

Discussion of “Are Long-Term Inflation Expectations Well Anchored in Brazil, Chile, and Mexico?”*

Refet S. Gürkaynak
Bilkent University

Emerging-market economies (EMEs) and developed economies are often studied using different tools either because of data limitations for EMEs or because economists think of applying state-of-the-art methods only to developed economies. This paper notes that many EMEs by now have a substantial history with good data, especially for financial markets, and the authors apply cutting-edge methods that were in the recent past used to study U.S., euro-area, and similar economies to the study of inflation expectations in Brazil, Chile, and Mexico. Showing that one can use the same methods in the applied study of macroeconomic phenomena in developed and emerging economies is in itself important, and this paper does that very well. The paper has a refreshing change of focus from the usual set of countries that are studied for anchoring of inflation expectations and clearly shows that we do not have to give up methodological rigor when doing empirical work on emerging-market economies.

The literature of market-based measurement of the anchoring of inflation expectations is quite new, dating back to the very important work of Ellingsen and Söderström (2001), who developed the theory behind the current applications. Ellingsen and Söderström showed that the yield curve will react to monetary policy surprises with a change in slope if the surprise is interpreted by financial market participants as conveying information about the state of the economy but that there will be a level shift if the surprise is

* Author contact: Bilkent University, Department of Economics, 06800 Bilkent, Ankara, Turkey; e-mail: refet@bilkent.edu.tr.

interpreted as signaling information about the preferences of the policymakers. This is very intuitive: if financial market participants interpret a policy surprise as informative about the state of the economy, their beliefs about the steady state are unchanged but interest rate expectations for the near future are updated, leading to constant far-future forward rates and updated short-term rates, which leads to a change in the slope of the yield curve. But if the surprise is interpreted as informative about the central bank's preferences, then beliefs about the steady state are updated based on the new perception of policymaker preferences, which changes the far-forward rates as well.

This intuition was used in subsequent work for many developed economies by observing that if inflation expectations are well anchored, far-forward rates should be unresponsive to news about the current state of the economy. This news may be policy surprises or inflation announcements or employment news. If the public perception of the inflation target and the credibility of the central bank to reach that target are unchanging, steady-state expectations of inflation will be constant and asset prices that depend on that expectation will be unresponsive to all news. It is even better to use inflation-indexed and nominal yields together in analyzing whether this is the case, as current news may be informative about the long-run growth rate of the economy, which may change real interest rate expectations far into the future. Hence far-forward inflation compensation, the difference between nominal and indexed forward rates, is the usual object of interest.

The analysis of sensitivity to news of far-forward inflation compensation was done for advanced economies, and the results had contributed to the debate on whether the United States should have an inflation target and whether small open economies can follow sufficiently independent monetary policies that would successfully anchor inflation expectations around an inflation target. This paper applies that state-of-the-art methodology to emerging-market economies. The findings are not very surprising but important nonetheless. In all three countries long-run inflation expectations are quite successfully anchored. In fact, a casual look at the emerging-markets data suggests that actual and expected inflation have come down remarkably in all emerging markets (not only the three under study here) between 1995 and 2005.

The sample in this paper starts at about 2000, but inflation and its expectations had come down and stabilized in most countries by this time. Indeed, the paper finds that inflation expectations were anchored in both the early and the late parts of the sample under study. Hence we do not learn from the paper when this stabilization happened. More importantly, we do not learn why it happened.

This question is beyond the scope of the paper but is of primary importance. The earlier literature using the event-study methodology in far-forward inflation compensation rates had big-picture arguments such as whether inflation targeting is effective and whether the United States incurs costs of not having an inflation target (at the time). This paper documents the fact that inflation expectations are now anchored in three emerging-market economies but does not tell us why inflation came down around the globe in EMEs beginning about 1995 or what policies and political economy concerns/actions were instrumental in making this very welcome change from decades of high and volatile inflation—and the associated unanchored inflation expectations—in these countries.

In that sense this paper is an important first step in the study of EME inflation and inflation expectations. It documents a fact but does not attempt to explain it. It is extremely important to have a good understanding of how and why inflation was brought under control in EMEs and what institutional and policy factors helped anchor inflation expectations in these countries. Only then can we feel secure that the right policy prescriptions should inflation creep up and inflation expectations become unhinged in these countries again.

References

- Ellingsen, T., and U. Söderström. 2001. "Monetary Policy and Market Interest Rates." *American Economic Review* 91 (5): 1594–1607.