Discussion of:

*Central Bank Credibility: Insights from an Historical and Quantitative Exploration*

M. Bordo

Tommaso Monacelli - Bocconi University, IGIER and CEPR

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Paper: two parts

1. **Pre-crisis**
   - IT successful in achieving low inflation
   - Pendulum
   - IT especially effective in EMEs
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1. **Pre-crisis**
   - IT successful in achieving low inflation
   - Pendulum
   - IT especially effective in EMEs

2. **Post-crisis**: challenges for the future
   - Will CBs continue to have credibility for low inflation?
IT and emerging markets: Peru
Inflation target and inflation expectations: Peru

Source: Consensus forecast.
Challenges

1. Financial crisis forced CBs to focus on financial stability and/or LLR
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2. Non-conventional policies like QE have softened boundaries btw. monetary and fiscal authorities → Challenge for independence
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**Conclusions**

1. Caution as to whether CBs should take on broader responsibilities for financial stability.
Bordo and Siklos "consensus"

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▶ **Conclusions**

1. Caution as to whether CBs should take on broader responsibilities for financial stability

2. Financial stability policies **might impinge on CBs mandate** for low and credible inflation
The elephant in the room
The Zero Lower Bound
Estimated natural rate of interest (annual rate)

Percentage pts

Note: Blue shaded areas represent the range of possible estimates with 70% (darker) and 90% (lighter) probability. Gray bar indicates NBER recession dates.

Source: Curdia (2015), Curdia, Ferrero, Ng and Tambalotti (2015)
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- Still hinge on credibility: requires CB to commit to future "inflationary boom"
- Time inconsistent
Is "credibility for low inflation" a blessing or a curse?
Higher inflation in normal times to avoid liquidity traps

1. Higher inflation can act as a buffer (Blanchard et al 2010, Ball 2014, Fed President Rosengren April 2015)
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   - Coibion, Gorodnichenko and Wieland (2013): optimal size of "inflation buffer" is small
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2. **Signaling**: inflation as a means to **strengthen** the credibility of FG policies
Higher inflation in normal times as a signaling device

- Suppose environment with **asymmetric information**: agents do not know CB type (flexible IT or conservative?)
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Increasing inflation ex-ante can be only available tool to achieve a separating equilibrium (Barthelemy and Mengus, 2016)
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→ Increasing inflation ex-ante can be only available tool to achieve a **separating equilibrium** (Barthelemy and Mengus, 2016)
In other words: aim at **higher (relative) inflation ex-ante** to achieve credibility ex-post → Higher inflation during normal times can be used as a signaling device.
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**ECB asymmetric** inflation target
Should We Care About Financial Stability?
A tale about "stress" and a typical "household evening"

A typical shock
Scenario 1: tranquil times
Scenario 1: tranquil times
Scenario 2: crisis times
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Why such a different reaction?
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The underlying level of "stress"
The need of non-linear models

- Financial fragility ("stress") accumulates slowly in normal times ("Great Moderation")
The need of non-linear models

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► It does not take large shocks to generate large recessions
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The need of non-linear models

- **Financial fragility** ("stress") accumulates slowly in normal times ("Great Moderation")
- It does **not** take **large** shocks to generate **large** recessions
- A typical ("normal") shock interacting with **high** financial fragility $\rightarrow$ **crisis**
- Foundation for **macroprudential** policies