

# **“Lack of Credibility, Inflation Persistence and Disinflation in Colombia”**

González and Hamann (2006)

Discussion by  
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# Outline

- Main ideas
- Methodology
- Results
- Policy discussion

# Main Ideas (1)

- Main source of inflation persistence in Colombia has been the ***inability of the central bank to anchor inflation expectations***
- Inflation persistence can vary with the stability and transparency of the monetary policy regime
- Agents learn gradually about the permanence of the inflation target shocks

## Main Ideas (2)

- First, credibility falls (or was already low?) because the central bank fails to meet its targets
  - Lack of credibility because of previous macroeconomic imbalances (high inflation). Many previous attempts to curve inflation down
- Then, credibility should increase when the central bank starts meeting the target (persistence should fall)
- Did the central bank know the inflation target? Was it a problem of communicating it? Or, indeed, lack of credibility?

# Objectives

- Main Question:
  - Does lack of credibility account for the observed disinflation process in Colombia?
- Other Questions:
  - Tests between “ad-hoc indexation” model or “lack or credibility” model to explain inflation persistence
  - How costly has been to disinflate without well anchored expectations?

# Methodology (1)

- Measure of inflation persistence:
  - Trend and persistence are modelled simultaneously (+)
  - Smooth trend (+)
  - Do not consider time varying persistence (-)
- The model: Standard New Keynesian
  - To induce persistence, imperfect information is introduced (rather than an ad-hoc indexation) (+)

$$u_t = \beta \left( E_t \pi_{t+1} - \hat{\pi}_{t+1} \right)$$

## Methodology (2)

- The inflation target varies over time due to a combination of a white noise shock and a shock with permanent effects on the inflation target

$$u_t = (1 - \kappa)u_{t-1} + (1 - \kappa)\eta\varepsilon_t^p$$

- The lower the speed of learning, the more persistence is inflation

# Methodology (3)

## On the Bayesian method:

- Usual comment: suitability of priors
- Well justify use of priors: existing literature
- More specific:
  - The learning parameter  $k$  is assumed as in US where there is no lack of credibility
  - Posterior distribution indicate  $k$  indeed around zero. But lack of credibility means learning at a low speed (not zero)
  - Besides,  $k$  might be time-varying



# Results

- Active central bank when responding to deviations from long run inflation and a passive one when responding to output:
  - Authors suggest, that due to lack of credibility, the central bank responds more to inflation...but, could it not be the other way round?
- The main source of inflation persistence in Colombia is the speed of learning. Agents learn at a very slow pace:
  - Are Colombians skeptical in nature?. This is associated to a long and gradual disinflation process
- The slower the speed of learning the greater the output costs and the effort of monetary policy

# Policy Discussion

- Was is lack of credibility what prevented monetary policy to anchor expectations or fiscal imbalances?
- Trade-off between disinflating at a speedier pace and output and social costs
  - It is a policy decision
  - The learning speed is endogenous: unobserved components subject to regime switching
- The lower the speed of learning the greater the output costs and the effort of monetary policy
  - Association to central government and fiscal deficit
  - Previous unstable scenarios, makes learning harder