# How important are inflation expectations in driving Asian inflation?

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We cannot overemphasize that inflation expectations play an important role in the conduct of modern monetary policy. A wide range of agents' decisions on saving, spending, and investing are influenced by expectations about future inflation. Central banks (CBs) track and compare them to internal forecasts and to the inflation target to check whether monetary authorities are able to influence them successfully. However, to be able to influence them with any degree of certainty, it is important to understand how expectations are formed.

The public's inflation expectations, I submit, are determined to a large extent by the way central banks conduct and communicate their monetary policy. Under inflation targeting, inflation expectations are linked strongly with the announced monetary policy objective, i.e. the inflation target. There is in fact some evidence that private sector inflation expectations have converged increasingly around the inflation target in many emerging economies (including the Czech Republic, Colombia, Mexico, and South Africa)[2] as the inflation target provided considerable information on the expected disinflation path while serving as an important commitment device. This helps shape inflation expectations.

In the Philippines, we have attempted to quantify the expectations channel.[3] Using a reduced-form equation model of survey-based inflation expectations, we found that the current actual inflation and the inflation target appeared to be significant in driving expectations. This implies that private agents assess the credibility of the Bangko Sentral and form their expectations based on what they have learned during the current period, and are similarly interested in the declining medium-term path of the inflation target as announced by the Bangko Sentral. At the same time, the significant impact of the real policy rate on inflation expectations reinforces the view that current monetary policy actions are effective tools for sending a clear signal on the central bank's future actions, thus influencing inflation expectations. However, results also indicated that inflation expectations in the Philippines remain backward-looking.[4]

We believe that imperfect information on the Bangko Sentral's policy intentions has been a source of inertia in the formation of inflation expectations. At the same time, imperfect knowledge of the market's inflation expectations can impart inertia to monetary policy responses.[5] Thus, it is important to factor into the monetary policy process an accurate measure of how inflation expectations are formed in the market. This is quite tricky because there are various measures of inflation expectations, including forecasts of professional economists, results from surveys of consumers, and information extracted from financial markets, which can provide different views about future outcomes. Likewise, these views can

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1 Deputy Governor, Bangko Sentral ng Pilipinas.

2 Madhusudan Mohanty and Philip Turner: "Monetary policy transmission in emerging market economies: what is new?" BIS background paper to Transmission mechanisms for monetary policy in emerging market economies (BIS paper no 35), January 2008.

3 Veronica Bayangos, Joselito Basilio, Danvee Floro and Eloisa Glindro, "Quantifying the inflation expectations channel in the Philippines: some preliminary results", Bangko Sentral ng Pilipinas (unpublished), 2010.

4 Current inflation Granger causes inflation expectations up to six months, while the opposite does not hold true.

5 Bayangos, et al., 2010.

reflect not only differences in economic agents' knowledge of the economy, but also errors due to information set construction and depth of financial markets. In economies with relatively sophisticated financial markets, inflation-indexed bonds are a key source of information on inflation expectations. By contrast, CBs in emerging markets have tended to rely more on survey-based measures of inflation. However, little is known about how respondents interpret survey questions, how their backgrounds affect their interpretations, and how their interpretations eventually influence their responses.[6] That various measures can provide different views on future inflation and that these divergent views could be due to factors other than the structure of the economy suggests that the anchoring of inflation expectations could be a challenge for monetary authorities.

These forecast disagreements will be the subject of Professor Pierre Siklos' presentation. In particular, his paper will explore the behavior of inflation forecasts from a variety of sources with the aim of measuring the size and evolution of forecast disagreements and their proximate sources. Prof. Siklos also looks at the role played by domestic and international shocks on changes in inflation forecasts, and whether developments since the global financial crisis have resulted in noticeable changes in the behavior of inflation expectations.

Like most modern CBs, the Bangko Sentral closely tracks inflation expectations and monitors their consistency with our policy objectives. One indicator we look at is the yield curve, which provides information on expected inflation based on the price of financial market assets. Likewise, we utilize survey-based measures of inflation expectations, which include results from our quarterly consumer and business expectations surveys, our monthly survey of private forecasters, which is presented in our report to the Monetary Board on the stance of monetary policy in the country, and other surveys conducted on a monthly basis by private organizations such as the Asia Pacific (AP) Consensus and Bloomberg. However, there has been considerable debate on the reliability of these survey results in providing information on inflation expectations and inflation uncertainty. Deputy Governor Jun Il Kim joins our panel to discuss the Bank of Korea's (BOK) recent work on inflation expectations based on consumer surveys. He will share with us BOK experience on how to make use of information from such surveys for monetary policy formulation and how to deal with potential biases arising from survey methodology and design.

It is with great honor that I open this session on the importance of inflation expectations in driving Asian inflation. Let me now invite Prof. Pierre Siklos from Wilfrid Laurier University and Deputy Governor Jun Il Kim from the Bank of Korea to deliver their presentations.

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6 Bruine de Bruin W., Potter S., Rich R., Topa G. and W. van der Klaauw (2010a): "Improving Survey Measures of Household Inflation Expectations," Current Issues in Economics and Finance, Vol. 16(7), Aug/Sept. 2010.