Box 1: Assessing the Forecasting Ability of Inflation Expectations in Colombia - Financial Markets Report, Fourth Quarter 2024

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Inflation expectations are a key factor in monetary policy decision-making. First, as crucial inputs for wage and price setting, they offer an estimation of the future direction of inflation. Second, they allow assessing the credibility of the inflation target set by the central bank (Sousa & Yetman, 2016). However, central banks do not have a single variable to measure such expectations; instead, they use a wide range of indicators whose selection depends on various characteristics, such as the source (e.g., surveys or market data), the type of agent (economic analysts, academics, market operators, etc.), the type of inflation considered (headline inflation or excluding food) and the time horizon (ranging from less than a month to more than ten years).

Banco de la República (the Central Bank of Colombia) has a wide range of measures of inflation expectations, and one of the main concerns associated with these measures lies in their forecasting ability. In recent years, specifically in 2018, 2019, and 2021, the Bank published studies addressing this question. However, almost four years have passed since the last documented analysis. This box aims to revisit this issue, using the most updated information available.

One of the main findings of this box is that expectations are not accurate predictors of future inflation, and their performance depends on the horizon and period assessed. Additionally, it is found that market-based expectations tend to perform better than survey-based expectations. However, these results should be carefully analyzed since large forecast errors do not imply that these expectations fail to reflect the agents' expectation formation process.

Fuente: https://d1b4gd4m8561gs.cloudfront.net/en/publications-research/financial-markets-report/box-1-fourth-quarter-2024