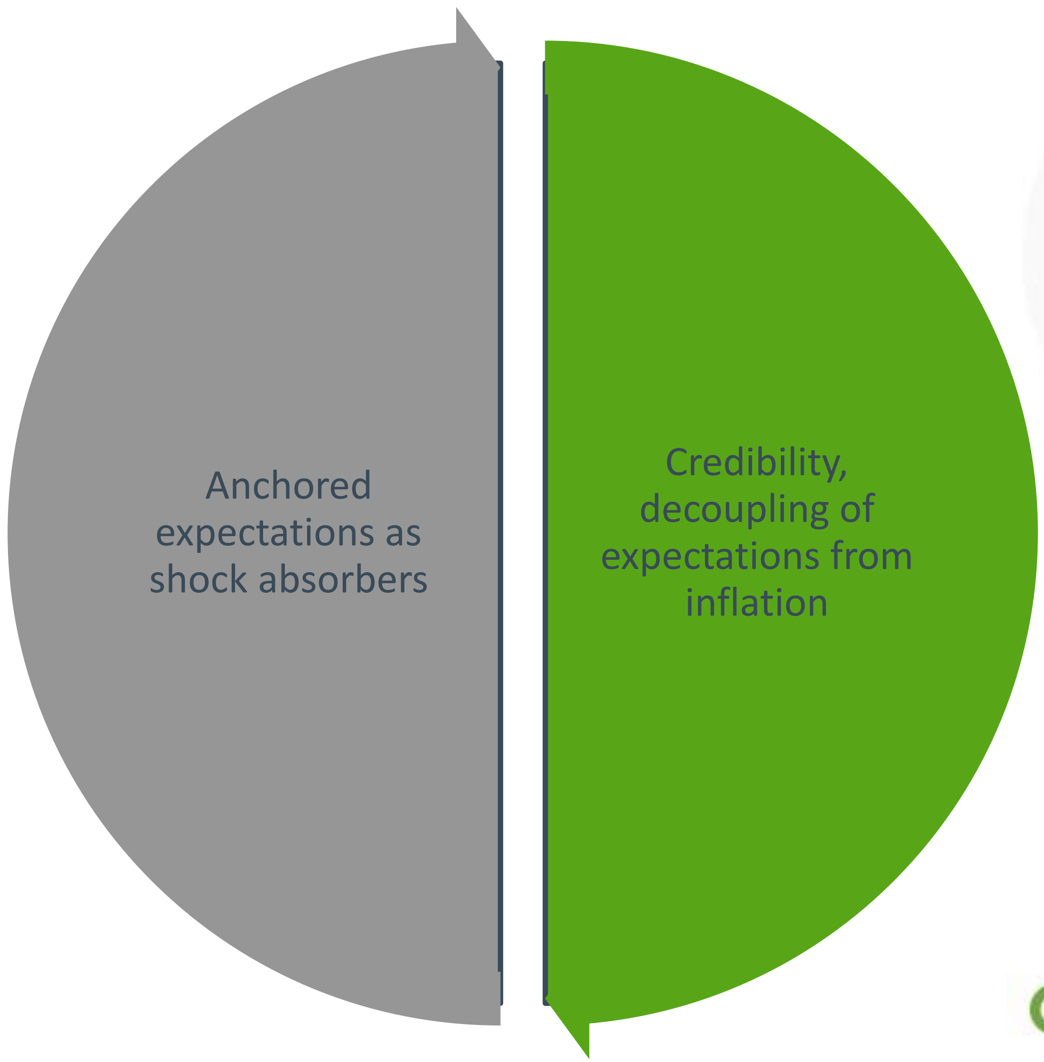
Source: NBP

Why is IT so popular?

- IT is a credibility yardstick- a collection of state-of-the-art practices of conducting a flexible exchange rate monetary policy
- Credibility loosens the link between inflation and inflation expectations as an effective shock absorber
- Credibility also opens room for maneuver …
- … but we need to suffer by constraining our choices to gain credibility

IT Mechanics

IT Mechanics



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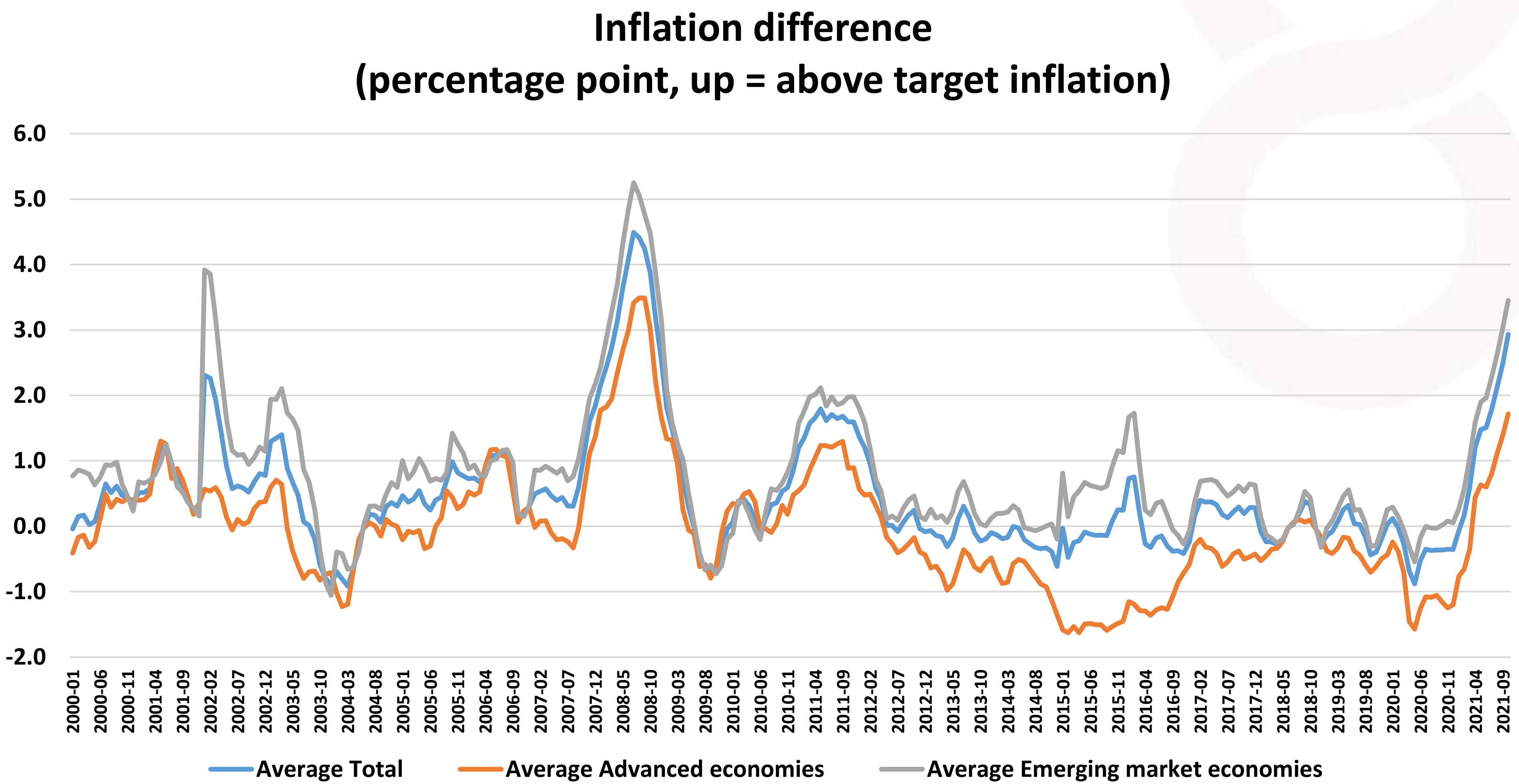
HAVE WE GOT ENOUGH CREDIBILITY TO STOP THE SUFFERING

Inflation highest on record for some EM ITers



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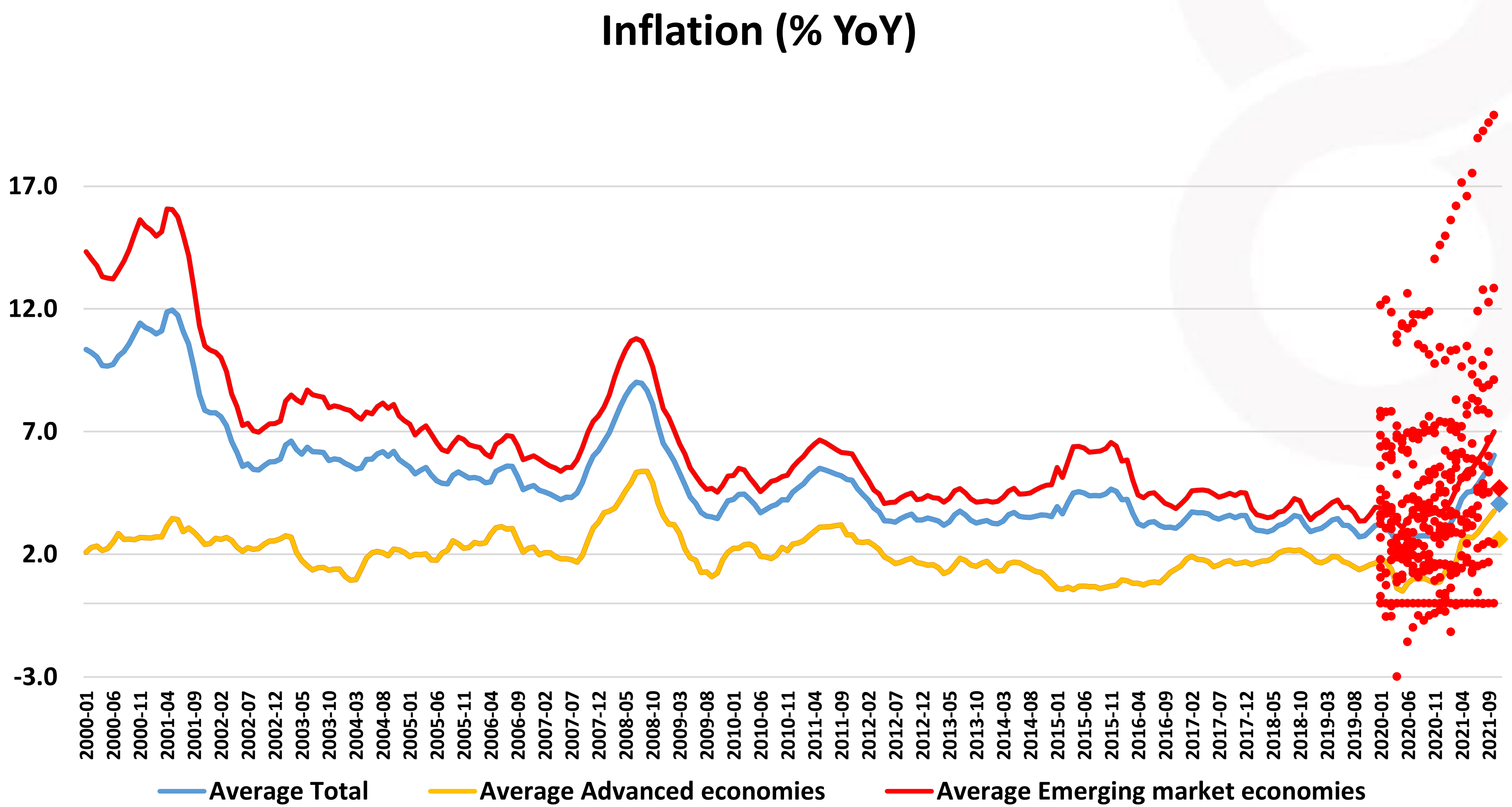

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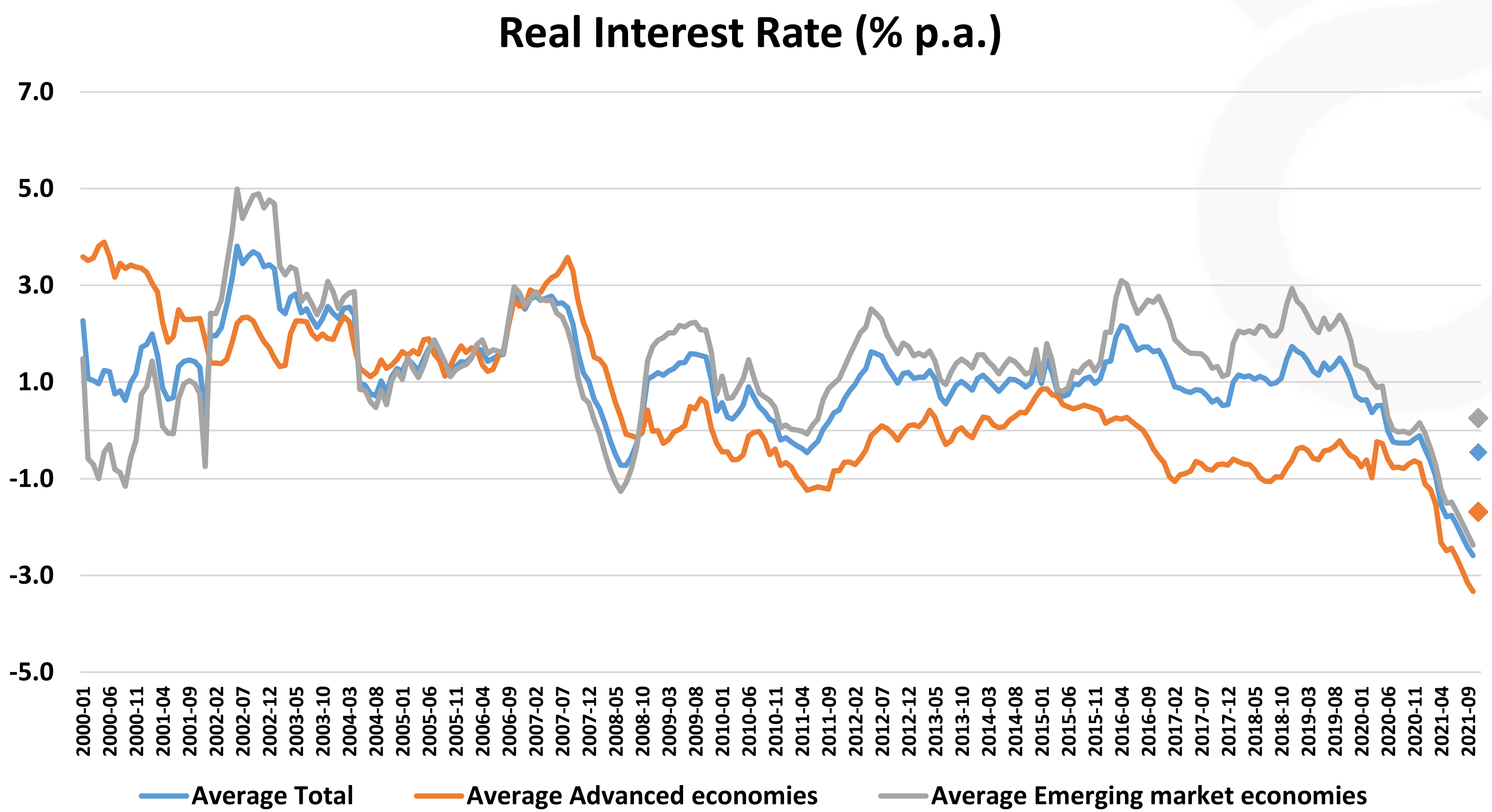
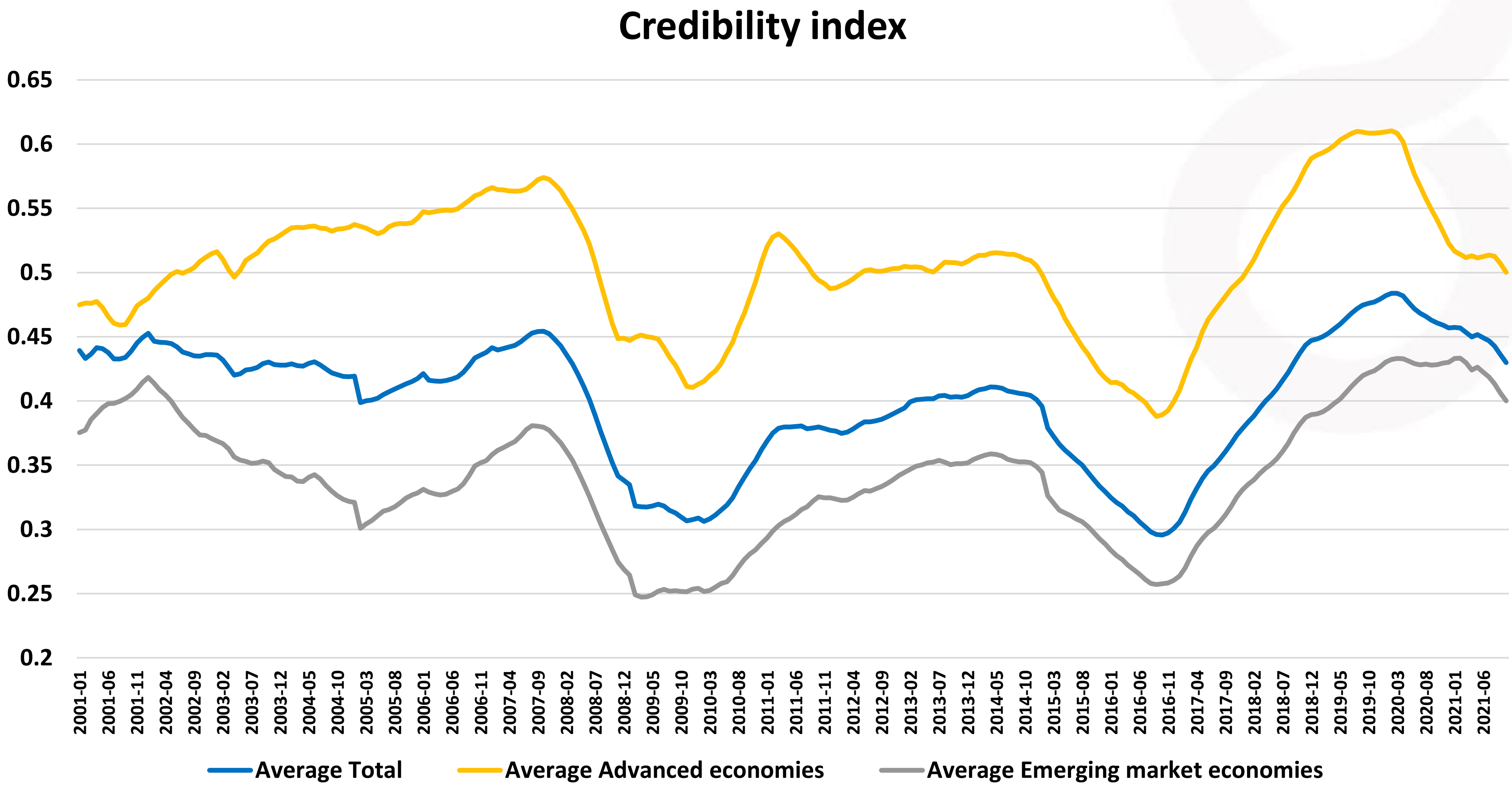
Real int. rates extra and equally lose for AEs and EMs ITers



Credibility still historically high



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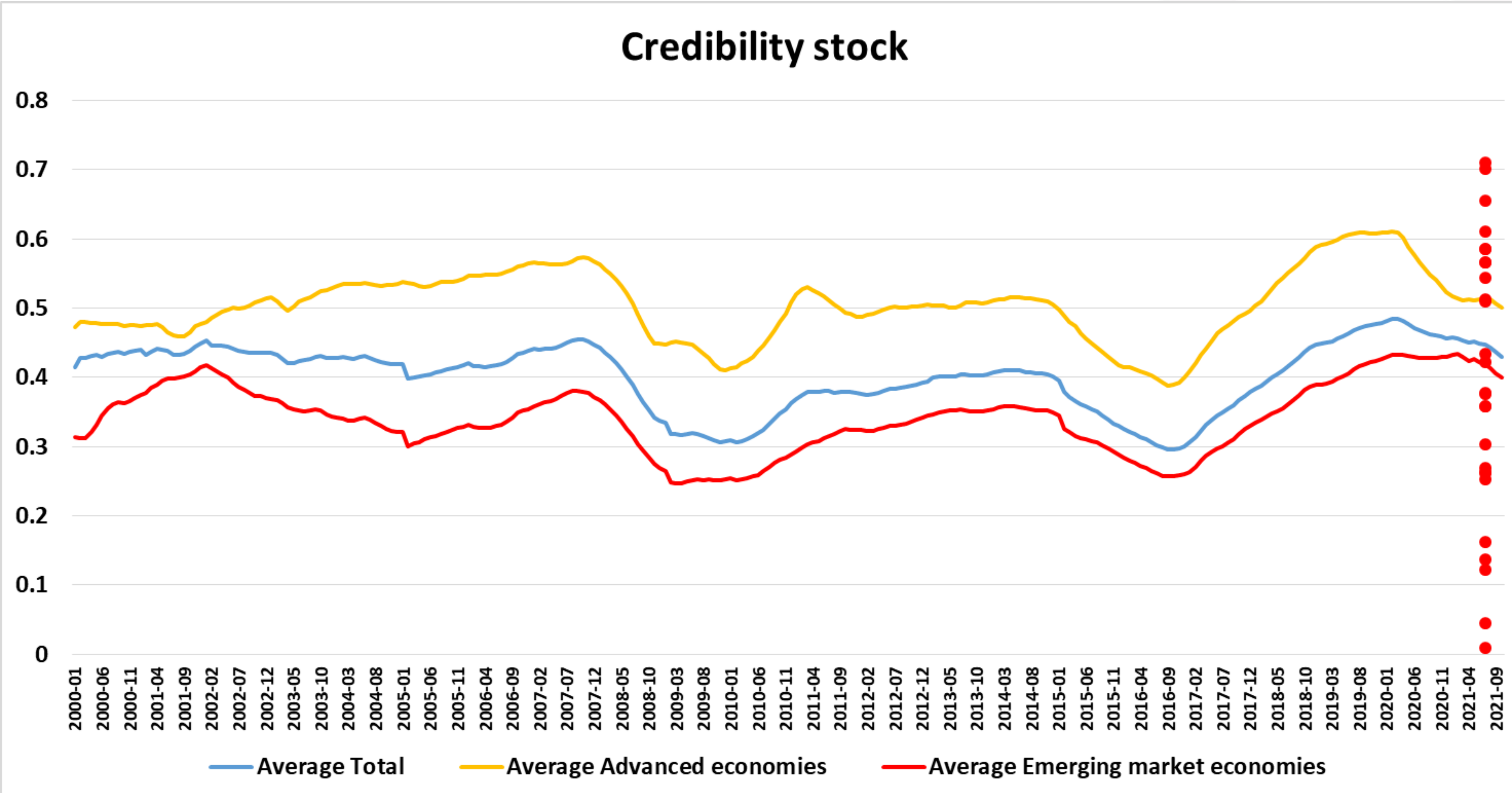
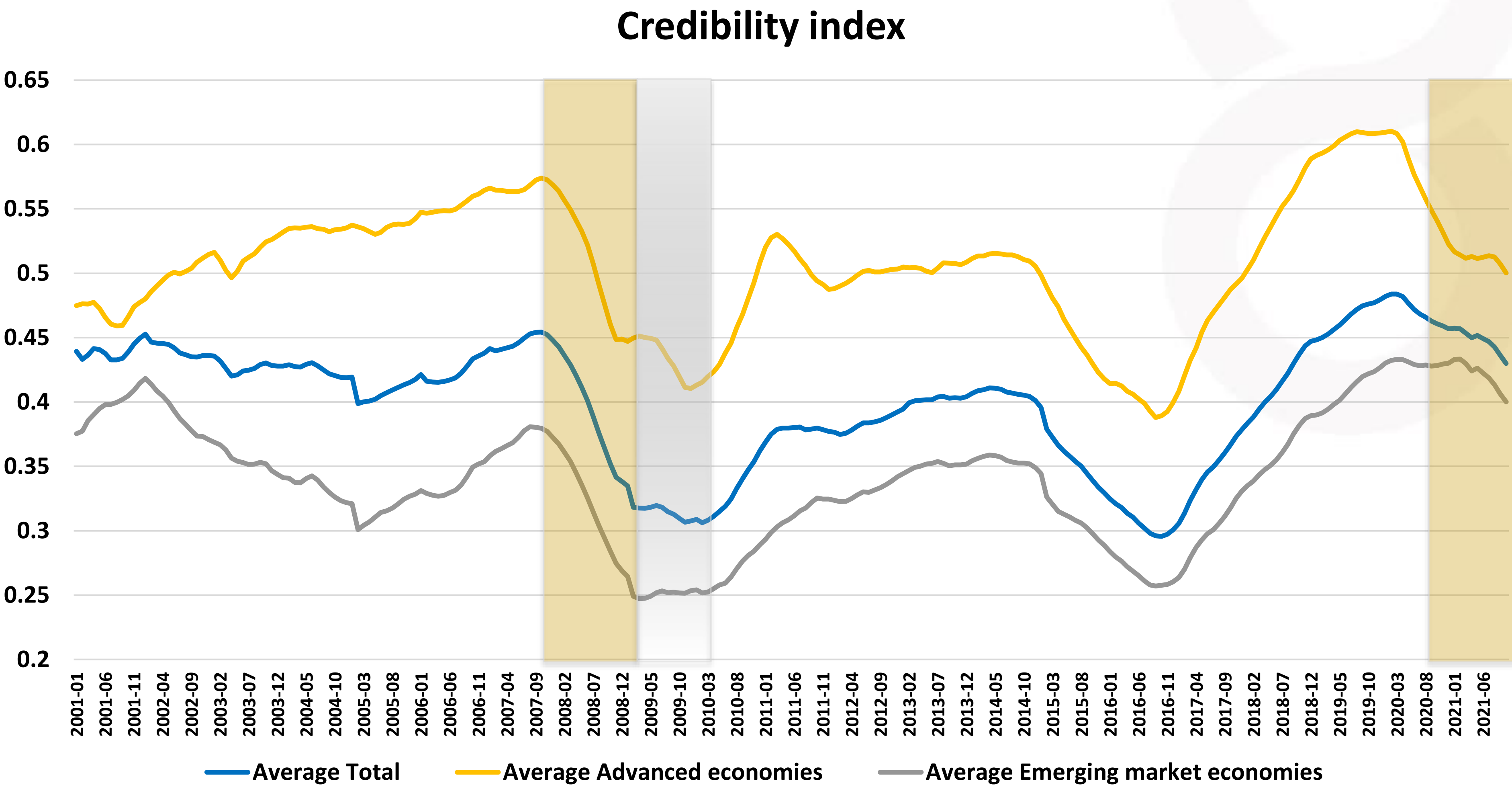
Credibility dispersion chart



Credibility=0.8*Credibility{-1} + (1-0.8)*exp(-(0.97*(Inflation{-1} - Target{-1}))^2)

Credibility still historically high



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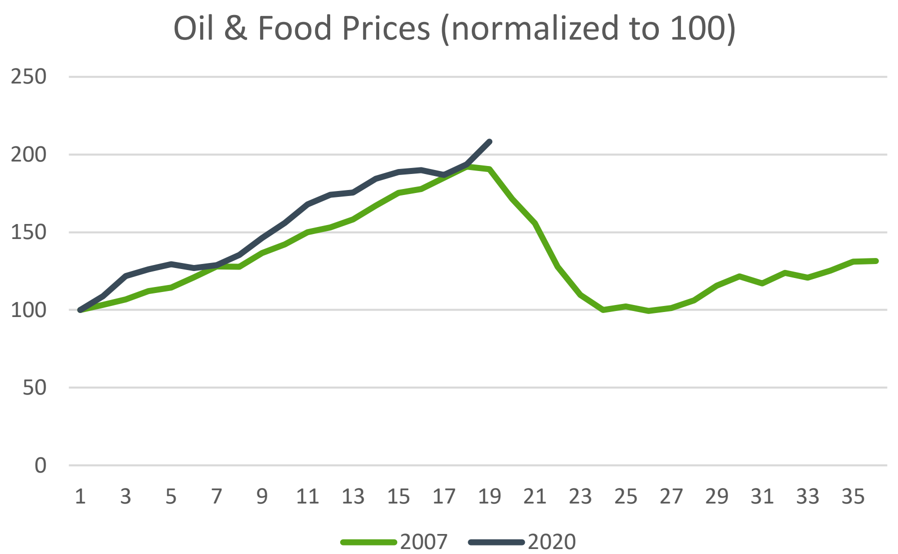
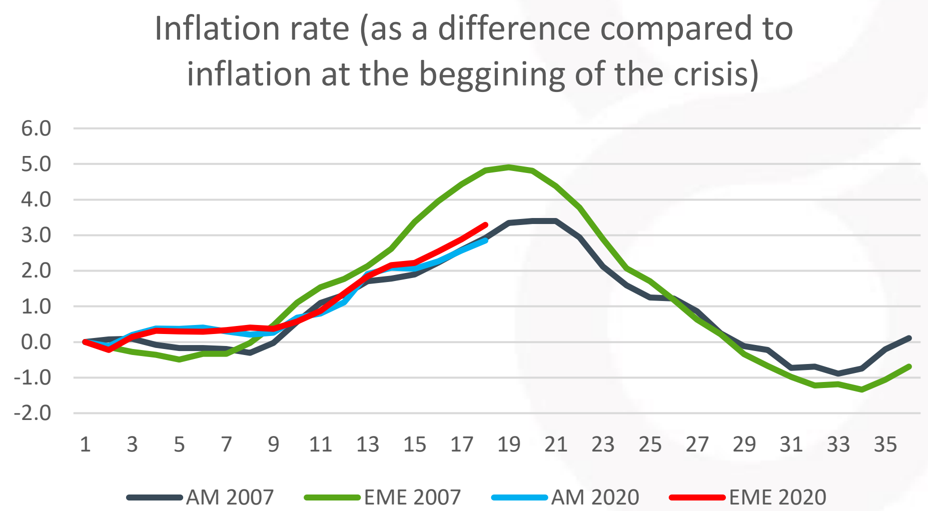
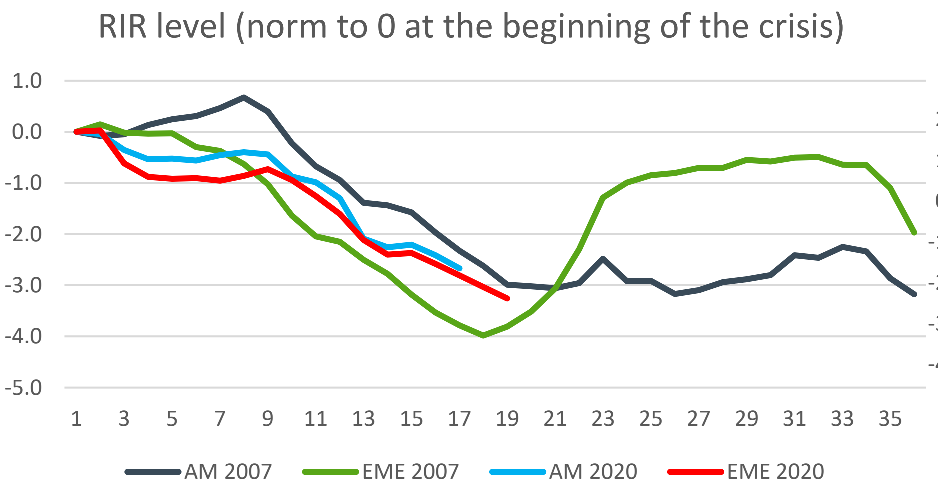
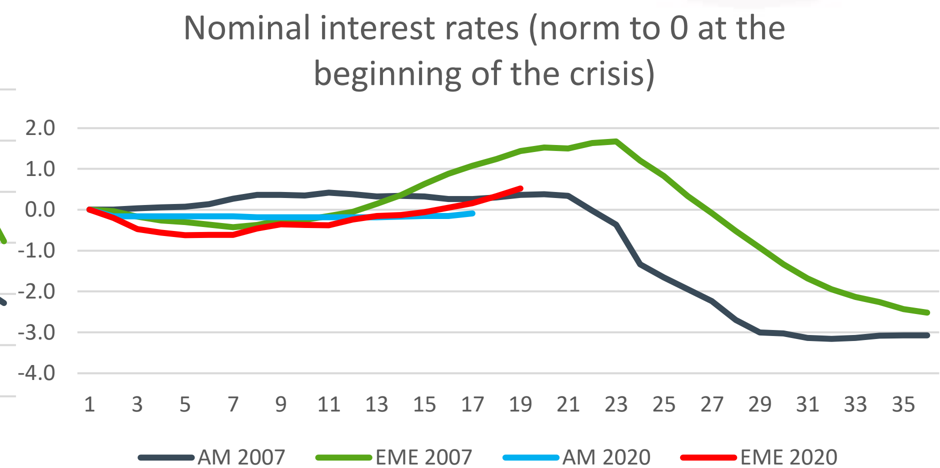
Similar experience in ‘07 and ‘20









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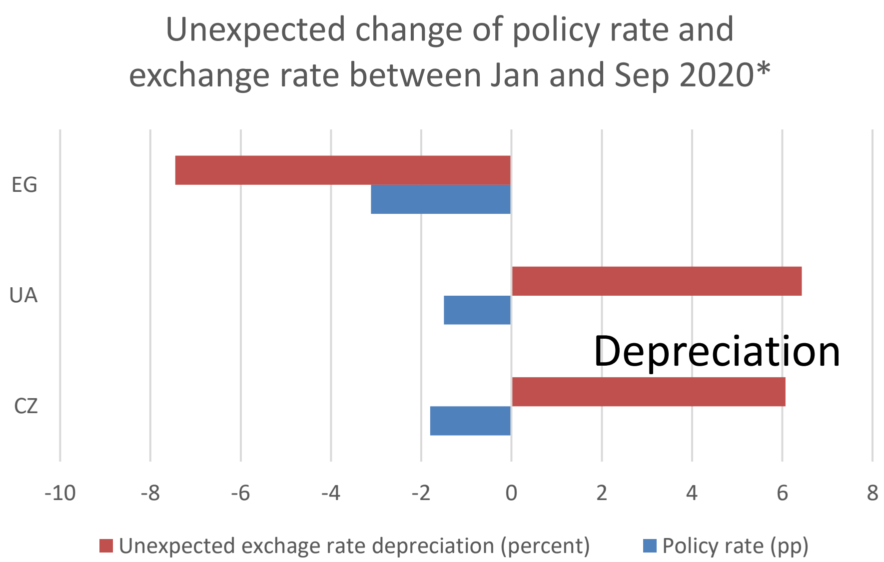
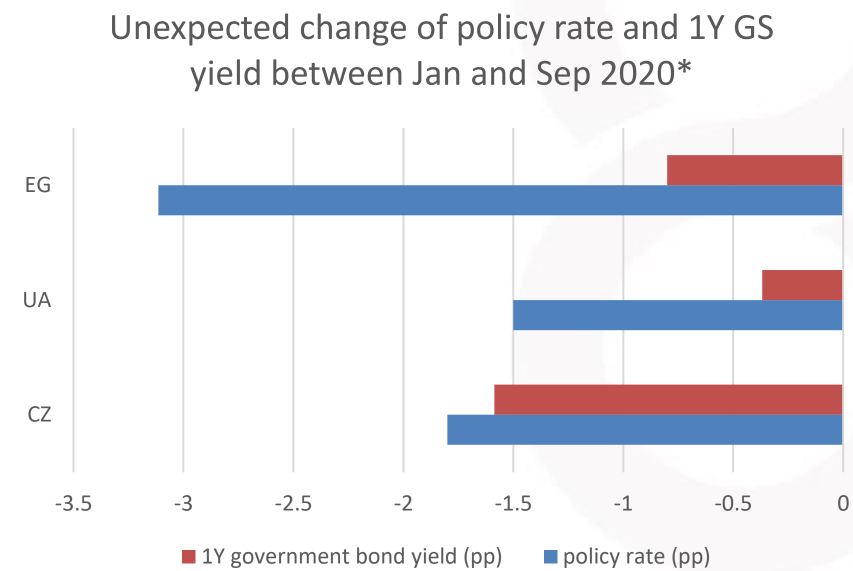
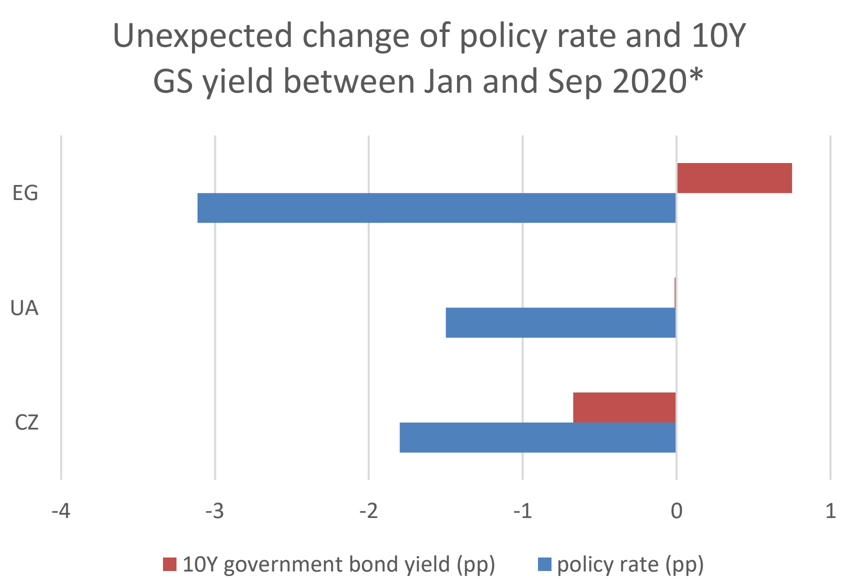
Hard targeting and high credibility seem to matter empirically

IT as a shock absorber







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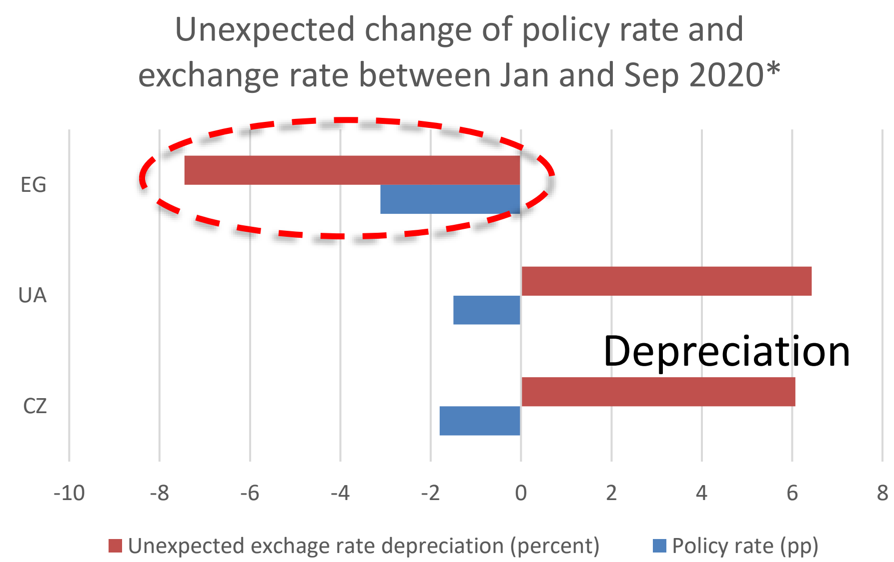

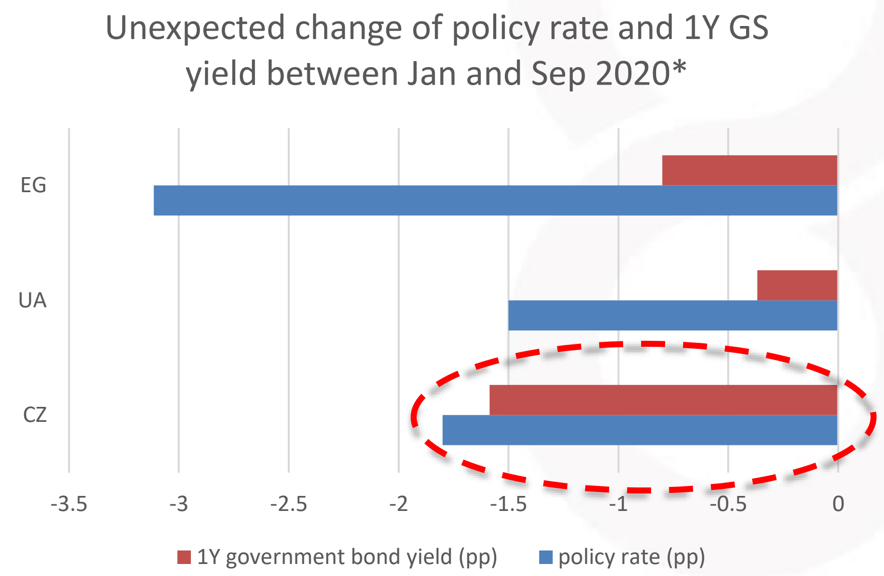

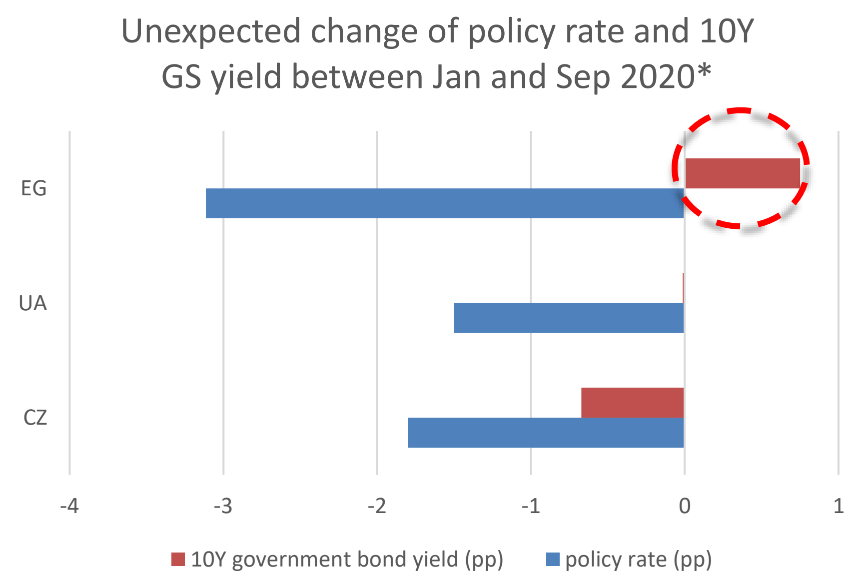

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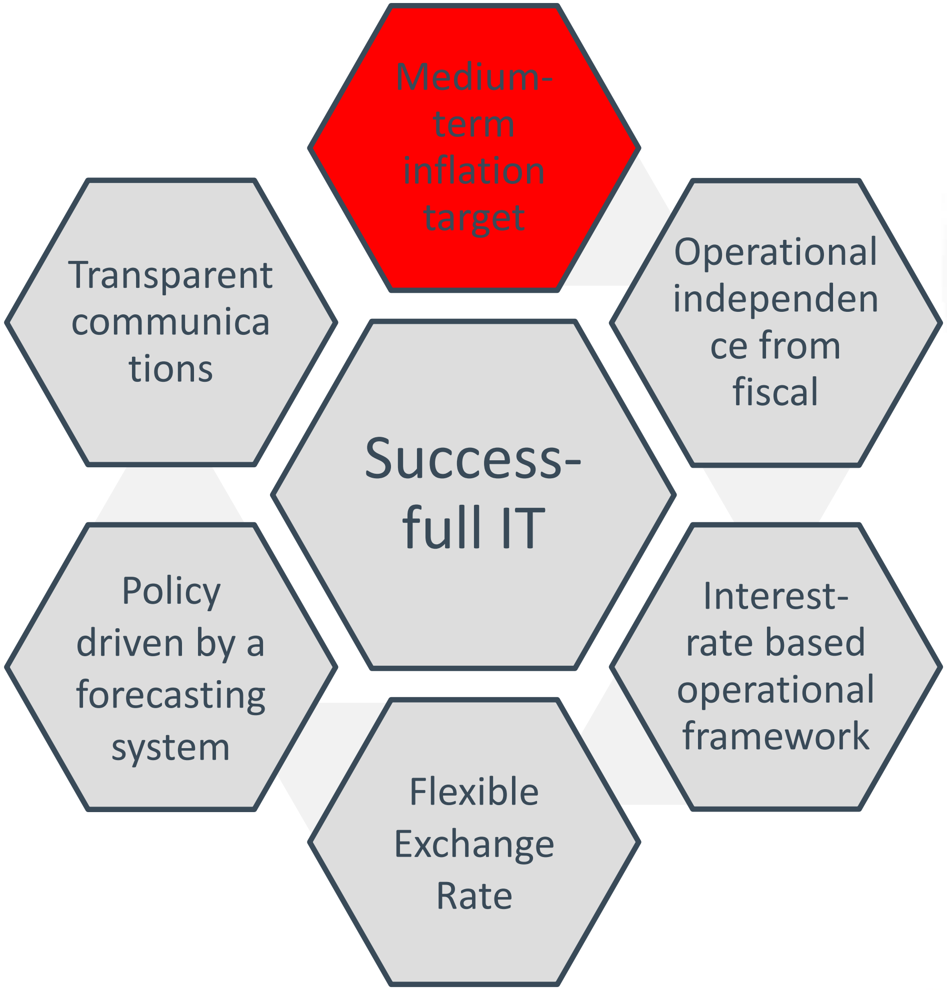
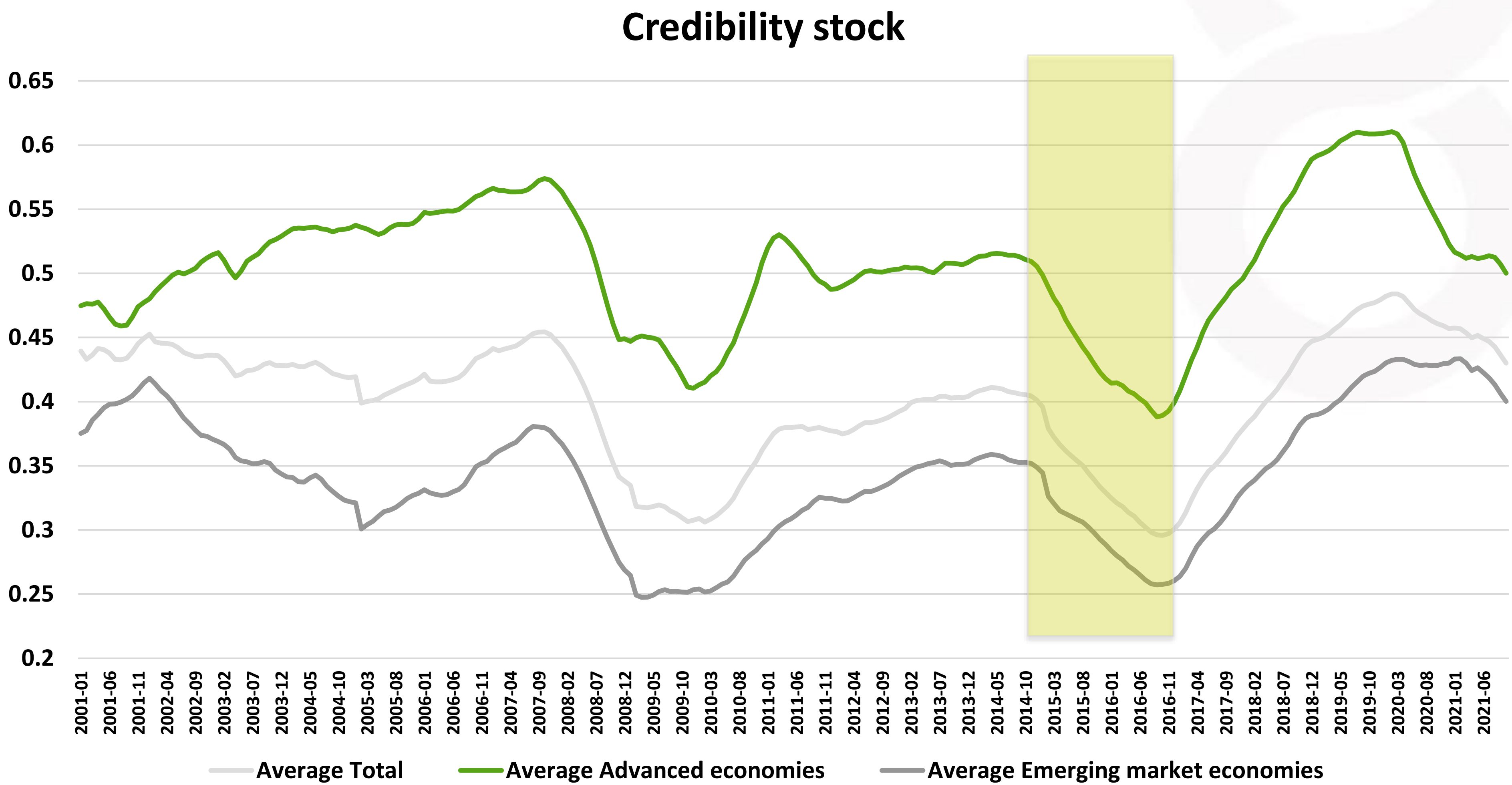
HAVE WE GOT ENOUGH CREDIBILITY TO STOP THE SUFFERING

Key ingredients of a successful IT regime and how to check them

Key ingredients of a successful IT regime



Credibility still historically high



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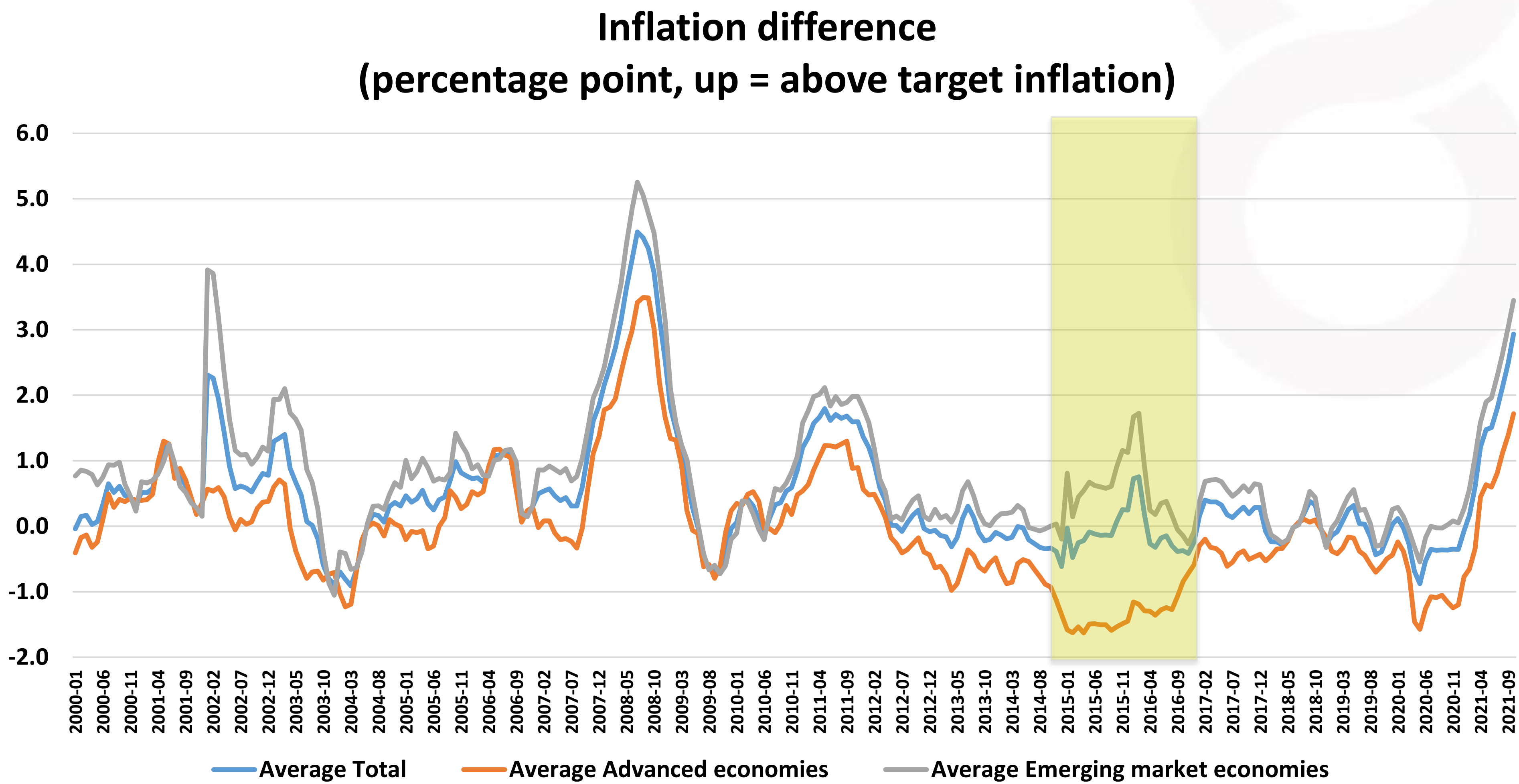
Inflation highest on record for EM ITers



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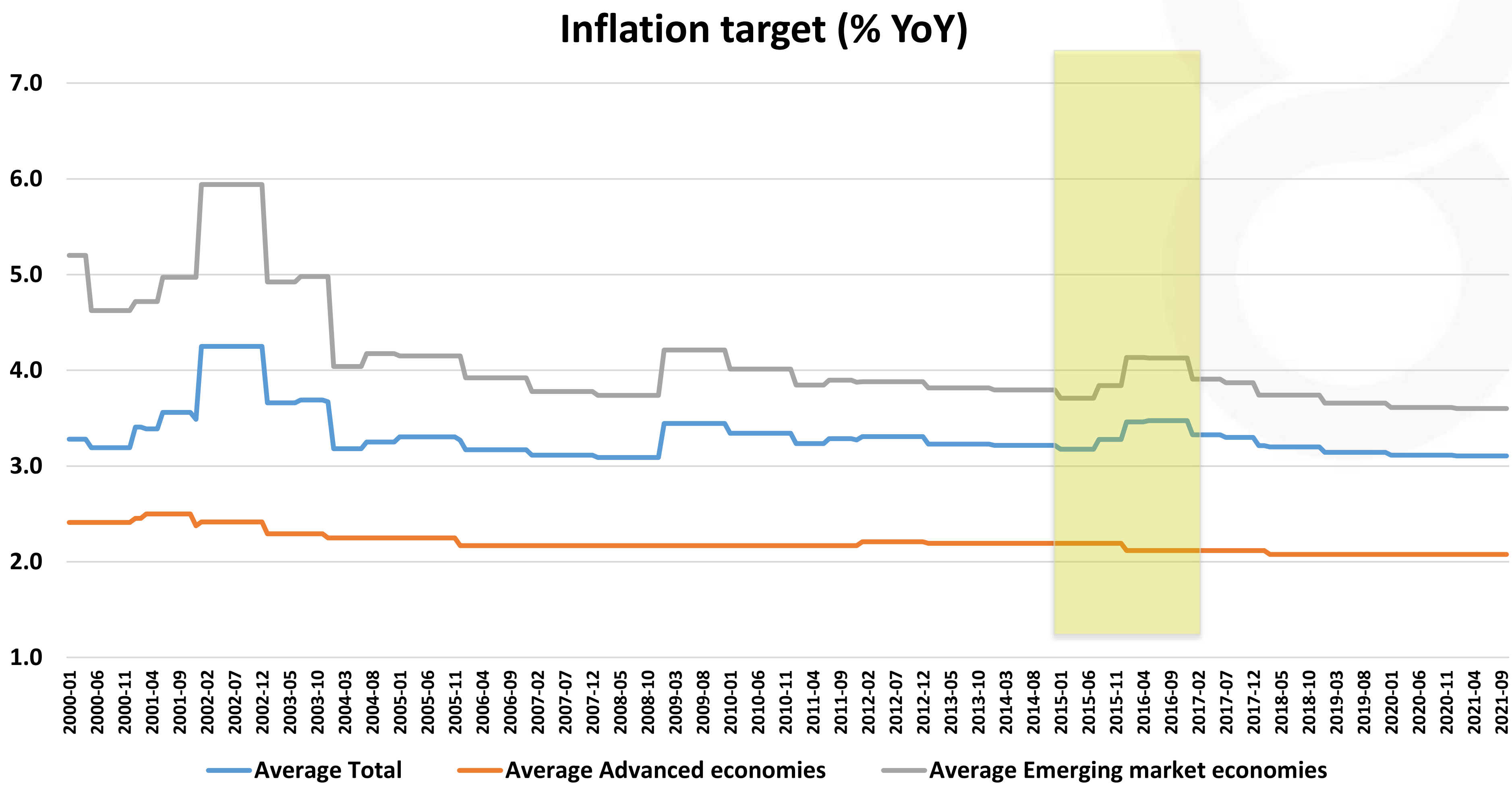
Target chart



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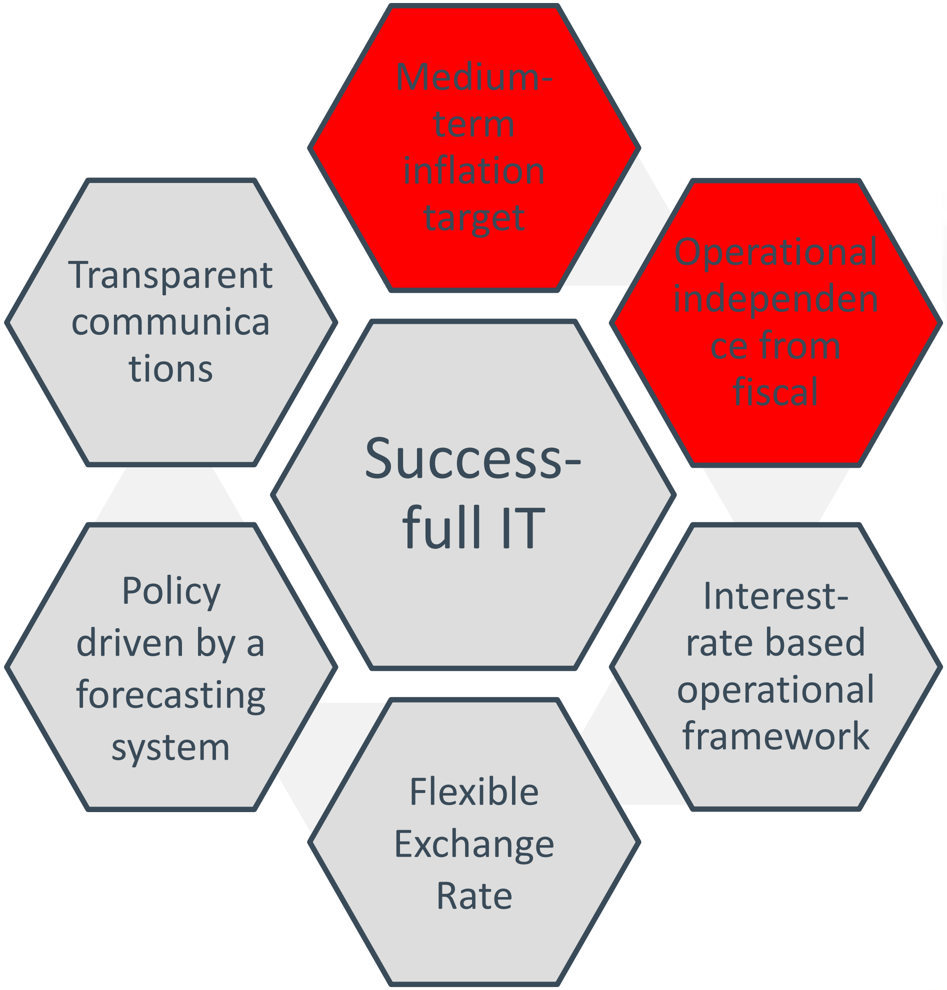
Key ingredients of a successful IT regime and how to check them

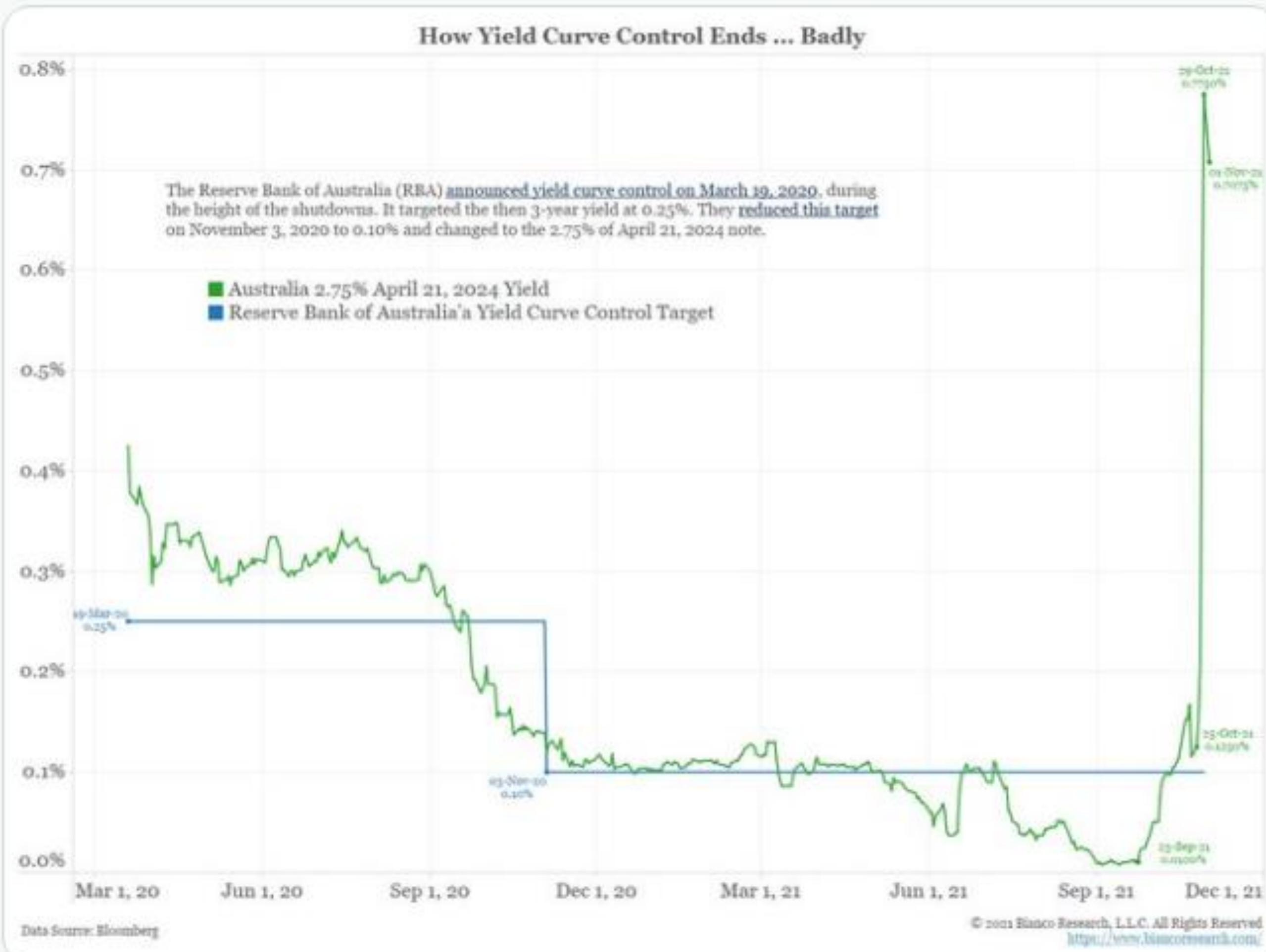


Ever more responsibility pushed to central banks, not with countercyclical but structural policies and debt

Unclear exit strategies

Can be chaotic: example Australia

*RBA SCRAPS APRIL 2024 0.1% GOVERNMENT BOND YIELD TARGET



Key ingredients of a successful IT regime and how to check them

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Policy Driven by a Forecasting System

- IT is in fact Inflation Forecast Targeting
- Staff is in the driving seat of policy
- Good policy react today to possible shocks in the future
- Pre-emptive policy is difficult, because it involves uncertain future
- Forecasting System helps to make such choices

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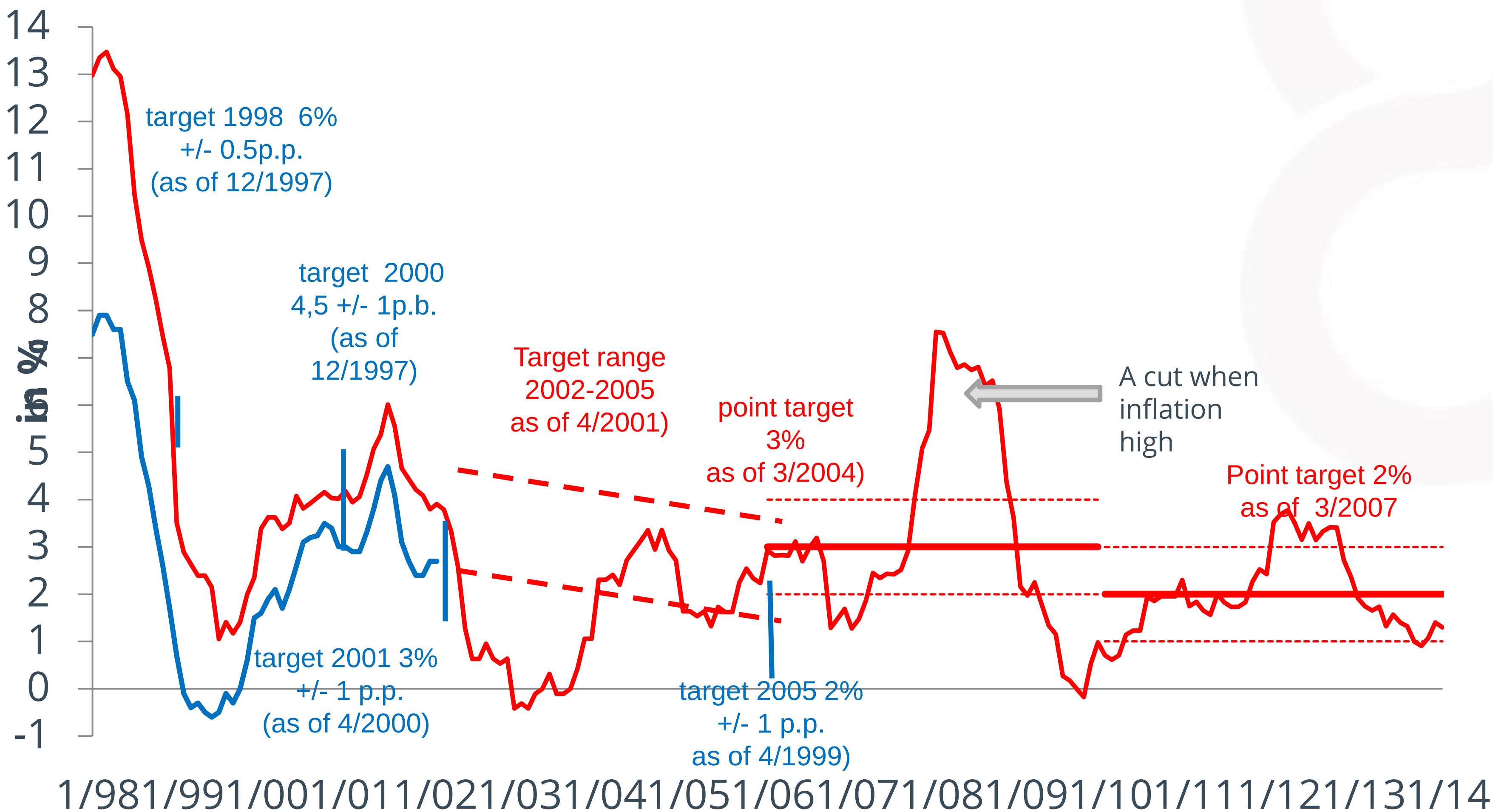
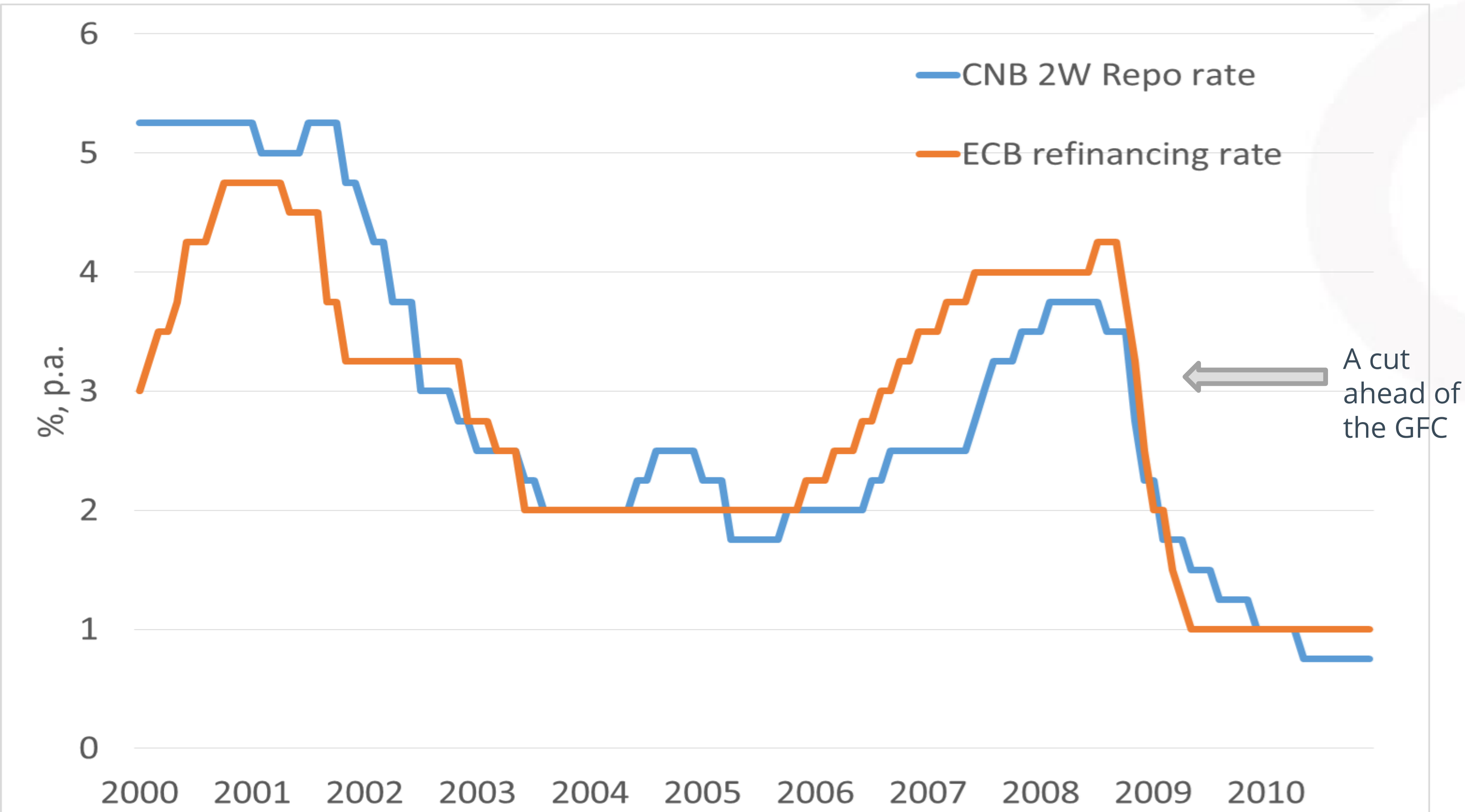
Cutting rates, when inflation is high



Source: Czech National Bank

…for being afraid demand may be far too weak in the future



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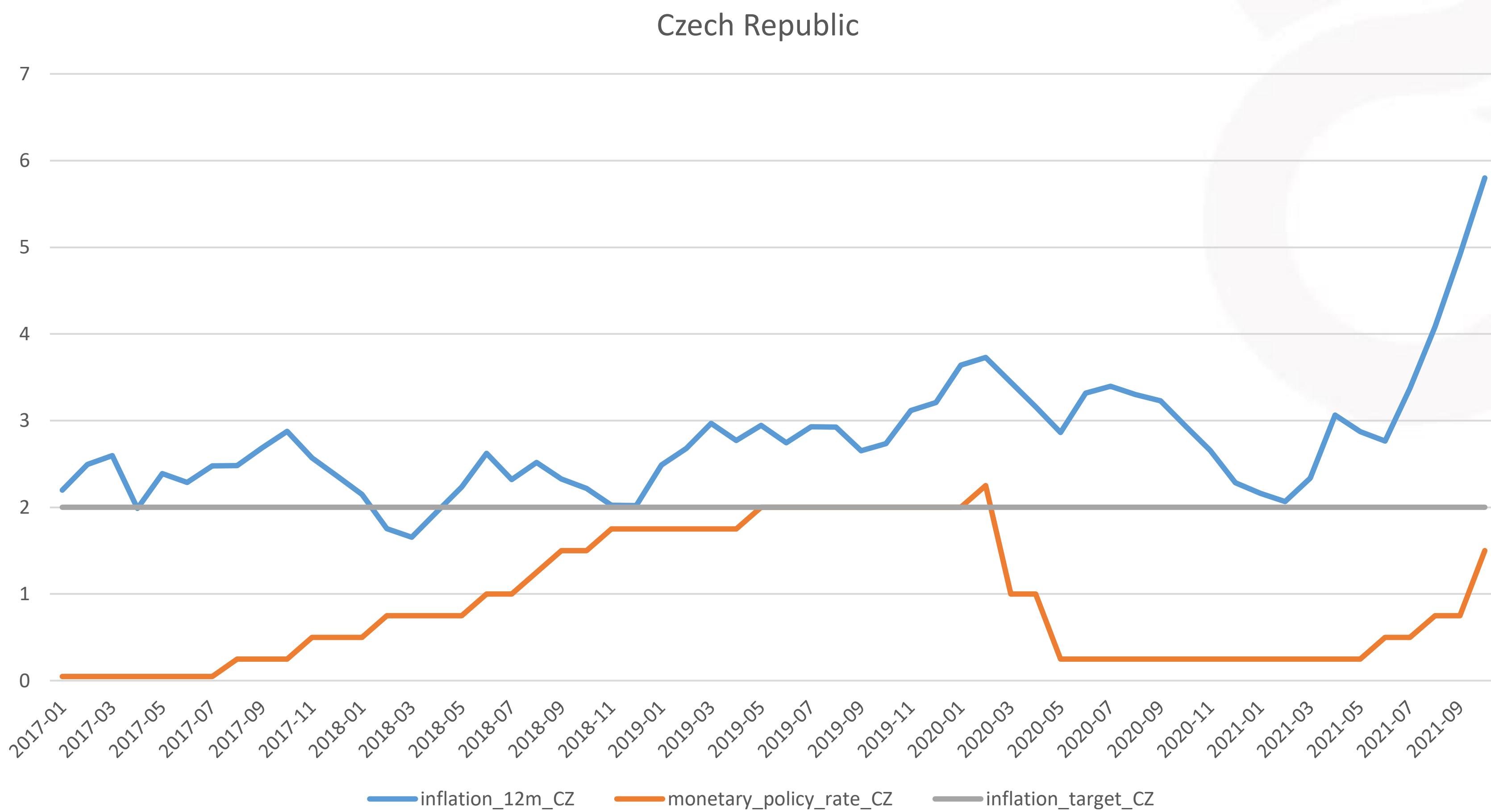
Recent Czech history much less impressive



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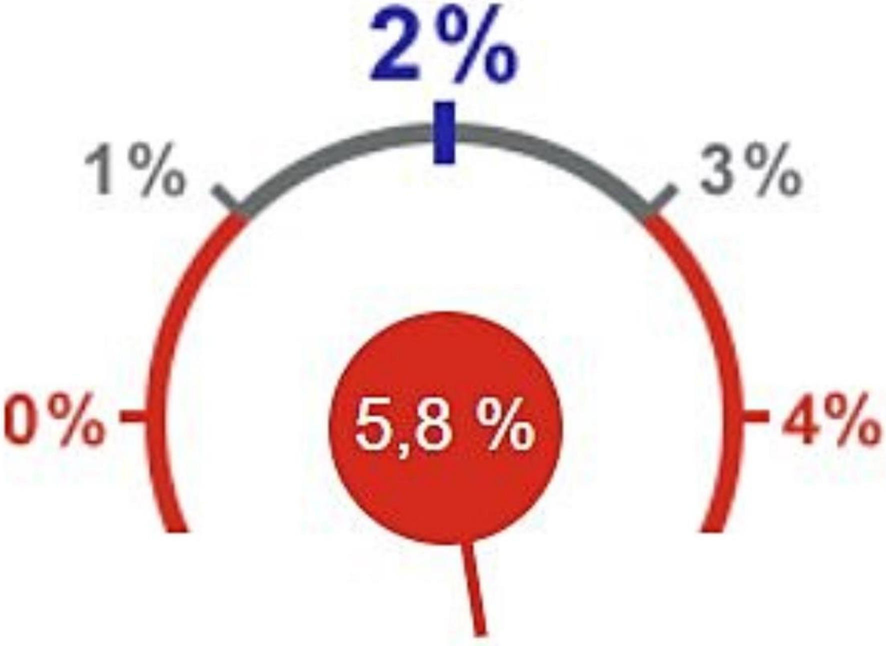
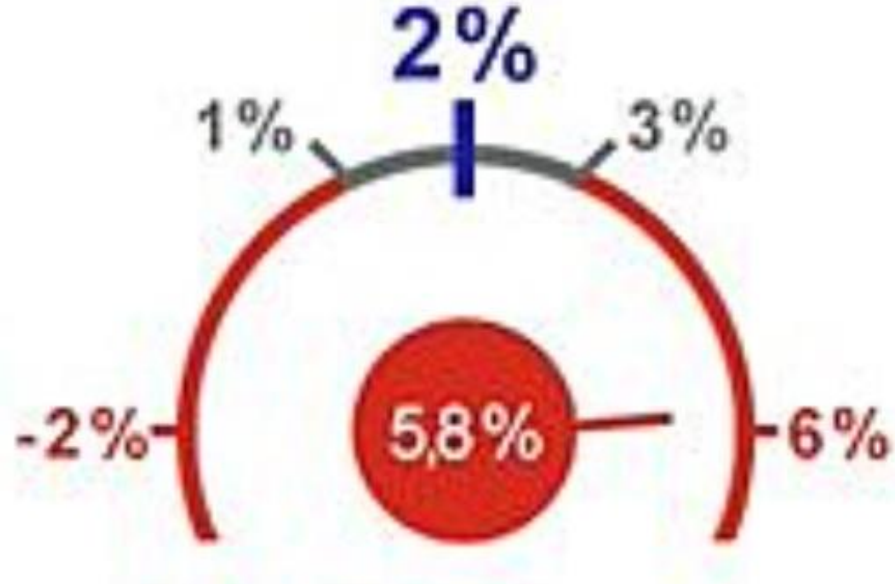
Key ingredients of a successful IT regime and how to check them

Policy Driven by a Forecasting System

- IT shifts the attention away from target achievement to explanations
- IT is more about missing targets than achieving them





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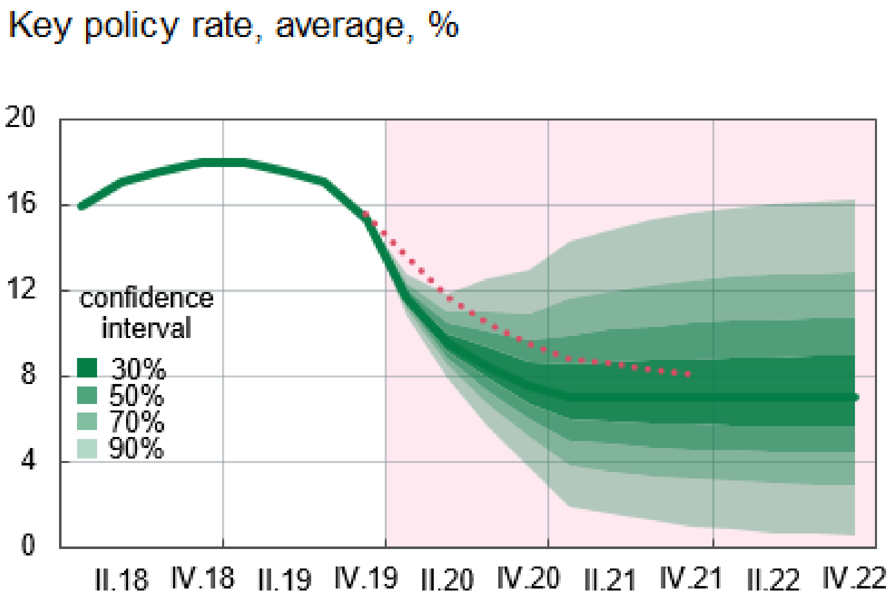
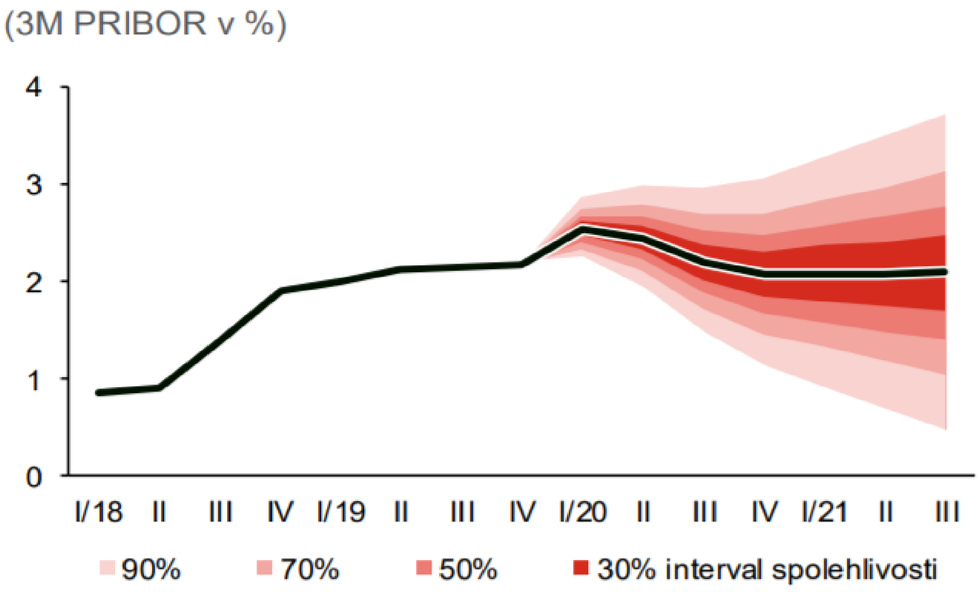
Publishing key policy rate trajectories may help





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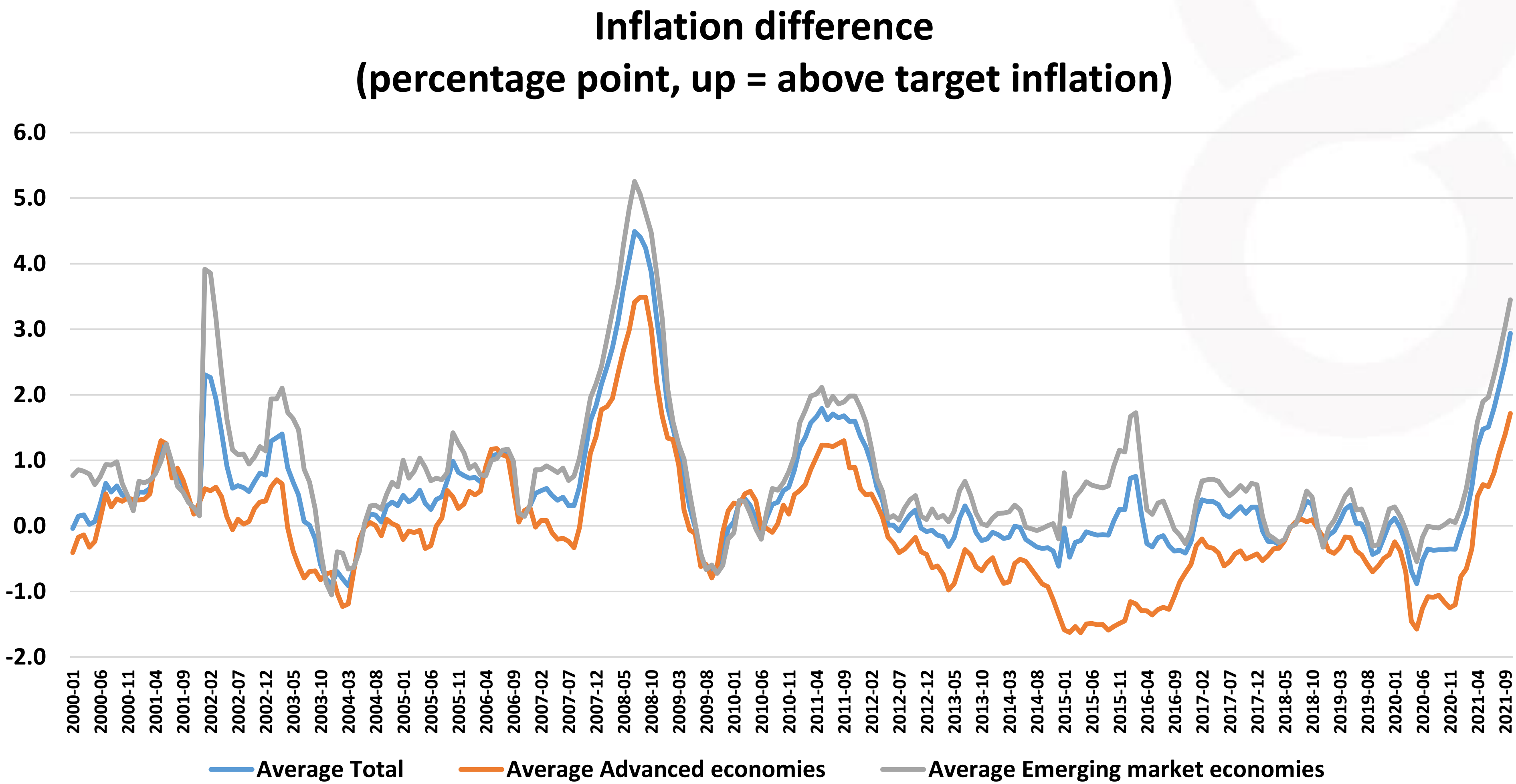

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Key ingredients of a successful IT regime and how to check them

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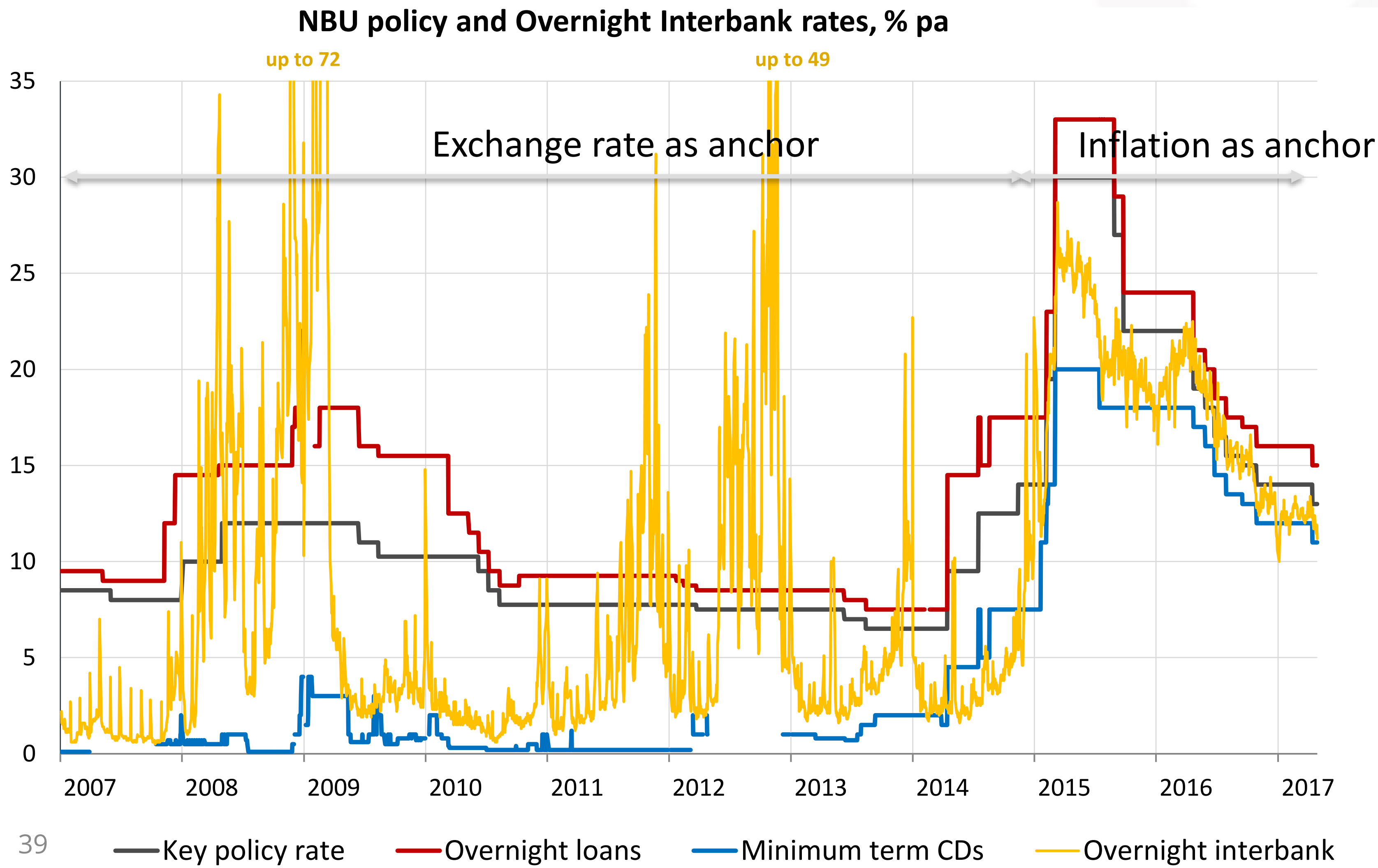
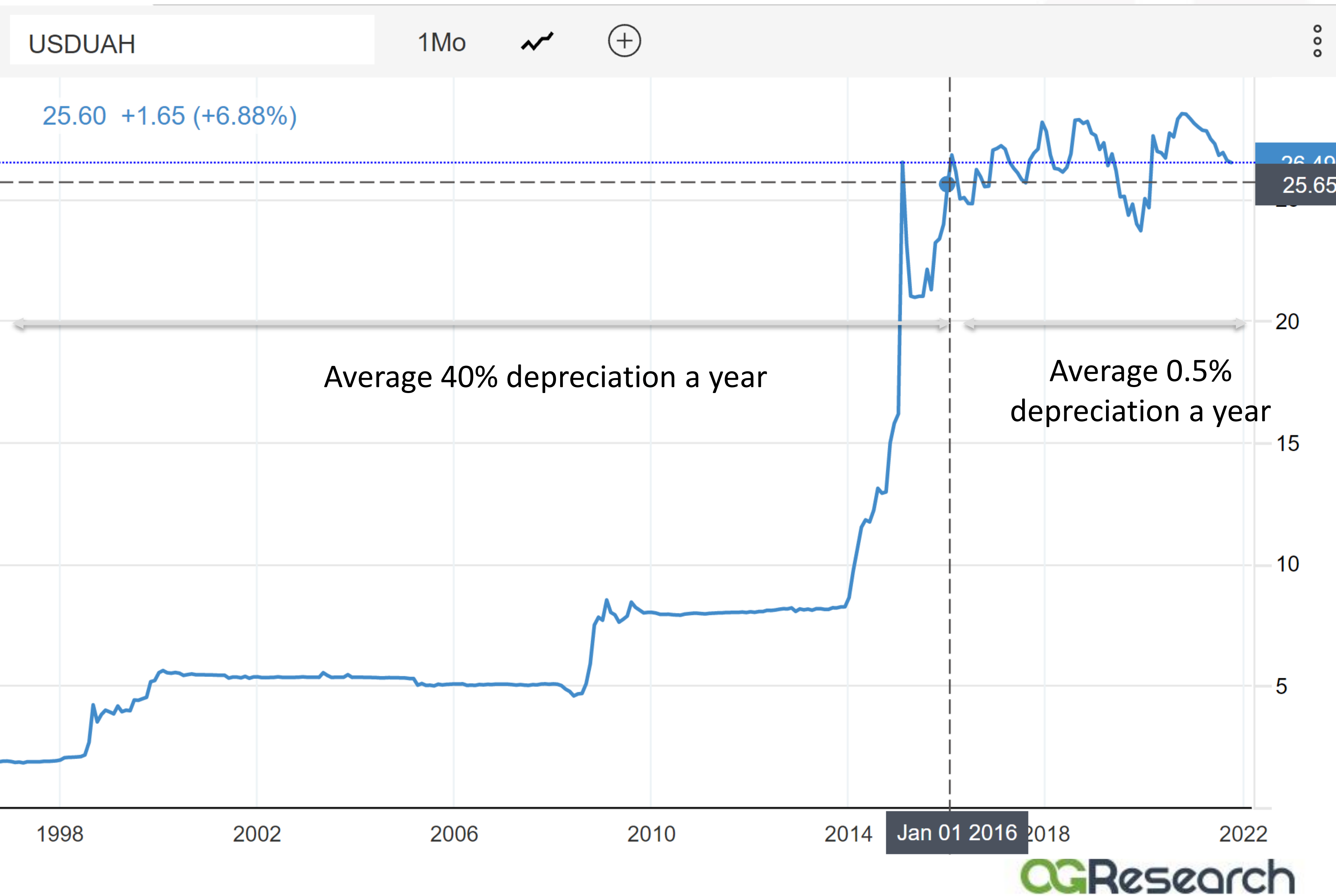
Ex rate anchor leads to volatile movements of interest rates



Source: NBU


USDUAH
1Mo
25.60 +1.65 (+6.88%)
25.65
20
15
10
5
Average 40% depreciation a year
Average 0.5% depreciation a year
1998
2002
2006
2010
2014
Jan 01 2016
2018
2022
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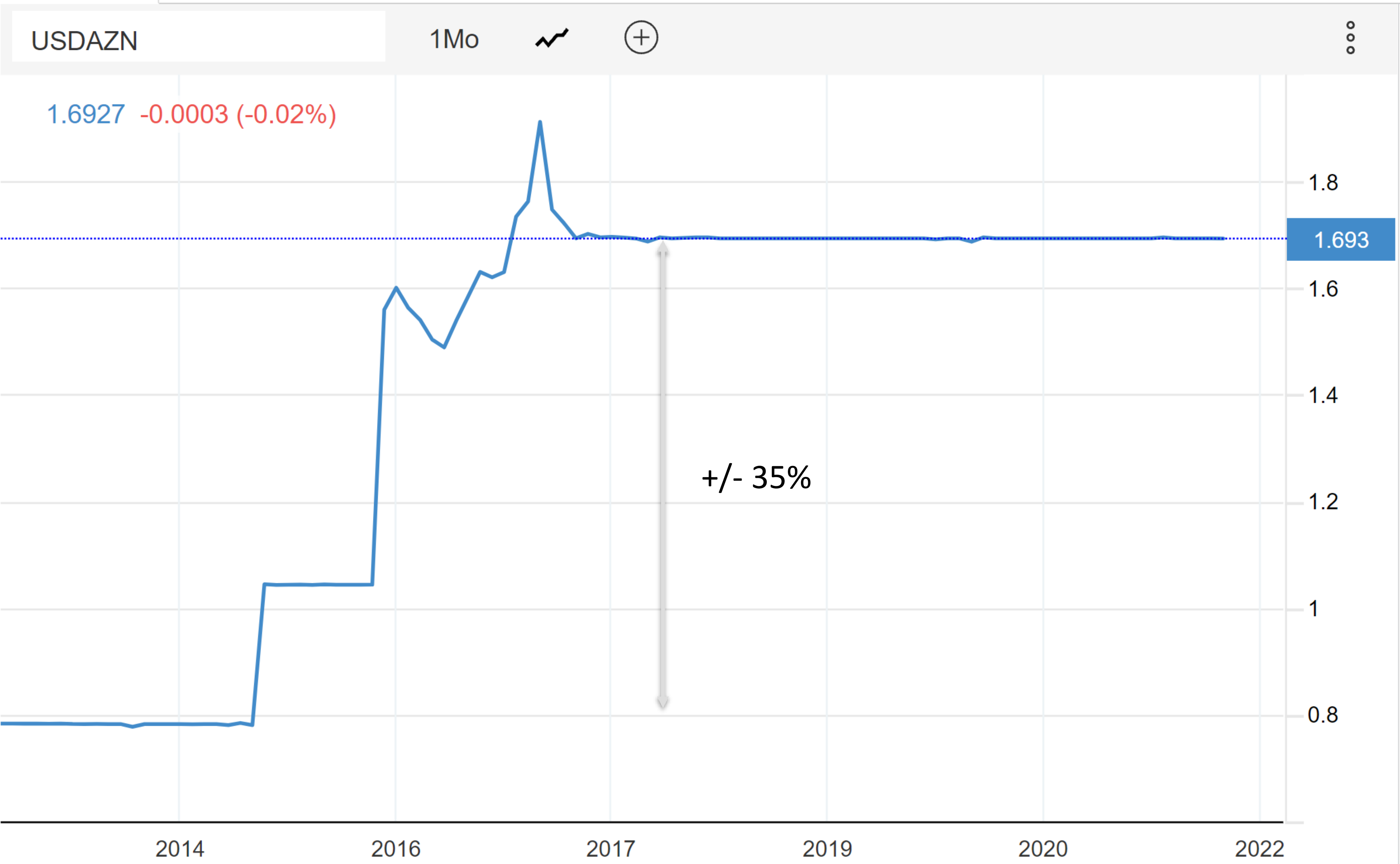
Long-term ex rate volatility much lower for floating currencies

Country	Standard error of monthly 5Y exchange rate change over 2009(2004)-2021* (pp)
Azerbaijan	56.1
Kazakhstan	50.5
Russia	44.3
…	…
Georgia	24.9
Australia	24.0
Czech Republic	20.6
Poland	17.3

* Group of Emerging Market and Developing Economies. Available monthly averages 2004-2021

‘ Technology company Apple halted online sales on Tuesday as the currency fell through the thresholds of 11, 12 and then 13 to the dollar, making it impossible for producers to price their products. “When I got into the elevator the dollar was 11.55. When I got out it was 12.15,” ‘


USDAZN
1Mo
1.6927 -0.0003 (-0.02%)
1.8
1.693
1.6
1.4
1.2
1
0.8
+/- 35%
2014
2016
2017
2019
2020
2022

USDAUD
1Mo
1.3710 -0.012423709287 (-0.90%)
+/- 35%
1.371
2
1.8
1.6
1.2
1
1998
2002
2006
2010
2014
2018
2022

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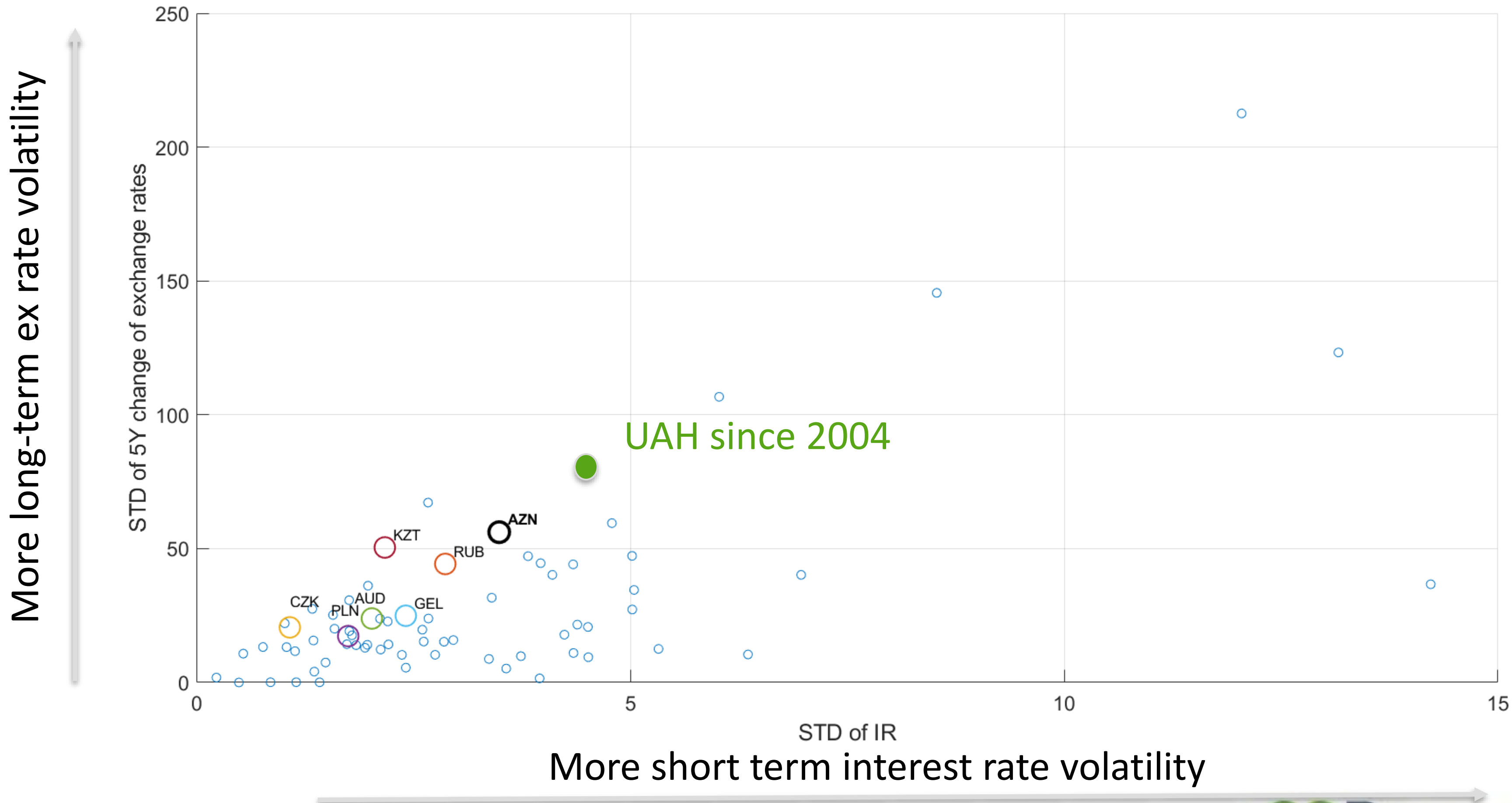
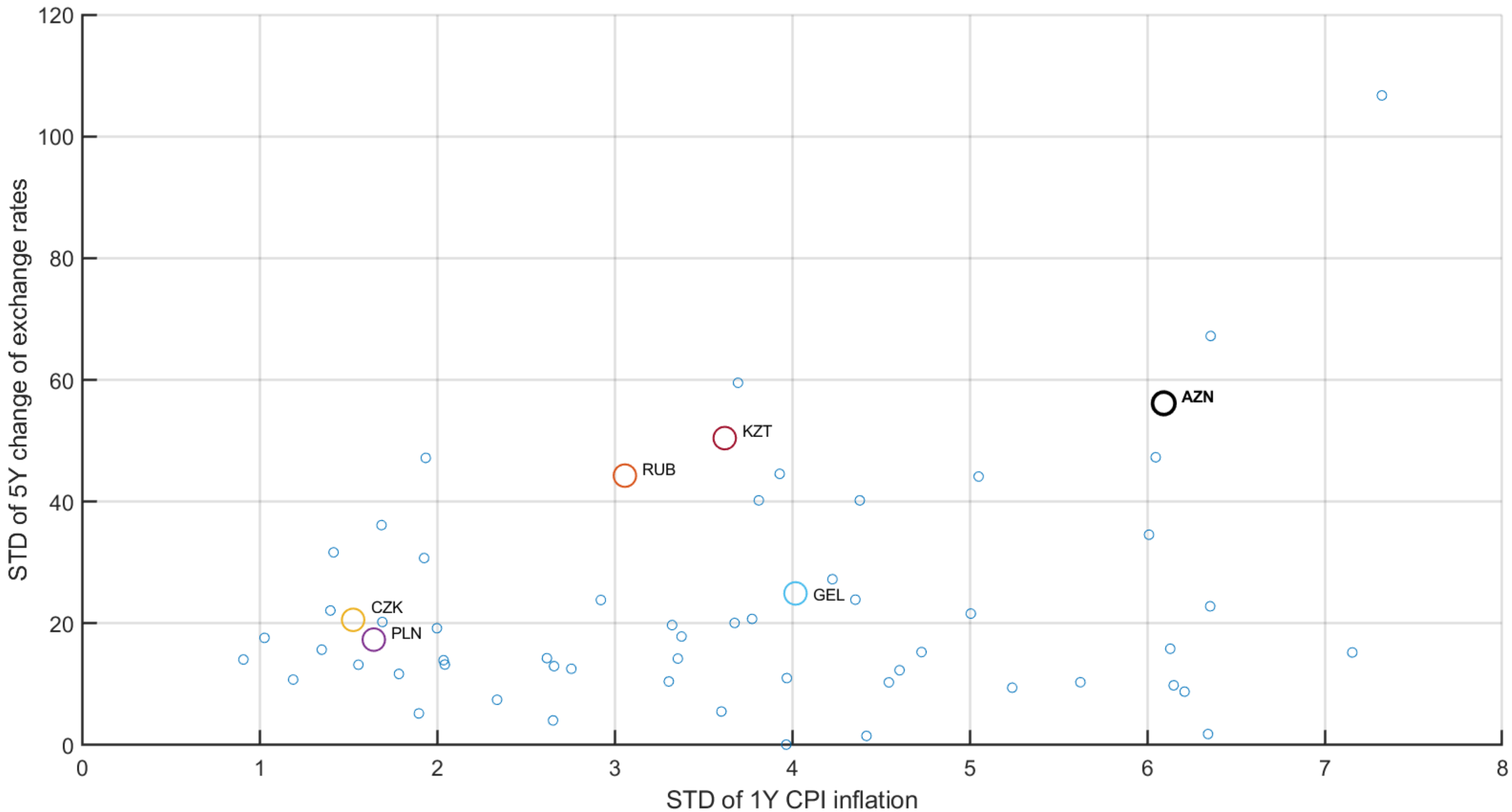
Long-term ex rate volatility is correlated with int rate volatility



Higher long-term ex rate volatility correlates with that of inflation

More long-term ex rate volatility



More inflation volatility

* Group of Emerging Market and Developing Economies. Available monthly averages 2004-2021

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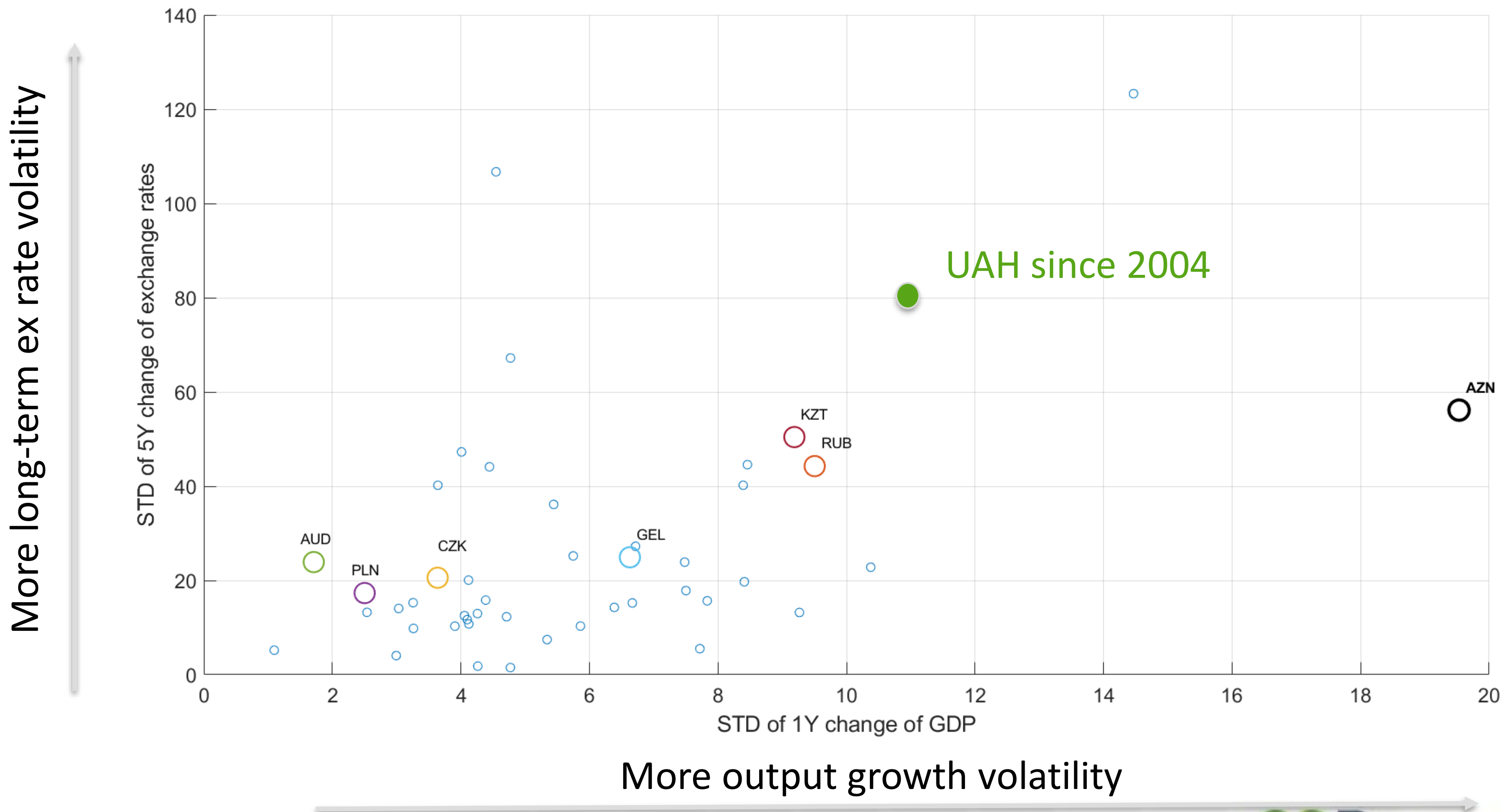
Output volatility increases with long-term exchange rate volatility



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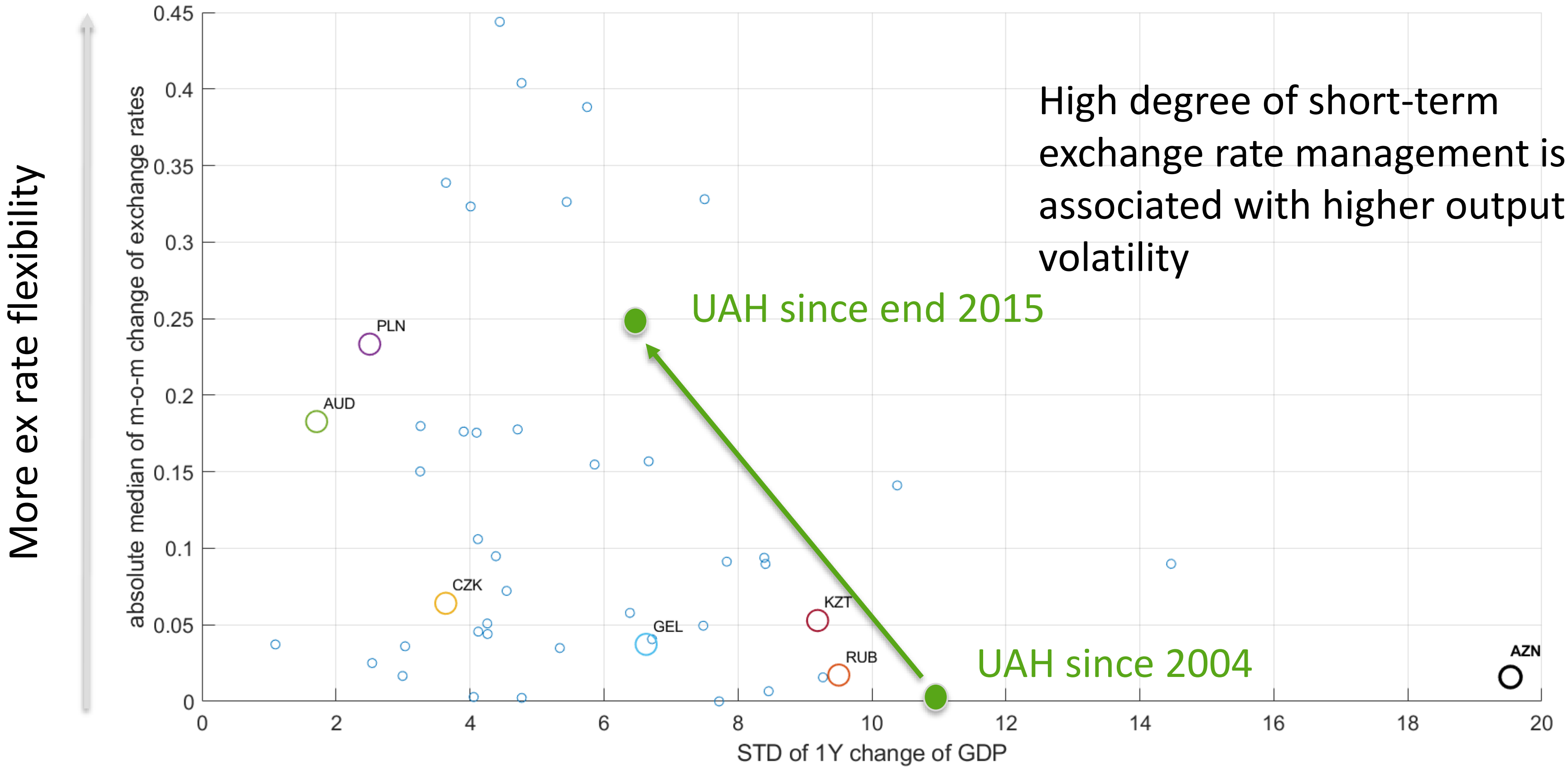
But not with short-term volatility



Unless we hate what we are not, we cannot love what we are

* S. Huntington

Main Themes Again

- Credibility often take as granted, especially by EMDEs
- New instruments deployed in an opaque manner
- Staff often over-ruled by political and fiscal considerations

- IT framework widely adopted to provide a nominal anchor
- Back-to-basics may be needed to reinforce its credibility
- Resist attempts to redefine the institutional framework to explicitly recognize the fiscal responsibility
- Inflation forecast targeting must be treated seriously
- Re-focus on one objective only and a flexible exchange rate

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