Understanding Inflation Expectations (the case of Ukraine)

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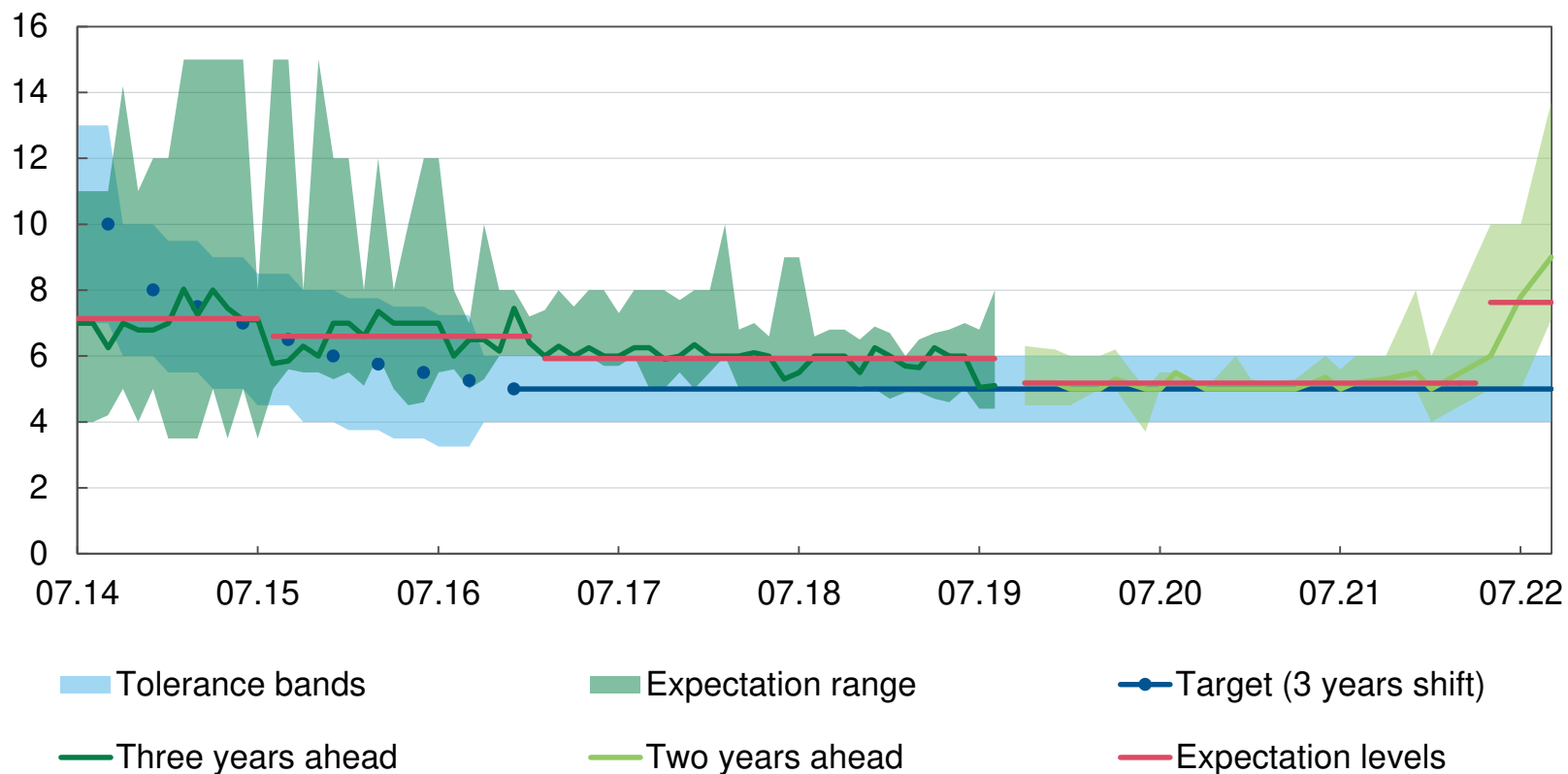
Geneva, 23 September 2022

Developments shaping the evolution of inflation expectations in Ukraine

Period	Developments
before 2014	Macroeconomic mismanagement – fiscal and quasi-fiscal imbalances, exchange rate peg to USD
2014-2015	Perfect storm in terms of macroeconomic crisis amplified by russian aggression
2016-2020	Shift to inflation targeting in line with prudent macro policy mix
2020-2021	Corona-crisis
Feb 2022	Full-scale russian invasion

National Bank
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Fact #1. Credible inflation targeting shows fast results. The level of inflation expectations gradually approach the target

## Medium-term IE of financial analysts and their range*, %

Legend:
- Tolerance bands
- Expectation range
- Target (3 years shift)
- Three years ahead
- Two years ahead
- Expectation levels

* Median value. The estimation of IE levels was done using the Bai and Perron (2003) methodology.
Source: NBU.

Fact#2. CB`s credibility is the most crucial factor in anchoring inflation expectations. In times of massive external shock (war), it helps to contain the panic
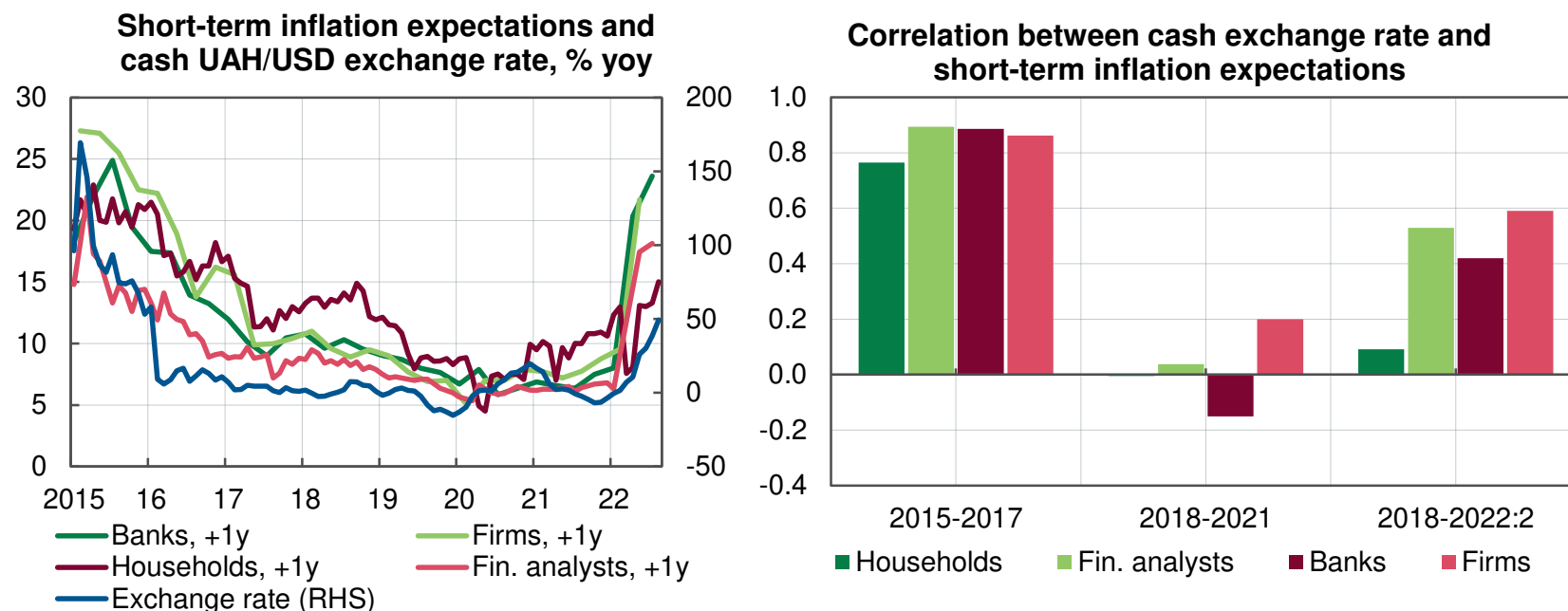
Firms' one-year-ahead inflation expectations and credibility*, %
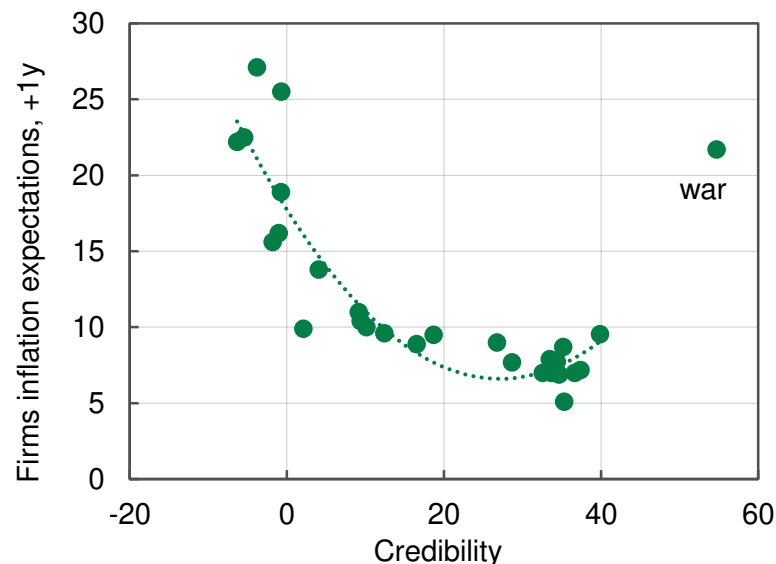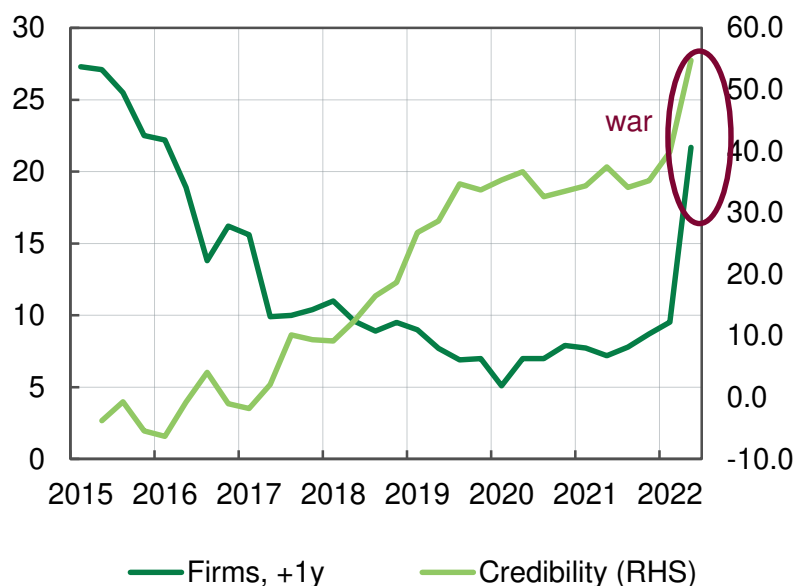
*Credibility: the share of respondents that do not trust NBU is subtracted from the share of respondents that trust NBU.
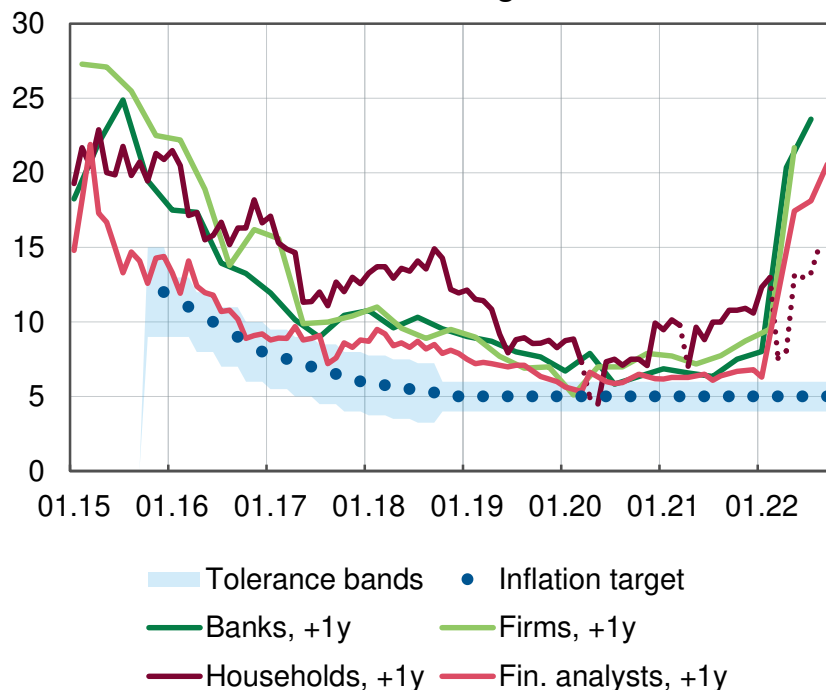
Source: NBU

Fact #3. The exchange rate in a small open economy matters a lot. Smoothing the ER volatility – minimizing shocks to expectations – more anchoring – more mature and stable FX market

Short-term inflation expectations and cash UAH/USD exchange rate, % yoy

- Banks, +1y
- Firms, +1y
- Households, +1y
- Fin. analysts, +1y
- Exchange rate (RHS)

Correlation between cash exchange rate and short-term inflation expectations

- Households
- Fin. analysts
- Banks
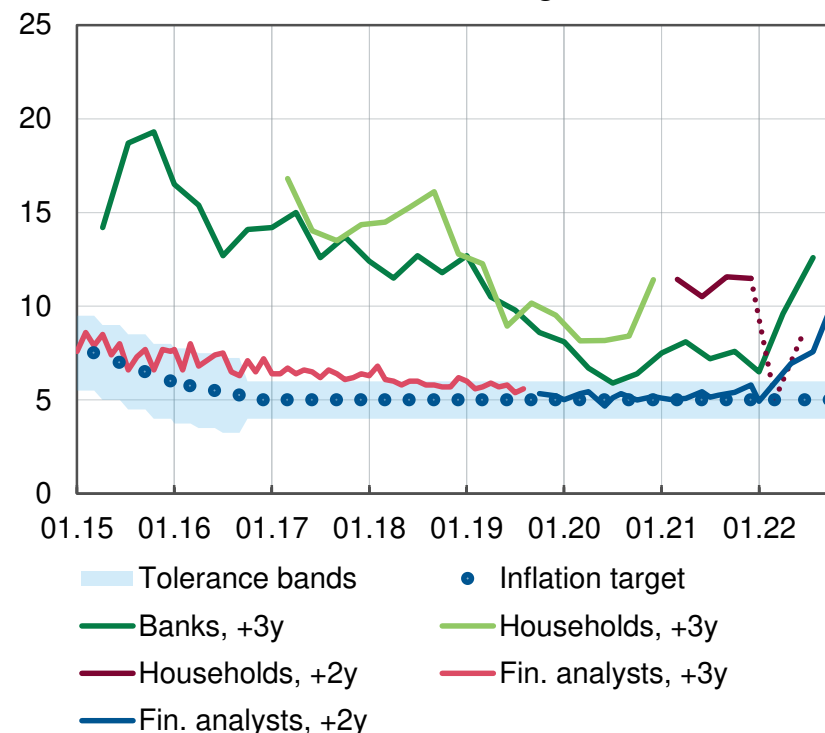- Firms

Source: NBU, NBU staff calculations

Coibion, Gorodnichenko (2015): One potential advantage of this signaling role of exchange rates for Ukrainian policy makers is that, unlike gasoline prices, the exchange rate is at least somewhat under their influence, so attempts to stabilize the exchange rate could have an unusually large positive externality through stable inflation expectations

Fact #4. Expectations are heterogeneous across groups of agents. They couldn`t be anchored in the same way, but dynamics matters

Short-term inflation expectations and the inflation target

Medium-term inflation expectations and the inflation target

Legend (left chart): Tolerance bands · Inflation target — Banks, +1y — Firms, +1y — Households, +1y — Fin. analysts, +1y

Legend (right chart): Tolerance bands · Inflation target — Banks, +3y — Households, +3y — Households, +2y — Fin. analysts, +3y — Fin. analysts, +2y

Note: The dotted line indicates a change in the method of survey to a telephone interview.
Source: NBU, GfK Ukraine, Info Sapiens.

Coibion, Gorodnichenko (2015): … even decades into inflation targeting regimes and with very credible central banks, household and firm expectations do not appear anchored in the way that professionals' are. One explanation is that as inflation falls and stabilizes, many economic agents have reduced incentives to track inflation and other macroeconomic variables. A similar outcome in Ukraine is likely if disinflation is successful
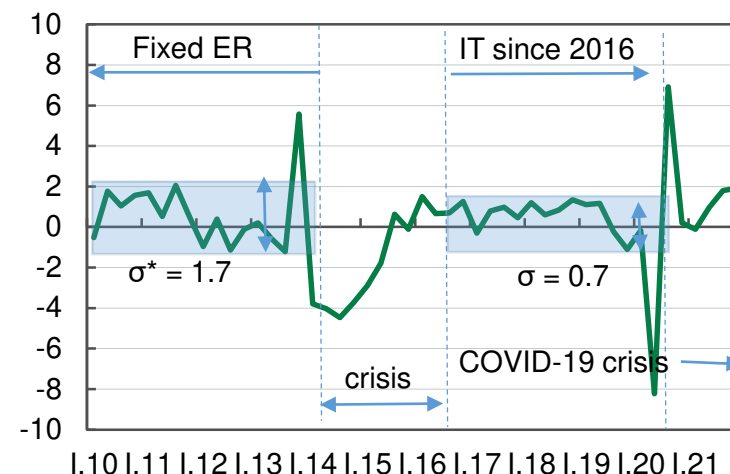
The results and lessons for the future

Consumer inflation and its volatility, % yoy

Mean = 9.1
σ = 7.3

Mean = 9.1
σ = 3.9

IT regime in action
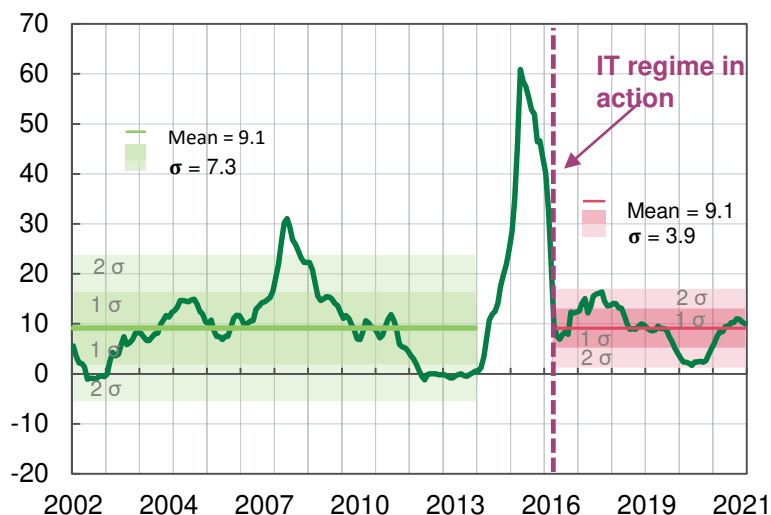
Source: SSSU, NBU staff estimates.

GDP volatility

Fixed ER

IT since 2016

$\sigma^* = 1.7$

$\sigma = 0.7$

crisis

COVID-19 crisis

GDP qoq, % (seasonally adjusted)

* σ – standard deviation.
Source: SSSU, NBU staff estimates.

Lessons:
- Inflation targeting proves to be a fast and effective regime to anchor expectations. This regime is still effective and actual
- Credibility is a hard-to-win prize but a precious one for the central bank. It pays off well in times of need
- Exchange rate fluctuations need to be smoothed at the initial stage. A floating exchange rate will bring its fruits in terms of a mature and self-balancing FX market
- Expectations are heterogeneous among economic agents. Different communication strategies need to be used to anchor them

National Bank of Ukraine