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Lack of Credibility, Inflation Persistence and Disinflation in Colombia

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Autor o Editor Andrés González , Franz Hamann Autores y/o editores González-Gómez, Andrés Hamann-Salcedo, Franz
Lack of Credibility, Inflation Persistence and Disinflation in Colombia Lack of Credibility, Inflation Persistence and Disinflation in Colombia* Andrés González
agonzago@banrep.gov.co Franz Hamann**
fhamansa@banrep.gov.co Abstract This paper measures inflation persistence in Colombia for the period 1990-2010 and estimates the implied speed at which agents learn about the central bank?s inflation target. We estimate Erceg and Levin?s (2003) imperfect credibility model using Bayesian techniques and compare the posterior odds of this model against a conventional Neokeynesian model with ad-hoc price indexation. The odds are strongly in favor of the imperfect credibility model, suggesting that lack of credibility on the inflation target is an important source of inflation persistence. We use the model to compute the sacrifice ratio associated to 100 basis points inflation target shocks and find that it is (0.83%) in line with previous estimates for Colombia. We also find that the speed at which agents learn in the model has increased, albeit marginally, since the central bank implemented its inflation targeting strategy. Although during this period macroeconomic volatility has fallen, inflation persistence has remained roughly constant suggesting that so far, the impact of those credibility gains has been modest. Keywords: Credibility, inflation, persistence, disinflation costs, Colombia. JEL Classification: C52 * The views expressed in this document are those of the authors and not necessarily those of the Banco de la República. We would like to thank specially to Ángelo Gutiérrez for his superb research assistance. We also thank the comments of two anonymous referees and those of the economists at the Second Monetary Policy Workshop in Latin America and the Caribbean on Monetary Policy, Uncertainty and the Business Cycle, in Lima Perú. Of course, any mistake in this paper is our responsibility. ** Corresponding author: fhamansa@banrep.gov.co Banco de la República, Cr 7a No 14-78.

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