

Discussion of:  
*Central Bank Credibility: Insights from an  
Historical and Quantitative Exploration*  
M. Bordo

Tommaso Monacelli - Bocconi University, IGIER and CEPR

*Suerf Conference - Bocconi , 14 April 2016.*

# Paper: two parts

## 1. **Pre-crisis**

- ▶ IT successful in achieving low inflation
- ▶ Pendulum
- ▶ IT especially effective in EMEs

# Paper: two parts

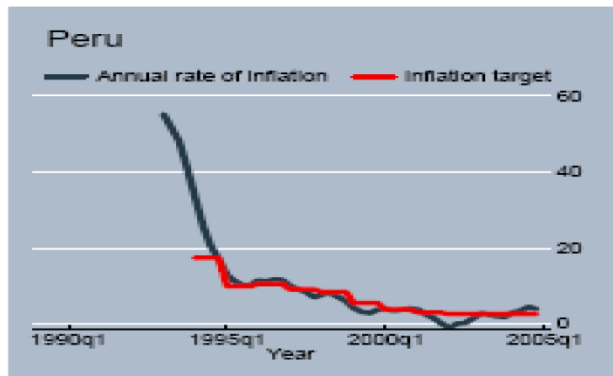
## 1. **Pre-crisis**

- ▶ IT successful in achieving low inflation
- ▶ Pendulum
- ▶ IT especially effective in EMEs

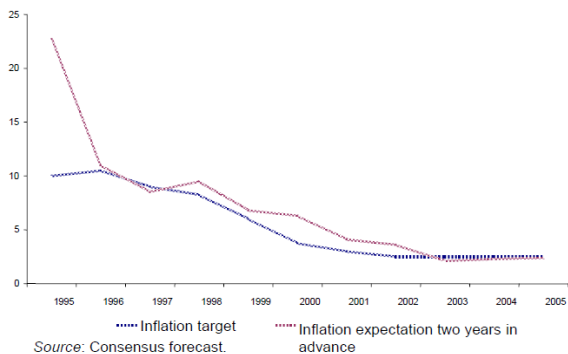
## 2. **Post-crisis**: challenges for the future

- ▶ Will CBs continue to have credibility for **low** inflation?

## IT and emerging markets: Peru



# Inflation target and inflation expectations: Peru



# Challenges

1. Financial crisis forced CBs to focus on **financial stability** and/or LLR

# Challenges

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

# Bordo and Siklos "consensus"

1. Through the crisis **nominal anchor has held** and inflation has been low and stable



## Bordo and Siklos "consensus"

1. Through the crisis **nominal anchor has held** and inflation has been low and stable
2. Financial crises can lead to credibility losses but **not** for all CBs

→When CBs perform well in terms of credibility, they respond to financial conditions

# Bordo and Siklos "consensus"

1. Through the crisis **nominal anchor has held** and inflation has been low and stable
2. Financial crises can lead to credibility losses but **not** for all CBs

→ When CBs perform well in terms of credibility, they respond to financial conditions

## ► **Conclusions**

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

## Bordo and Siklos "consensus"

1. Through the crisis **nominal anchor has held** and inflation has been low and stable
2. Financial crises can lead to credibility losses but **not** for all CBs

→When CBs perform well in terms of credibility, they respond to financial conditions

### ► **Conclusions**

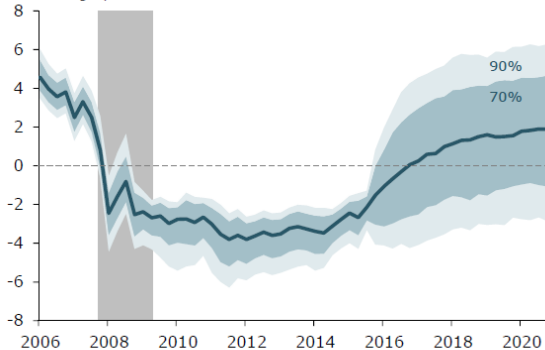
1. Caution as to whether CBs should take on broader responsibilities for financial stability
2. Financial stability policies **might impinge on CBs mandate** for low and credible inflation

- ▶ 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)

- ▶ Monetary policy tool extensively used at the ZLB: **forward guidance**

- ▶ Monetary policy tool extensively used at the ZLB: **forward guidance**
- ▶ Still hinge on **credibility**: requires CB to commit to future **"inflationary boom"**



- ▶ Monetary policy tool extensively used at the ZLB: **forward guidance**
- ▶ 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)

# 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)
  - ▶ Aruoba and Schorfheide (2013): recovery from Great Recession in US would have been a year shorter if Fed had targeted 4% inflation
  - ▶ Coibion, Gorodnichenko and Wieland (2013): optimal size of "inflation buffer" is small

# 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)
  - ▶ Aruoba and Schorfheide (2013): recovery from Great Recession in US would have been a year shorter if Fed had targeted 4% inflation
  - ▶ Coibion, Gorodnichenko and Wieland (2013): optimal size of "inflation buffer" is small
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?)

## Higher inflation in normal times as a signaling device

- ▶ Suppose environment with **asymmetric information**: agents do not know CB type (flexible IT or conservative?)
- ▶ Time inconsistency problem particularly acute for **conservative** CB: difficult to "commit to being irresponsible" if pursued IT earlier

## Higher inflation in normal times as a signaling device

- ▶ Suppose environment with **asymmetric information**: agents do not know CB type (flexible IT or conservative?)
- ▶ Time inconsistency problem particularly acute for **conservative** CB: difficult to "commit to being irresponsible" if pursued IT earlier
- ▶ Any CB that wants to be credible in committing to future inflation (at the ZLB) has incentive to be distinguished from the conservative CB



## Higher inflation in normal times as a signaling device

- ▶ Suppose environment with **asymmetric information**: agents do not know CB type (flexible IT or conservative?)
- ▶ Time inconsistency problem particularly acute for **conservative** CB: difficult to "commit to being irresponsible" if pursued IT earlier
- ▶ Any CB that wants to be credible in committing to future inflation (at the ZLB) has incentive to be distinguished from the conservative CB

→ 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

- ▶ 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
- ▶ 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





## Scenario 2: crisis times





## Why such a different reaction?



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

- ▶ **Financial fragility** ("stress") accumulates slowly in normal times ("Great Moderation")
- ▶ It does **not** take **large** shocks to generate **large** recessions

# 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 → **crisis**

# 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 → **crisis**
- ▶ Foundation for **macroprudential** policies