Inflation Targeting: A crisis of relevance?

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Kyiv, November 2021
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
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

- Accountability for reaching the target
- Anchored expectations as shock absorbers
- Institutional and Operational Independence
- Constrained choices
- Credibility, decoupling of expectations from inflation
IT Mechanics

Anchored expectations as shock absorbers

Credibility, decoupling of expectations from inflation
HAVE WE GOT ENOUGH CREDIBILITY TO STOP THE SUFFERING?
Inflation highest on record for some EM ITers

Inflation difference
(percentage point, up = above target inflation)
Inflation highest on record for some EM ITers

Inflation (% YoY)

-3.0 2.0 7.0 12.0 17.0


Average Total
Average Advanced economies
Average Emerging market economies
Real int. rates extra and equally lose for AEs and EMs ITers
Credibility still historically high
Credibility dispersion chart

Credibility stock

Credibility = 0.8 * Credibility(-1) + (1 - 0.8) * exp(-0.97 * (Inflation(-1) - Target(-1)))^2
Credibility still historically high

Credibility index

- **Average Total**
- **Average Advanced economies**
- **Average Emerging market economies**
Similar experience in ‘07 and ‘20

Oil & Food Prices (normalized to 100)

Inflation rate (as a difference compared to inflation at the beginning of the crisis)

RIR level (norm to 0 at the beginning of the crisis)

Nominal interest rates (norm to 0 at the beginning of the crisis)
Hard targeting and high credibility seem to matter empirically
IT as a shock absorber

Unexpected change of policy rate and exchange rate between Jan and Sep 2020*

Unexpected change of policy rate and 1Y GS yield between Jan and Sep 2020*

Unexpected change of policy rate and 10Y GS yield between Jan and Sep 2020*

Depreciation
IT as a shock absorber

Unexpected change of policy rate and exchange rate between Jan and Sep 2020*

Unexpected change of policy rate and 10Y GS yield between Jan and Sep 2020*

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

- Medium-term inflation target
- Operational independence from fiscal
- Interest-rate based operational framework
- Policy driven by a forecasting system
- Flexible Exchange Rate
- Transparent communications

Success-full IT
Key ingredients of a successful IT regime

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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

*The Reserve Bank of Australia (RBA) announced yield curve control on March 19, 2020, during the height of the shutdowns. It targeted the then 3-year yield at 0.25%. They reduced this target on November 3, 2020 to 0.10% and changed to the 2.75% of April 21, 2024 note.

Australia 2.75% April 21, 2024 Yield

Reserve Bank of Australia'a Yield Curve Control Target
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Success-full IT
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
Cutting rates, when inflation is high

Target range 2002-2005 (as of 4/2001)
- Target 1998 6% +/- 0.5p.p. (as of 12/1997)
- Target 2000 4.5 +/- 1p.b. (as of 12/1997)
- Target 2001 3% +/- 1 p.p. (as of 4/2000)
- Point target 3% (as of 3/2004)
- Target 2005 2% +/- 1 p.p. (as of 4/1999)

A cut when inflation high

Point target 2% as of 3/2007

Source: Czech National Bank
...for being afraid demand may be far too weak in the future.
Recent Czech history much less impressive
Key ingredients of a successful IT regime and how to check them

- Medium-term inflation target
- Operational independence from fiscal
- Successful IT
- Interest-rate based operational framework
- Flexible Exchange Rate
- Policy driven by a forecasting system
- Transparent communications

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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.
Publishing key policy rate trajectories may help

Key policy rate, average, %

(3M PRIBOR v %)
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Success-full IT
Ex rate anchor leads to volatile movements of interest rates

Source: NBU
Average 40% depreciation a year
Long-term ex rate volatility much lower for floating currencies

<table>
<thead>
<tr>
<th>Country</th>
<th>Standard error of monthly 5Y exchange rate change over 2009(2004)-2021* (pp)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>56.1</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>50.5</td>
</tr>
<tr>
<td>Russia</td>
<td>44.3</td>
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<tr>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Georgia</td>
<td>24.9</td>
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<tr>
<td>Australia</td>
<td>24.0</td>
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<tr>
<td>Czech Republic</td>
<td>20.6</td>
</tr>
<tr>
<td>Poland</td>
<td>17.3</td>
</tr>
</tbody>
</table>

‘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,” ‘
USDIZN

1.6927 -0.0003 (-0.02%)

+/- 35%


OGResearch
Long-term ex rate volatility is correlated with int rate volatility since 2004.
Higher long-term ex rate volatility correlates with that of inflation

Output volatility increases with long-term exchange rate volatility.

More output growth volatility
But not with short-term volatility

High degree of short-term exchange rate management is associated with higher output 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-rulled 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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