RESEARCH INSIGHTS

How Do Monetary Policy Announcements Affect Expectations on Inflation and on the Monetary Policy Rate?

- **Monetary policy announcements by the Central Bank of Mexico influence professional forecasters' expectations on inflation and the monetary policy rate.**
- **Our fixed-effects models suggest that Mexico's long-run inflation expectations are anchored.**
- **Mexico's central bank communication strategy has been an effective tool to manage inflation expectations in the short run and to anchor inflation expectations in the long run.**

CONTEXT

The economic literature suggests that agents' expectations are a relevant mechanism in the transmission of policy actions. Monetary policy is a good example, considering that its effectiveness relies on the trust consumers' and producers' trust in central banks' ability to control inflation. Since Mexico implemented its inflation targeting regime in 2003, the Central Bank has made a special effort to improve its communication strategies so that agents' expectations are aligned with the Central Bank's objectives. But have these strategies paid off?

PROJECT

In order to understand the role of Mexico's central bank announcements in inflation and monetary policy rate expectations we built a dataset using Citibanamex surveys, which ask professional forecasters about their expectations. Using fixed-effects regressions, we found that central bank communications, measured by the announcement of its decisions on the monetary policy rate, are crucial to understand professional forecasters' expectations on short-run inflation and the monetary policy rate.

RESULTS

Agents' expectations of inflation and the monetary policy rate are shaped by the Central Bank's announcements. Our models suggest that, while the inflation surprise (when the inflation rate surpasses the inflation expectation rate) is an important variable to explain monetary policy rate expectations, this result does not hold during periods of monetary policy announcements, when the monetary policy rate surprise (when the monetary policy rate surpasses the expected monetary policy rate) is a key determinant of monetary policy rate expectations. A similar result arises when we study inflation expectations in the short run. When monetary policy announcements are included in the model, the inflation surprise loses explanatory power on inflation expectations, and the monetary policy rate surprise plays a relevant role.

Finally, none of the variables included in our models (inflation surprise, previous inflation, monetary policy rate surprise, previous monetary policy rates, expectations on nominal exchange rate, and expectations on gross domestic product) was important in explaining inflation expectations in the long run. The expectations on the nominal exchange rate, moreover, were statistically significant in only one of our four models. Nevertheless, the coefficient of this variable was close to zero. This result indicates that Mexico's inflation expectations are anchored in the long run, which is one of the aims of the inflation targeting regime, and the central bank is achieving its main target.

Key Concept

MONETARY POLICY RATE

Reference interest rate set by central banks to control the amount of money circulating in the economy.

POLICY IMPLICATIONS

Although the Central Bank of Mexico has advanced in controlling the inflation dynamic, using monetary policy instruments to preserve the value of the Mexican peso through time, it has not always been the case. In the 1980s, Mexico had average inflation of 69 percent, reaching a peak of 131 percent in 1987. Even though Mexico has not experienced two-digit inflation since 1999, the inflation rate was nonetheless outside the target range for 40 percent of the period of our study (2010-2017). Hence, although the recent achievements of Mexico's central bank in inflation control are remarkable, there is still work to be done.

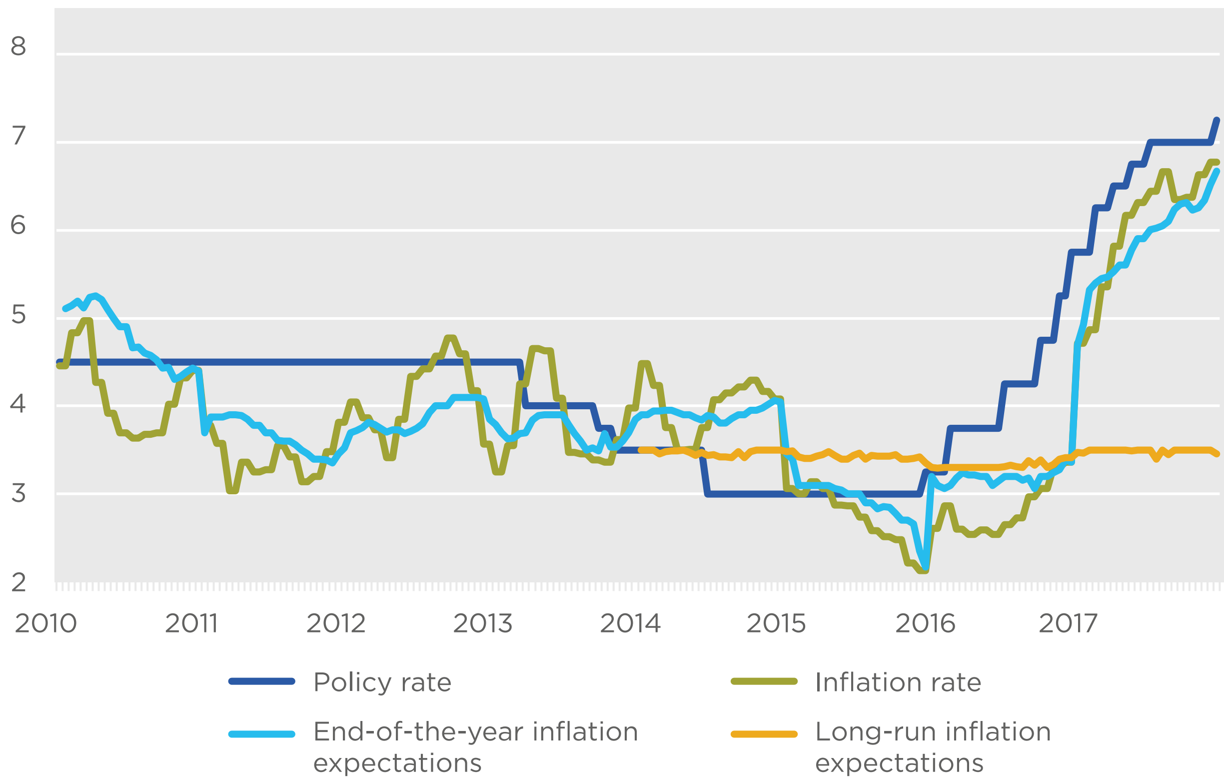
Understanding expectations on inflation and monetary policy is particularly important for inflation control, given that anchoring those expectations prevents price-increase spirals that have dire economic consequences. In this study, we found that Mexico's central bank monetary policy announcements are a fundamental element in explaining monetary policy rate and short-run inflation expectations, providing new evidence about the effectiveness of the central bank's communication strategy on this subject. Thus, our results suggest that monetary policy communication is a powerful tool for fighting inflation and that inflation-targeting central banks can use this tool to accomplish their objective.

Key Concept

INFLATION ANCHORING

Agents' belief in a central bank's ability to keep inflation within its target range in the long-run.

Figure 1. Reference Interest Rate, Inflation Rate, and Inflation Expectations



FULL STUDY

Aguilar-Argaez, Ana, Carlo Alcaraz Pribaz, Victoria Nuguer, and Jessica Roldán-Peña. 2022. "Monetary Policy Announcements and Expectations: The Case of Mexico." BIS Working Paper No. 1026. Bank of International Settlements, Basel.

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

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