

Central Banking when Credibility is at Stake

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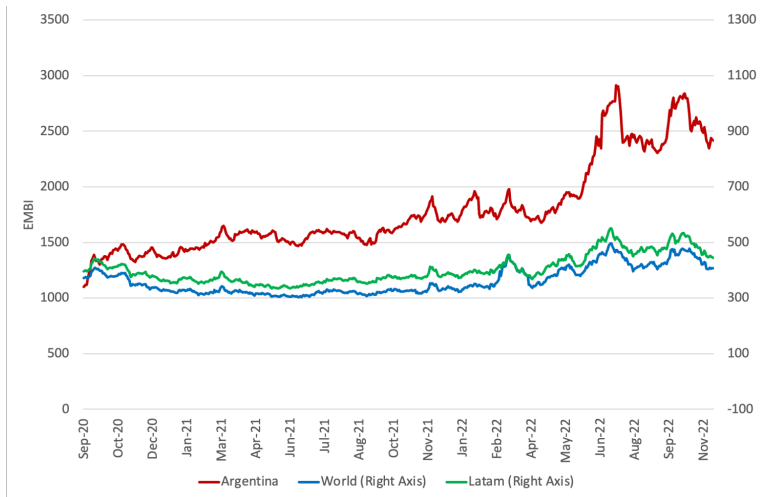
Kiev, November 2022

The costs of defaults

- Countries that default are typically not penalized
- Spreads increase 400bps first year, 250 second year, 0 afterwards
- Access is resumed after 0-2 years.
- Net borrowing is obtained after 5,5 years in the 80s, 4,1 years in the 90s and 2,5 years in the 2000's

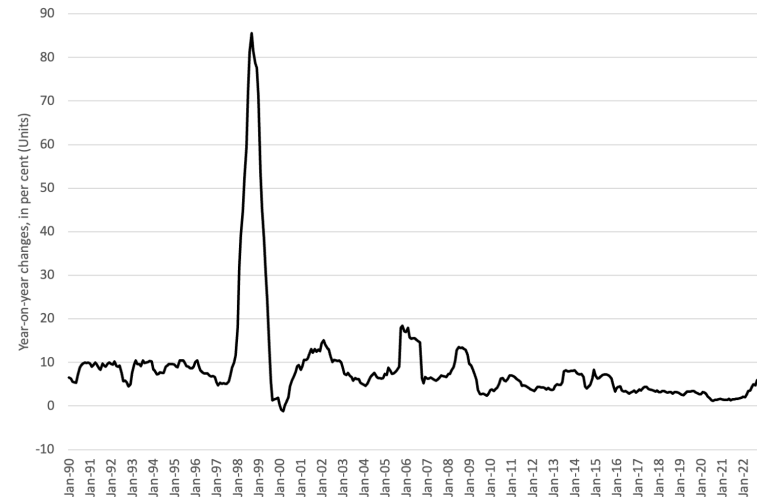
- Why is this?
- Grossman and Van Huyck (1988) coined the term "excusable defaults"
- An excusable default does not damage credibility
- Argentina is a counter-example

A non-excusable restructuring



- A similar concept may apply to IT...
- Visible shocks that induce the Central Bank to temporarily deviate do not necessarily damage credibility
- Indonesia's 2005 oil shock may be an example

Indonesia's temporary deviation



- After 40 years of success we believe IT is a sturdy, stable regime
- Theory says it is not:
 - Money is endogenous
 - This means there are multiple equilibria
 - Requires the Taylor principle to pin down a unique equilibria
 - And even then equilibria is pinned down because the dynamics are globally unstable

A Tale of Two Countries

- Is it possible to rescue IT once its credibility has been tampered?
- Argentina and Turkey couldn't

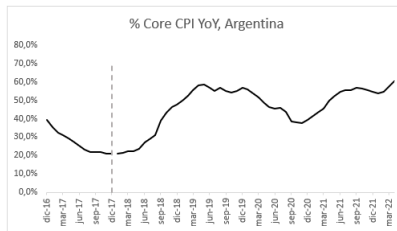
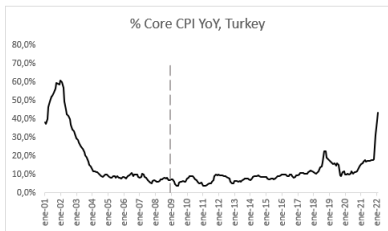
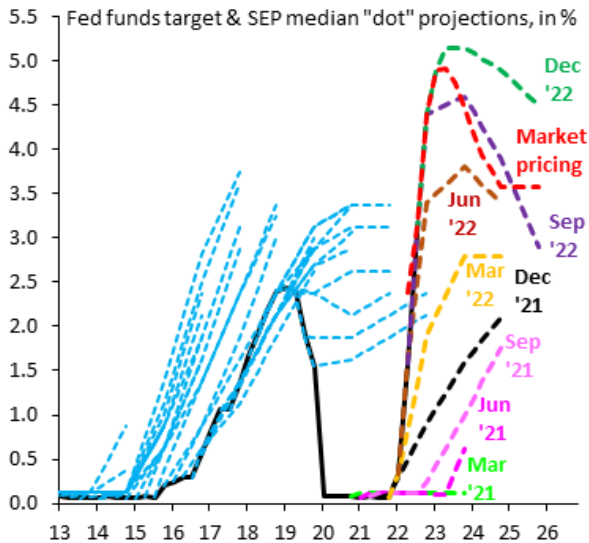


Figura: Turkey and Argentina

How about in the US...?



The unpleasant credibility arithmetic

- Once credibility is lost things get nasty
 - Increasing interest rates affects credibility not necessarily the right way
 - November 2017
 - April 2018
 - Fiscal monetary interactions start to become relevant
 - FX interventions only mess up things
 - FX shocks do not cause inflation if monetary policy is well anchored

How to keep credibility

- Do not look for other reasons (excuses) for inflation (continue in control)
- Keep the targets (even if you don't reach them)
- Keep conducting monetary policy consistently along the lines of IT
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- *"He that can have patience can have what he will."* Benjamin Franklin