Central Bank Credibility: From Faith to Experience

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*The views expressed are those of the speaker and not necessarily those of the BIS.

Saint-Thomas

"Unless I see the nail marks in his hands and put my finger where the nails were, and put my hand into his side, I will not believe.", John's gospel 20:25

Saint-Thomas and Otmar Issing

"Unless I see the nail marks in his hands and put my finger where the nails were, and put my hand into his side, I will not believe.", John's gospel 20:25

"There is nothing such as a track record.", Otmar Issing

Has the «Track Record/Credibility» of Inflation Targeting reached another Level?

- The anchoring of inflation expectations had been arguably a matter of faith

- The 2023-24 disinflation validates that Credible Inflation Targeting works
  The 2022-23 tightening have preserved a "low inflation regime ":
  "where inflation goes back to 2% predominantly through the anchoring of expectations"

- The new challenge is to monitor the credibility "capital" of central banks
  - Inflation at risk (Kilian&Manganelli and disciples; BIS Bulletin #28)
  - The cross-sectional moments of inflation expectations (Andrade et al)
    - Mean inflation expectations
    - Variance of inflation expectation (ie disagreement)
    - Skewness of inflation expectations or "inflation expectations at risk"
    - Conditional moments, the response of inflation expectations to shocks (ie fiscal, oil)

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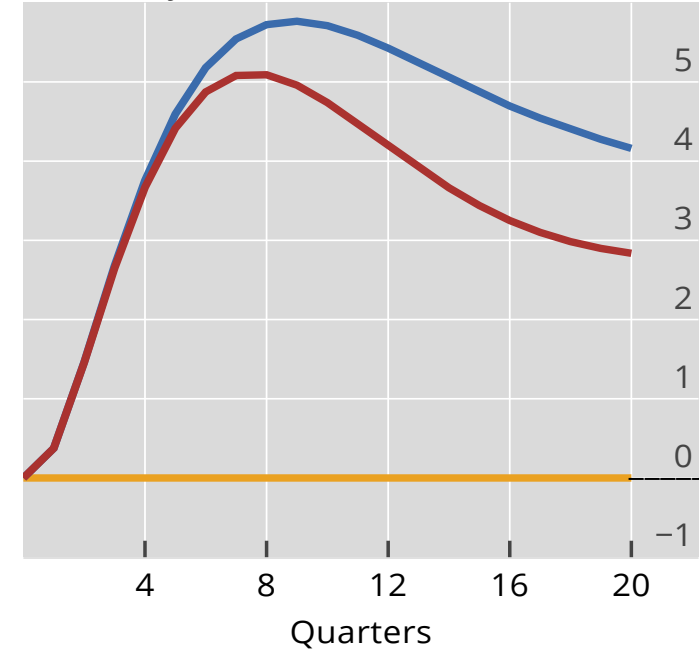# The Contribution of Monetary Policy to Disinflation
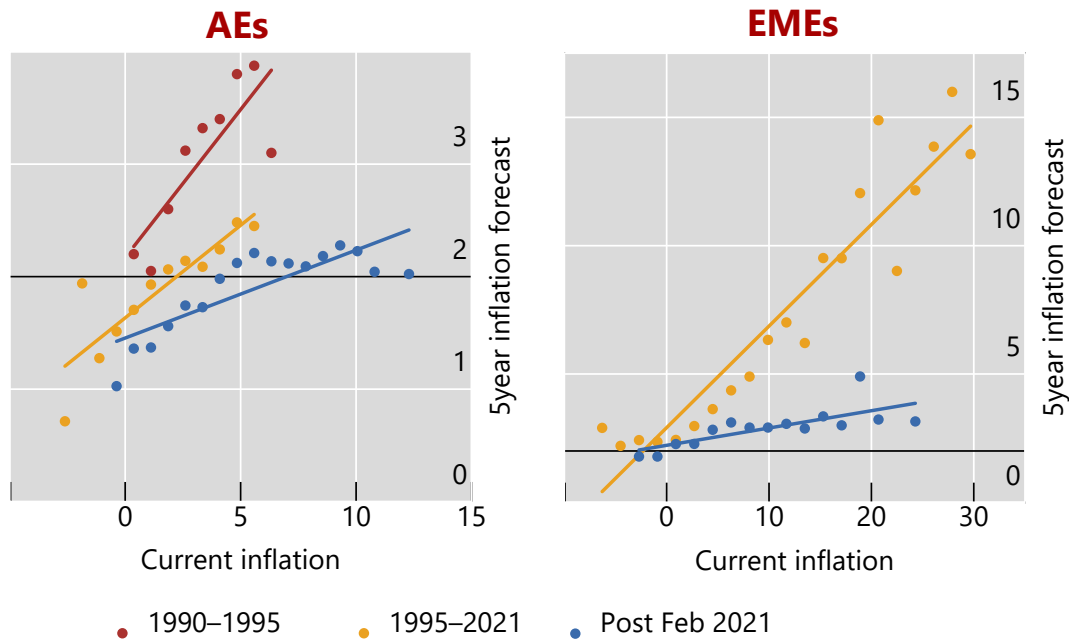

A. Unemployment
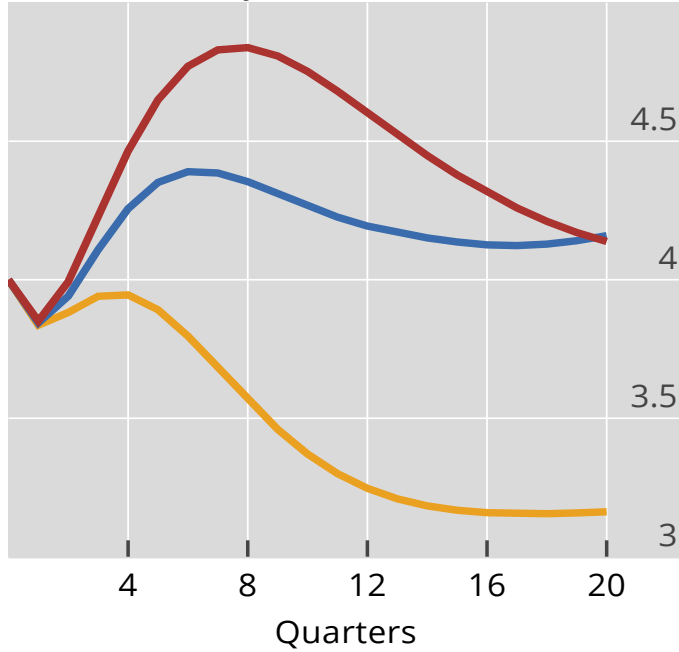
B. Core inflation
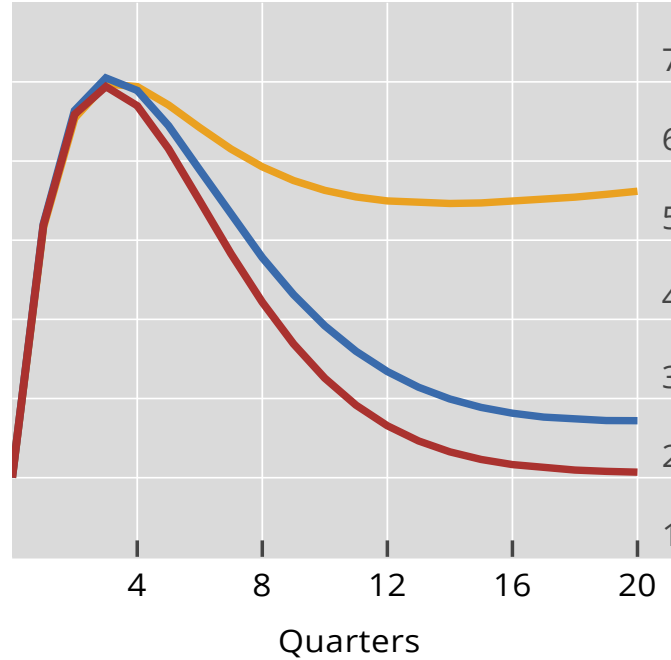
C. Policy rate

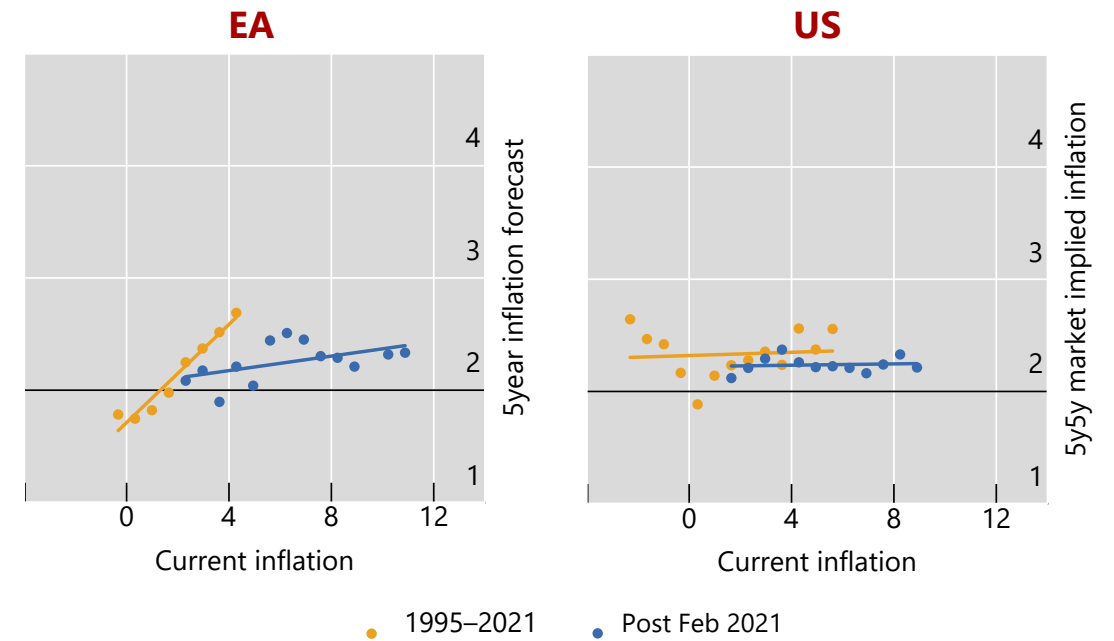— Anchored π*
— Learning on π*
— Learning on π*, no MP

Source: simulations reported in BIS bulletin #82, using Hofmann et al. (2021)

CB Credibility Test #1: Does Mean[E(inflation)] Respond to Inflation?

Sensitivity of 5y inflation forecasts to current inflation

Sensitivity of 5y5y market implied inflation to current inflation
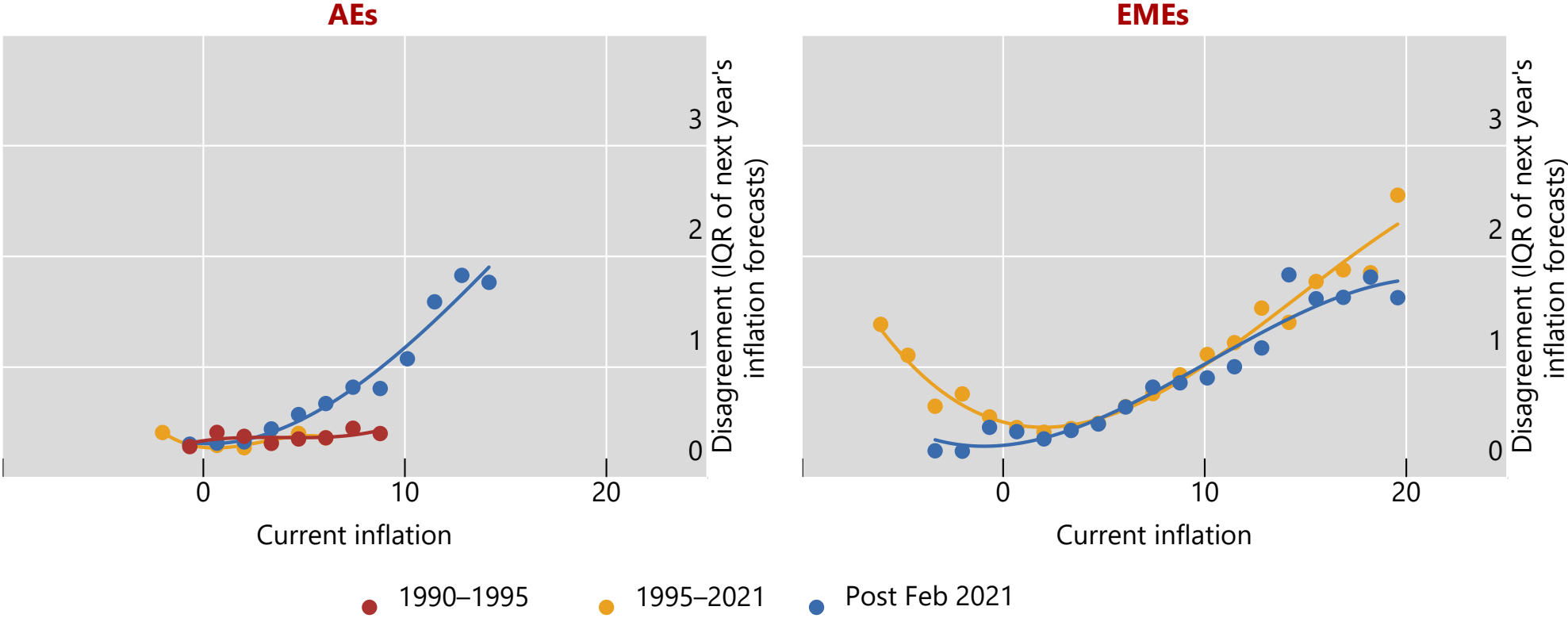

Dots show averages of 5-year ahead inflation forecasts from professional forecasters (y-axis) and the headline inflation rate (current inflation) at the time of the forecast (x-axis) in equally spaced bins of current inflation. Data pooled across advanced (AE) and emerging economies (EMEs) respectively

Dots show averages of 5-year, 5-year market implied inflation rates (y-axis) and the headline inflation rate (current inflation) at the time of the forecast (x-axis) in equally spaced bins of current inflation.

CB Credibility Test #2: Does Disagreement[E(inflation)] Respond to Inflation?

*Sensitivity of inflation forecast disagreement to current inflation*

Dots show averages of the interquartile range of 12-month ahead inflation forecasts from professional forecasters (y-axis) and the headline inflation rate (current inflation) at the time of the forecast (x-axis) in equally spaced bins of current inflation. Data pooled across advanced (AE) and emerging economies (EMEs) respectively
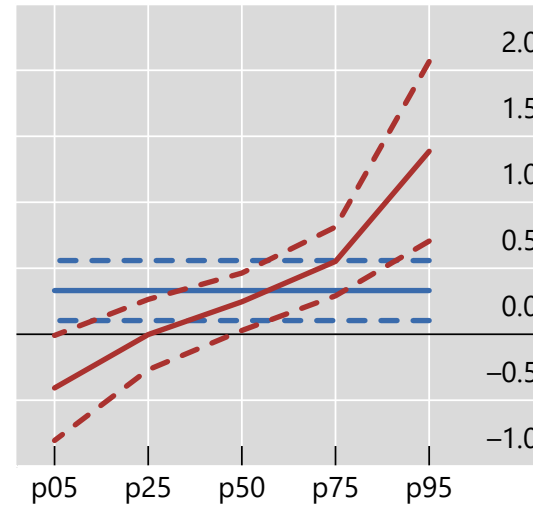
Do Inflation expectation and disagreement predict inflation (and its tails)?
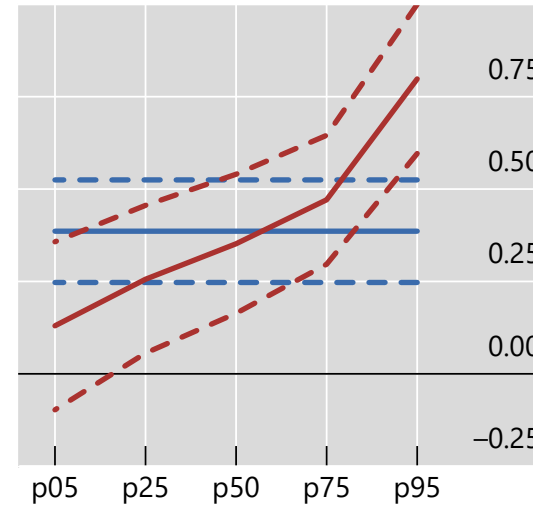
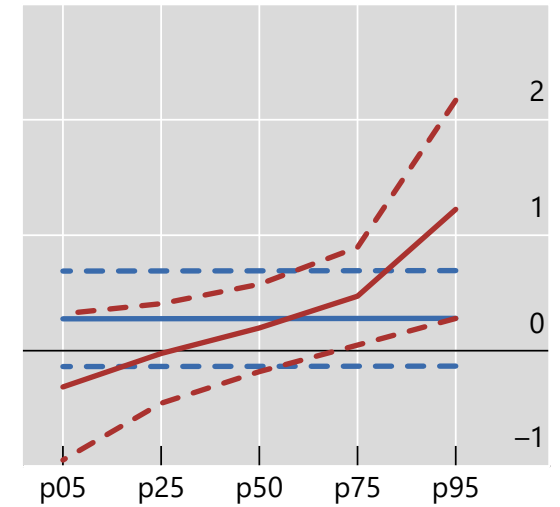## AEs

Inflation expectations
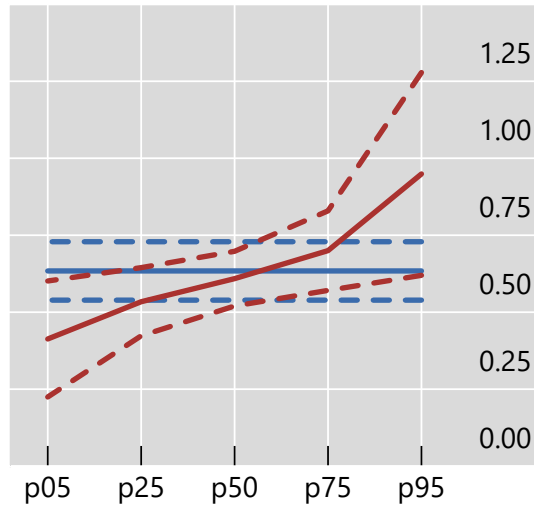
Inflation disagreement

EMEs

Inflation expectations

Inflation disagreement

Estimates:
— OLS regression
— Quantile regression

95% confidence interval:
- - - (blue)
- - - (red)

Panel OLS and quantile regression estimates from regressing headline inflation in month t+12 on period t Consensus inflation expectations, the log of the interquartile range of individual forecaster inflation expectations, output gap, log change in nominal effective exchange rate, log change in energy prices and country fixed effects. Bootstrapped standard errors clustered by country. See Banerjee et al (2024) for additional details (link).

Inflation and inflation expectations (mean and disagreement) in the euro area

Moments of euro area inflation expectations
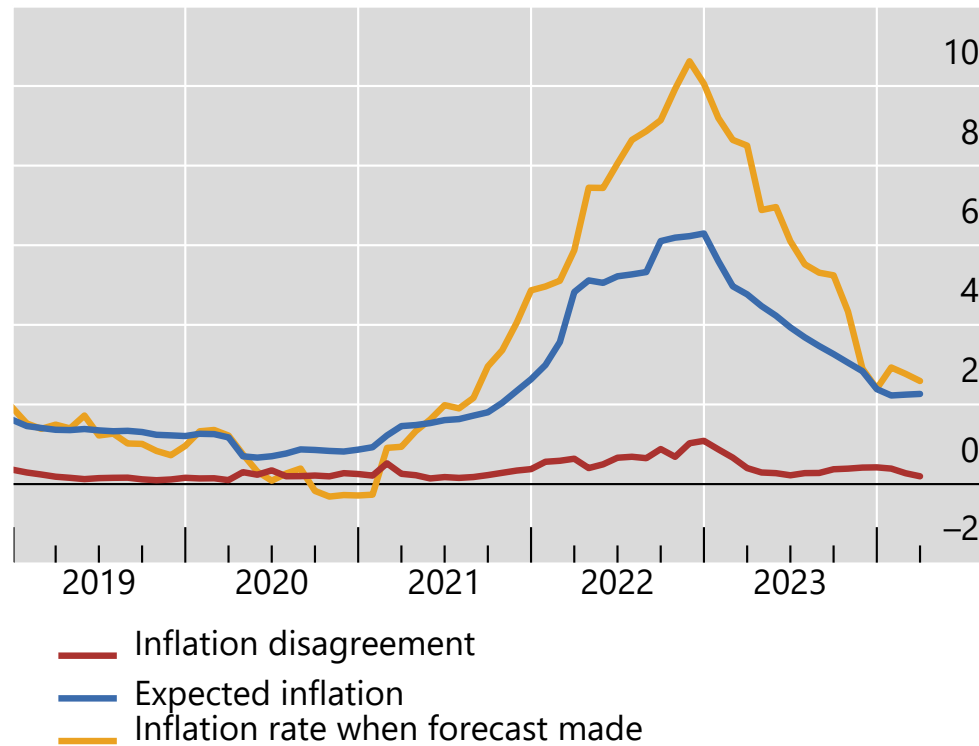
Moments and predicted inflation

Legend (left chart):
- Inflation disagreement
- Expected inflation
- Inflation rate when forecast made

Legend (right chart):
- Predicted inflation: baseline + disagreement
- Predicted inflation: baseline
- Headline inflation

Inflation disagreement = interquartile range of individual consensus forecasters. Expected inflation = consensus forecast. Baseline inflation predictions based o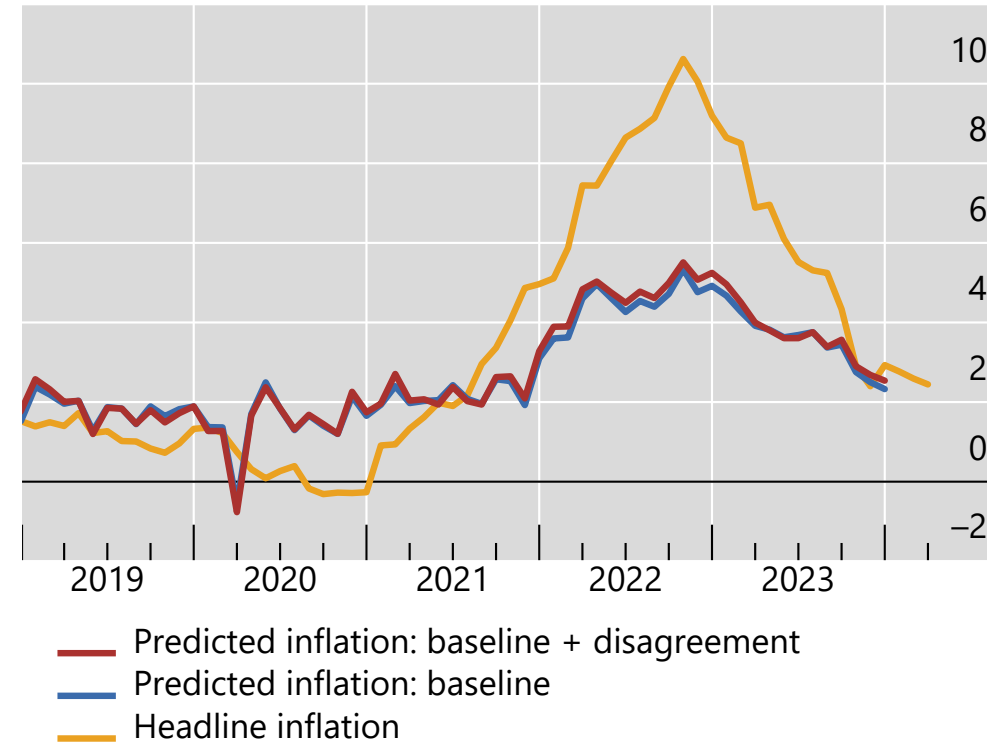n OLS panel regression regressing headline inflation in month t+12 on period t Consensus inflation expectations, output gap, log change in nominal effective exchange rate, log change in energy prices and country fixed effects. Baseline + disagreement also includes the log of the interquartile range of individual forecaster inflation expectations.

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Conclusions

- The credibility of inflation targeting in greatly reinforced by the 2023-24 disinflation

- The main challenge of monetary policy makers is to stay in a low inflation regime where inflation is returning to 2% through the expectation channel

- Research should focus on new leading indicators of low inflation regime "credibility"

  - The mean, variance and skewness of inflation expectations showed a potential deterioration of CB credibility in 1970s (Ricardo Reis) and in 2021-2022
  - 2023 has been much better than 1976 (thanks to higher real interest rates?)
  - 2024 and 2025, the jury is still out

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References

- The contribution of monetary policy to disinflation, BIS Bulletin #82

- "Inflation at risk from Covid-19" , BIS Bulletin #28

- The two-regime view of inflation, BIS Paper #133

- Andrade et al "Tails of Inflation Forecasts and Tales of Monetary Policy", BDF WP (2012)

- Hofmann et al "Fiscal and monetary policy interactions in a low interest rate world", forthcoming IJCB

- Kilian&Manganelli, "The central banker as a risk manager: Estimating the Federal Reserve's preferences under Greenspan" JMCB (2008)