Inflation Targeting, Expectations and Uncertainty in Monetary Policy

Finance a úvěr – Czech Journal of Economics and Finance published since 1997, approximately twice a year, an issue focusing on a single topic. One of the first issues of the sort was the package of papers in No. 4, 1998, engaging in a then new monetary framework of the Czech economy – inflation targeting. At that time, inflation targeting was a new phenomenon and a hot topic in macroeconomic literature. The Czech National Bank became pioneers of inflation targeting, at least in countries that are marked as transitional or emerging-market economies. The goal of the issue from 1998 was to provide a general introduction to inflation targeting and discuss its applicability to the Czech Republic and similar economies. Many of the people who participated in this issue, such as authors or editors, subsequently were or currently are influencing fundamentally the course of the Czech monetary policy.

During the next seven years inflation targeting in the Czech Republic went through a dynamic progression and as such was labelled as fully-fledged inflation targeting. In other words, the use of the regime in the Czech Republic does not differ much from the ones in the United Kingdom, Sweden, New Zealand or Canada. The Czech National Bank, the same as the central banks in these countries, strives for maximum credibility that is based on transparency, consistency and predictability of the policy. Given that, the authors of this single-topic issue do not have to deal with general questions of policy based on inflation targeting. Instead, they can afford to focus on detailed and specific features of the inflation targeting framework.

The paper written by K. Šmídková *"How Inflation Targeters (Can) Deal with Uncertainty"* comes out of the assumption that central banks targeting inflation have a need for a well-designed methodology for dealing with uncertainty in policy-making. The reasons are the forward-looking nature of monetary policy and the necessity of being able to explain the implications of uncertainty to the public. The central banks, up to now, have neglected this area a bit. It is rather easy to find the description of the forecasting models of central banks on their web sites. On the contrary, an exact delineation of the framework for dealing with uncertainty is not so easy to find. The author thus proposes, as one of the possible solutions, a comparative framework based on the description of the methods available to deal with uncertainty for each element of the interest rate decision-making process. Such a general framework may encompass the disadvantages of the individual methods that can differ quite substantially.

V. Kotlán and D. Navrátil in the paper *"Is the CNB Predictable?"* analyze the predictability of the Czech National Banks' decisions on the changes in the monetary policy interest rate setting. They conclude that on average the interest changes are predictable. That holds especially for interest rates with longer maturities that may serve as an indicator of the expected future direction of interest rates. The analysis also suggests that predictability increases with time.

M. Fukač in his contribution *"Inflation Expectations in the Czech Interbank Market"* looks at the characteristics of surveys of inflation expectations carried out by the Czech National Bank. One of the conclusions states that the surveys fail to forecast future inflation, but they have a predictive power for interest rates and that they do not statistically differ from market expectations. Along with these results, the author articulates a number of questions related to dealing with the expectations of private agents in macroeconomic models and in the analyses of the optimal monetary policy.

T. Holinka in the paper *"Faktory ovlivňující dlouhodobé úrokové sazby v ČR" (The Determinants of Long-Term Interest Rates in the Czech Republic)* quantifies the factors behind changes in Czech long-term interest rates and separates the nominal and real components of the movements. The paper is a reflection of the major decline in the interest rate differential between the Czech and the Euro area markets in 1999–2002. The conclusion is that the drop in Czech long-term rates is due to the decline in relative inflation premium and also due to the moderation of inflation expectations. At the same time, the fall in the interest rate differential can hardly be attributed to the changes in the Czech real interest rates.

J. Filáček deals similarly to the paper by M. Fukač with the role of the expectations in monetary policy. The paper *"Inflační očekávání v měnové politice"* (*Inflation Expectations in Monetary Policy*) emphasizes the impact of interest rate formation on the economy's behaviour and monetary policy performance. In a model of inflation targeting in a small open country, the economy is exposed to bunch of shocks and its reaction is described depending on whether the inflation expectations are formed in a naive, adaptive or rational way. From a monetary policy perspective, only expectations shaped in a rational style have potential to deliver the optimum results. The materialization of this particular state depends to a large extent on the way in which monetary policy is conducted, i.e. on its credibility, transparency and predictability.

Jan FRAIT
issue editor