

Comment on

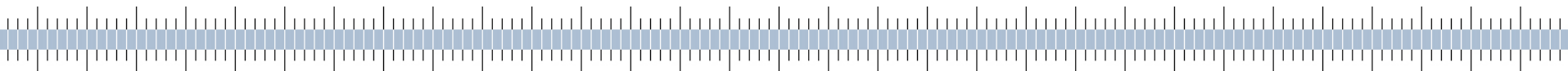
Inflation Expectations of Experts and ECB Communication

by
Katrin Ullrich

Christina Gerberding
Deutsche Bundesbank

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Mannheim



Main results

Paper investigates influence of ECB communication on short-term inflation expectations

If real-time data problems are accounted for, there is

a measurable positive influence of the wording indicator on inflation expectations

accompanied by an opposite effect of interest rate decisions

Interpretation

Positive impact of wording on inflation expectations implies that agents believe the inflation risks are identified and communicated by the central bank

Negative impact of changes in interest rates implies that agents believe risks will be counteracted by central bank and that policy changes will have first effect on inflation within relevant time horizon (?)

In short: words as well as deeds of Governing Council are credible and well understood by financial market experts!

General assessment

Agree that influence of monetary policy – words and deeds – on private sector expectations – is an important topic

Article on information content of survey data on private sector inflation expectations for monetary policymakers in Bundesbank, Monthly Report October 2006

Agree that link between central bank **communication** and **private sector inflation expectations** is not well investigated so far, in particular with regard to euro area

Agree that use of revised data to uncover the determinants of expectations formation is problematic - paper should focus on use of real-time data!

However: I have a couple of questions/doubts, especially on

the link between the theoretical model and the empirical model

the construction of the wording indicator

the estimation results

Theoretical model

Transformation of the theoretical model (Eq (1)) into the empirical model is far from straightforward and relies on a number of strong assumptions

for instance, disregarding unity coefficients implied by Eq (1)

approximating current period expectations for inflation five months ahead by six-month-ahead expectations formed one period before etc.

Furthermore, forward-looking rather than backward-looking version of the model should be used

Why? Evidence that euro area inflation is characterized by relatively low degree of intrinsic inertia; see Gali et al. (2001), Smets and Wouters (2003), ECB (2005), Stracca (2006)

Treating private sector expectations as adaptive is at odds with both

the idea that CB communication influences private sector expectations

the fact that the equation for expectations in the empirical model has a forward-looking dimension (allows for adjustment of expectations towards the subsequently realized outcomes)

Data issues

Inflation expectations based on qualitative data from ZEW Financial Market Survey

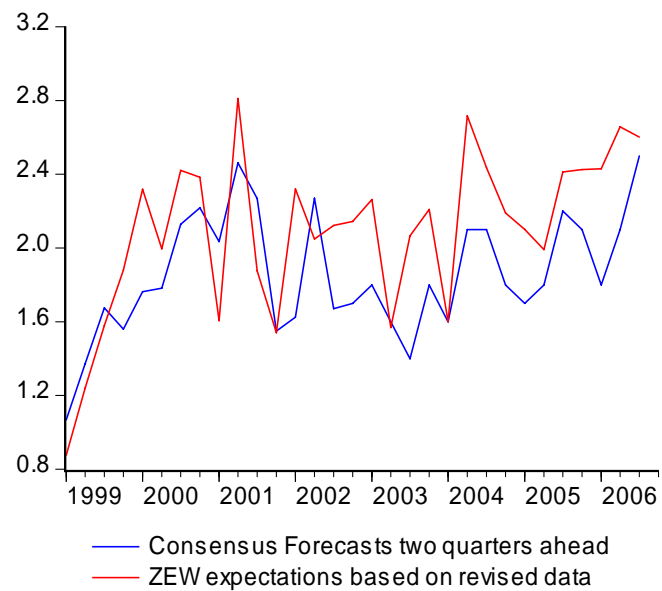
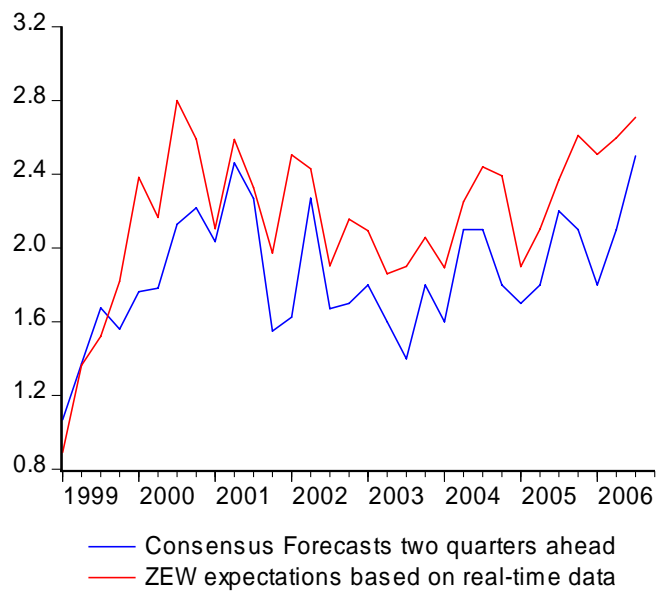
Question refers to the expected change in the rate of inflation

Derivation of level of inflation expectations from these data relies on the assumption that experts' perceptions of current inflation match actual rate of inflation (real-time or revised?)

Comparison with two-quarter-ahead Consensus forecasts of euro area inflation

Data issues, cntd

Consensus Economics and ZEW Survey Data on Inflation Expectations



Data issues, cntd

Wording indicator based on two-year period 1999-2000

but Governing Council never committed to the use of specific „code“ words!

Informational content of wording may well have changed over time; for instance, Trichet may be using other wording than Duisenberg

Further problem: Wording indicator constructed to proxy increasing „hawkishness“ of ECB rhetoric

thus, in keeping with medium-run nature of Eurosystem strategy, it should signal increasing upward risks to medium-term price stability

but here used as an indicator of ECB communication on shorter-term risks to price stability

Might be worthwhile to construct an indicator that is more tailored to communication on these risks

Estimation results

Whether survey expectations and subsequently realized inflation are cointegrated should be tested rather than assumed

Stracca (2006) finds that euro area inflation and inflation expectations are stationary for post-1986 samples; Gerberding (2006) finds 2 cointegrating equations in models for Germany, France, Italy (sample period 1990-2006)

What would that mean for the model considered here?

Test whether constant in the cointegration equation can be restricted to zero

Focus should be on real-time data and out-of-sample analysis (also most promising results!)

Might be worthwhile to repeat the analysis with full real-time data set (should be available from EABCN)

