

Forecasting, analysis and policy process in inflation targeting

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Outline

1. Forecast objective
2. Current practices
3. Elements of the process
4. Summary and challenges

1. Objective of the Forecast - I

- IT implies a medium-term approach
- necessary to have consistent and clear methods to derive a forecast for inflation
- important also externally - want forward looking agents to form expectations according to systematic reactions of CB (show you are systematic!)

1. Objective of the Forecast - II

- Present a consistent view of
 - where the economy is, and what the current trends are
 - what are their likely evolution into the future
 - what are the implicit risks
 - what are the underlying pressures in terms of policy

1. Objective of the Forecast - IV

- *Transparency* requires broad involvement of all the staff with clearly defined roles in the process
- *Efficiency* requires use of a common language among the staff
 - role of a core model
- and open architecture
 - flexibility to incorporate various views and alternatives

2. Current practices: history and overview - II

- Development - NT forecasting
 - NT forecasting - “expert approaches” at first
 - NT forecasting - more data-based approaches
 - single-equation
 - some simultaneous systems
 - policy horizon (4-6Q) covered
 - no active MP
 - detailed sectoral forecasts

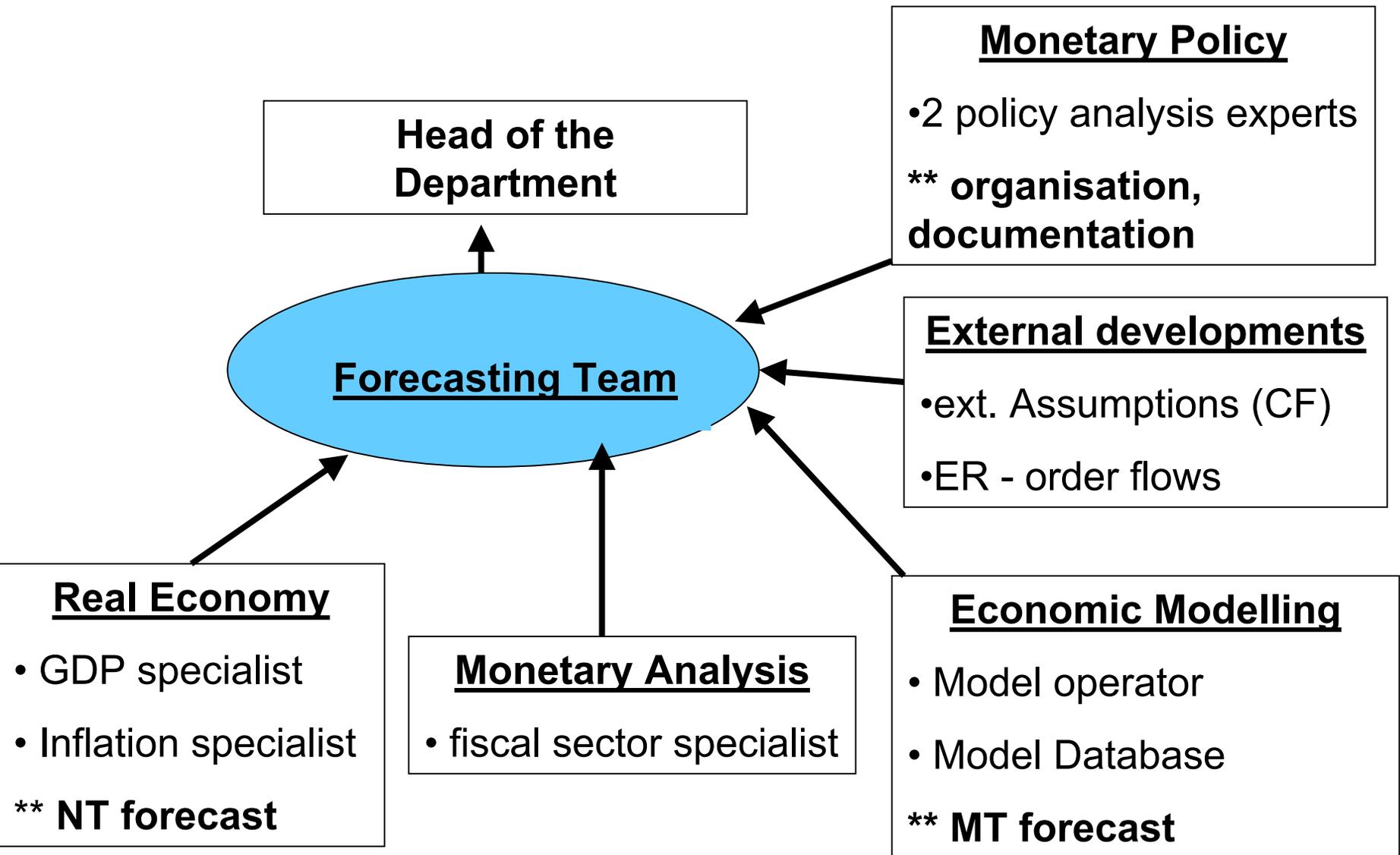
2. Current practices: history and overview - III

- Development - MT forecasting
 - striving for “the best model” for a couple of yrs
 - introduction of simple gap model (2000/2001)
 - calibrated
 - forward looking
 - active MP
 - policy experiments possible and appreciated by the board
 - lot of work on internal forecasting process

2. Current practices: history and overview - IV

- Current state:
 - one forecast - combines advantages of both approaches
 - intra-departmental forecasting team
 - board meets monthly
 - Q projection exercise + “dark times” w/o forecast
 - “situation reports” (30-60p.) monthly + “inflation reports” quarterly

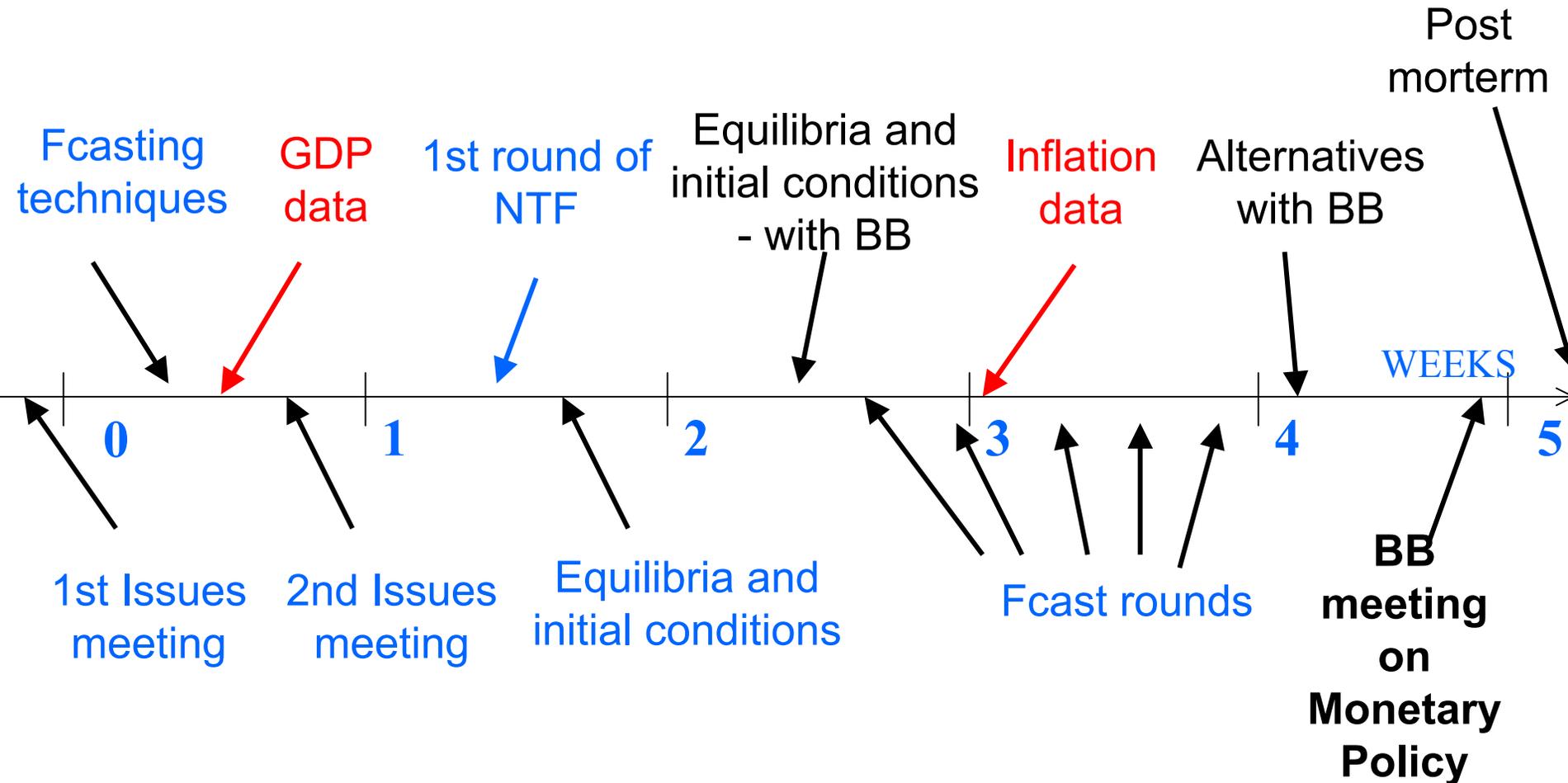
2. Current practices - V



2. Current practices - VI

- Forecasting team
 - 10-15 economists
 - all divisions represented (head + 1-2 economists)
 - experts may get invited to topics
 - open entry: department, advisors, board members
 - head of team: head of department + co-ordinator

3. Elements of the Process - I



3. Elements of the Process - II

- Meetings on Forecasting Techniques
 - properties of main forecasting tools are re-introduced
 - opportunity to introduce changes and their significance
 - refreshes staff's and FT's familiarity with the techniques and their pitfalls

3. Elements of the Process - III

- Issue Meetings
 - collective and intuitive view among the staff where the economy is and what are the current economic issues
 - designed to address a wide range of questions
 - recent data out-turns
 - analytically sophisticated issues
 - broad participation of staff encouraged

3. Elements of the Process - IV

- Meeting on Near Term Forecast
 - is more about where the economy is and what the current shocks are
 - essential input for Medium Term (model) Forecast
 - integral part of the overall message

3. Elements of the Process - V

- Meeting on Equilibrium and Initial conditions
 - gap model
 - have the equilibrium trends changed (not often) ?
 - where are we now ? - Kalman filtering + expert knowledge
 - + external assumptions (Consensus forecast)
 - exchange rate - mix of model consistent UIP and order flow forecasts (BoP)

3. Elements of the Process - VI

- Forecast Rounds of Medium Term Forecast
 - is more about where the economy is going to go beyond the NTF
 - make the core model behaviour consistent with the views of experts and other model tools
 - work incrementally to alter the baseline scenario
 - if consensus emerges, prepare alternatives
 - use the model mechanisms to interpret the forecast

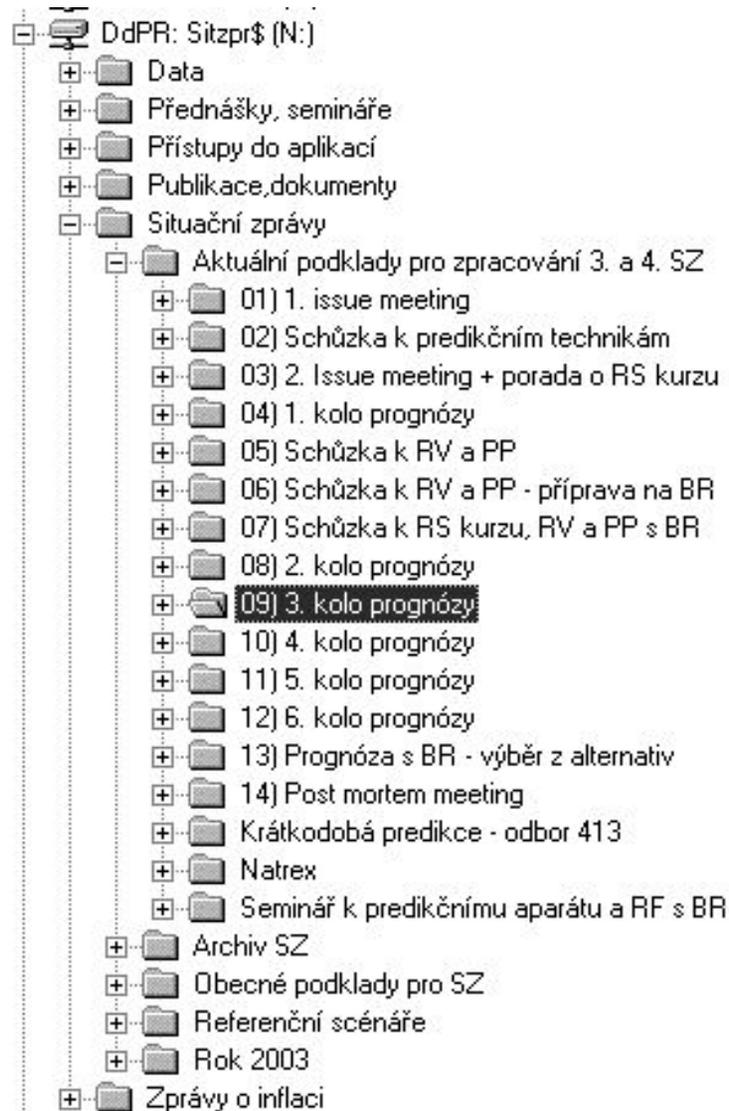
3. Elements of the Process - VII

- Meetings with the BB
 - staff's forecast but active involvement necessary
 - build credibility, feeling of openness
 - two meetings prior to official BB meeting:
 - equilibrium and initial conditions (+ formal approval of external assumptions)
 - alternatives - which risks it is worth to elaborate

3. Elements of the Process - VIII

- Post Mortem Meeting
 - opportunity to systematically assess what went to wrong and what should be strengthened
 - broad participation encouraged
 - effective tool to transform fresh emotions into effective measures for the next time

3. Elements of the Process - Documentation



4. Summary and challenges -I

- Shift from data collection to information extraction
- More structured debate about risks and policy issues + common language
- “*what if...?*” questions can be answered
- Forecast with active monetary policy (includes rates trajectory consistent w/ fcast)

4. Summary and challenges - II

- no pure model forecast => consistency check role is partially an illusion
- more dis-aggregated discussion within the same framework may be difficult => new model?
- writing reports vs. doing analysis - situation vs. inflation report
- decision making system in between Q projection rounds (RBNZ scatter plot ?)
- interaction with the bank board