The Legacy of High Inflation on Monetary Policy Rules*

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Abstract

We explore the key, yet overlooked, role of past inflation on monetary policy. First, we propose a New Keynesian model that adds path-dependence and potentially imperfect central bank credibility. We show that hitting the inflation target requires more aggressive monetary policy reactions, and entails higher costs, when past inflation shapes expectations. We then show empirically that countries that experienced high levels of inflation before adopting the inflation targeting regime respond more aggressively to inflation deviations. Finally, we point to a credibility puzzle—central banks' monetary policy response to deviations from the target remains broadly unchanged even as they gain credibility.

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1 Introduction

The implicit use of Taylor rules as central banks' reaction functions to shocks (usually within the context of inflation targeting, IT), has been established as the key institutional monetary framework. It has become the workhorse for the efficient conduct of monetary policy in central banks in advanced economies and in an increasing number of emerging markets and developing economies. There is a vast literature, both theoretical and empirical, focusing on the workings of the IT monetary policy framework and the dynamic response of key macroeconomic variables. Yet, all these studies rest, among others, on two key assumptions (e.g., Woodford, 2003). First, inflation targeting central banks' reaction function is not path-dependent, in the sense that countries' characteristics prior to the adoption of IT, in particular the history of high inflation, do not affect the central bank's monetary policy rule. Second, central banks are perfectly credible, that is, that central banks have perfectly anchored inflation expectations.

In this paper, we revisit these assumptions theoretically and empirically. Theoretically, we embed path dependence in an otherwise standard Dynamic New Keynesian Model. We show that, if the economy experienced an episode of high inflation in the past that affects expectation formation, achieving the inflation target is more costly in terms of lost output and requires a more hawkish monetary stance relative to a rational expectations benchmark. We also show that although expectations are exclusively shaped by events occurring in the past, the cost of inflation stabilization depends not only on how agents discount the past but also on how they discount the future.

In turn, our empirical findings suggest that IT central banks, given their legacy of high past inflation, have "fear of past inflation," which challenges the two important assumptions from the received wisdom. On the one hand, unlike existing theory, central bank credibility can't be automatically assumed. On the other hand, we highlight the importance of factoring in path dependence explicitly, given the prominent role of a country's past inflationary experience; that is, the importance of having had high inflation in the past. We show evidence that suggests, in fact, that fear of de-anchoring inflation expectations (especially in countries with a high inflationary past) is an important driver of the conduct of monetary policy in inflation targeting countries. The combination of these two issues is what generates a credibility puzzle as given by the relevance of a country's past inflation experience in delineating the current strength of the reaction function of central banks to expected inflation shocks, regardless of how much credibility central banks may have built over time.

Specifically, we point to the legacy of past high inflation in the conduct of monetary policy, as we show that having experienced high inflation prior to the establishment of the IT regime is the key factor shaping a central bank's response to contemporaneous inflation gaps. We also highlight the preponderant weight that central banks put on anchoring inflation expectations when setting interest rates by showing that inflation targeting central banks display a stronger response to deviations of inflation expectations from target than to deviations of observed inflation (in line with received theory, e.g., Svenson, 1997). We argue that these factors point to the existence of the mentioned credibility puzzle—in that the weight of inflationary past appears to persist even as central banks build credibility and that, in fact, inflation targeting central banks' reaction function are mostly time-invariant.

We squarely focus on studying and comparing only countries following IT, looking at them in a granular fashion. Within their homogeneity as a monetary policy framework, we exploit empirically IT countries' institutional and economic diversity to ascertain the nature of the central banks' reaction function and pin down the key factors affecting it. We stress that inflation targeting countries are heterogeneous, as their inflation background is remarkably diverse, they differ on their level of income, their financial sector development and capital account openness, and several countries feature financial dollarization. Moreover, some countries are more vulnerable than others to real shocks and central bank independence and transparency vary across countries.

Methodologically, we estimate Taylor rules using panel data in the spirit of Guerra et al. (2025) to study the conduct of monetary policy among IT central banks. We specify a standard small open economy Taylor rule that, in addition to taking into account the output and inflation gaps, controls for variations in the country's exchange rate and for global financial conditions. The latter two variables are particularly important for emerging markets, which comprise a large fraction of our sample. To explore monetary policy heterogeneity among our group of countries, we augment our baseline panel regressions by allowing a country's policy rate response to both the output and expected inflation gap to vary with country specific characteristics, including the country's average level of past inflation (i.e., up to a decade prior to the adoption of the IT regime) and factoring in the Phillips and IS curves (as given in theoretical models).

Our results[1] point to the statistically and economically significant role played by past inflation in explaining differences in the response of policy rates to the inflation gap. We find that, on average, for any one percent deviation of expected inflation from its target, a central bank changes its policy interest rate by between 20 and 30 basis points.[2] And that for economies that experienced high inflation in the past, interest rates move by an additional 25-27 basis points. Alternatively, we also estimate country-by-country Taylor rules and associate these coefficients with the variables of interest (Annex B), with findings from the two exercises being broadly aligned.

Literature Review. This paper contributes to a large literature on inflation targeting, which flourished in the 2000s up until the Great Financial Crisis (GFC). Ball (2010), Svensson (2010), and Walsh (2010) summarize three important results from these studies: (i) inflation targeting, when compared to non-inflation targeting countries, has made a difference in terms of achieving low and stable inflation in emerging market economies, but not so much in advanced economies[3]; (ii) an explicit inflation target stabilizes inflation expectations and help handle sup-

[1] All econometric results are shown in Annex A.

[2] The Taylor rule coefficient is less than one because, as is common in the literature, the estimation includes the lagged interest rate–see the result in Table 3, which shows the associated Taylor coefficient larger than one.

[3] For example, Ball and Sheridan (2005) find no evidence that the adoption of an inflation targeting regime imporves macroeconomic outcomes among advanced economies. By contrast, Goncalves and Salles (2008) find

ply shocks; and (iii) inflation targeting has not been associated with output growth but can reduce output volatility in emerging market economies. Interest in studying inflation targeting subsided in the aftermath of the GFC, as inflation plummeted and attention shifted to assessing the effects of the unconventional monetary policies, but re-emerged after a surge of inflation following the Covid pandemic. Recent papers include Guerra et al. (2025), who explore changes in Taylor rules in the aftermath of Covid among Latin American countries, Zhang and Wang (2022), which highlights the effects of the inflation-targeting countries' track record on macroeconomic outcomes, Bhalla et al. (2023) that revisit the impact of adopting inflation targeting on anchoring inflation expectations in a sample of advanced economies and emerging markets and developing countries, and find better outcomes on early inflation-targeting adopters, and Duncan et al. (2022) that focuses on assessing the effectiveness of inflation targeting in the same type of countries, and find stronger results in emerging markets and developing countries.

Our work diverges from most previous papers in two important ways. First, those studies rest on the premise that inflation-targeting countries are a homogeneous group and, thus, conduct monetary policy in a uniform manner. In contrast, our study digs into the differences observed among inflation-targeting countries aiming at unveiling whether their economic and institutional features and heterogeneity help to explain the way central banks conduct monetary policy. Second, our paper explores the role played by the countries' history of inflation when taking monetary policy decisions, an angle that, to the best of our knowledge, has not been previously addressed.

Our analysis relates, alternatively, to a growing literature that underscores the importance of inflation history on individuals' inflation expectations. This include Malmendier and Nagel (2016), which documents that older individuals in the US tend to have higher inflation expectations, Salle et al. (2023) who show that people that experienced past episodes of high inflation have higher inflation expectations, Magud and Pienknagura (2024) who show that cross-country cohorts of individuals (going back to those born in the early 1920s) that were exposed to longer bouts of high inflation were more averse to inflation in general and in particular to unexpected inflationary shocks, and Gennaioli et al. (2024) that document that in the US, during the Covid inflation shocks, older people expected higher inflation rates than younger individuals. Relatedly, Malmendier and Nagel (2011) show how individuals that experienced the great depression in the US were more risk averse—including staying away from investing in the stock market (see also (Malmendier, 2021)), whereas Binder and Makridis (2022) find that individuals that experienced the 1970s oil shocks in the US had higher inflation expectations than other people, and Giuliano and Spilimbergo (2023, 2024) that document the role of aggregate shocks in individuals' expectations. All these studies focus on individuals' expectations as driven by personal experience. Instead, our work focuses on the policymaking side. It could thus be more closely

evidence that, among emerging markets, IT countries exhibit lower and less volatile inflation compared to non-IT countries. Similar results are found by Lin and Ye (2009), although the authors find that the extent to which IT is associated with lower inflation varies according to the coutnry's fiscal position, the central bank's desire to limit the movements of exchange rate, its willingness to meet the preconditions of policy adoption, and the time length since the policy adoption.

associated with Malmendier et al. (2021) that show how FOMC policymakers that were exposed to high inflation when younger in other countries tend to systematically vote for more hawkish policy decisions.[4] Our paper takes for granted individuals' reaction and implicitly assesses how the policymaker internalizes aggregate choice. Along these lines, from a theoretical perspective, our analysis in consistent with Rogoff (1985) who, in the context of simple Barro-Gordon model, shows the need for a central bank that is more conservative (in terms of monetary policy preferences) than the average individual (see also Afrouzi et al., 2024, for a similar point). Recent work by Bocola et al. (2025) focuses on how, in the presence of uncertainty about the type of central banker (dove vs. hawk), it may be optimal for interest rates to react more strongly to demand and supply shocks to signal their type and thus strengthening the reputation of central bank to mitigate inflation expectations de-anchoring. Different from our work, however, they focus on monetary policy interest rate shocks' impact on inflation expectations.

The rest of the paper is structured as follows: Section 2 presents the theoretical model on which the empirical section is based; Section 3 describes the empirical specification used to conduct the analysis and the data feeding the study; Section 4 discusses the main results in the context of received theoretical assumptions about Taylor rules and presents various robustness tests; Section 5 distills the main conclusions of the paper.

2 A Simple Model of High Inflation History and Monetary Policy

Before turning to presenting the results of our econometric estimation, and to fix ideas, this section presents a simple New-Keynesian (NK) model that incorporates experienced learning (the legacy of past inflation). A young but growing empirical literature documents that past episodes of high inflation significantly affect current inflation expectations. This phenomenon is known as experienced learning. The model in this section explores the implications of incorporating experienced learning in an otherwise standard NK model. First, the section characterizes the optimal monetary policy when the experienced learning channel is turned off. Then it presents how experienced learning affects optimal monetary policy and how this affects the costs of economic stabilization.

2.1 The Rational Expectations Benchmark

Consider a three-equation linear new-Keynesian model. The Euler equation is of the form:

$$y_t = E_t y_{t+1} - \frac{1}{\sigma}(i_t - E_t \pi_{t+1}) \tag{1}$$

[4] Erceg and Levin (2003) study theoretically the role of imperfect credibility of the inflation target rather than the degree of credibility as reflected in how well-anchored inflation expectations are (that is, the gap between expected inflation and the inflation target), as we do.

where π_t is the deviation of inflation from the intended target, y_t is the output gap, i_t is the nominal interest rate expressed in deviation from its steady-state level, and E_t is the expectation operator conditional on relevant information in period t (which will depend on the expectation model being considered). The parameter $\sigma > 0$, where $1/\sigma$ is the intertemporal elasticity of consumption substitution. The Euler equation, thus, states that output growth is decreasing in the expected real interest rate.

The Phillips curve takes the form:

$$\pi_t = \beta E_t \pi_{t+1} + \kappa y_t \tag{2}$$

where $\beta \in (0, 1)$ is the subjective discount factor and $\kappa > 0$ is a parameter that is decreasing in the degree of price stickiness. The fact that in the Phillips curve current inflation depends not only on the current output gap but also on people's expectations about future inflation will play a central role in determining the cost of inflation stabilization under alternative assumptions about how expectations are formed.

Assume that the central bank implements strict inflation targeting, so that:

$$\pi_t = 0 \tag{3}$$

for all $t \geq 0$. We assume that the central bank can commit to maintaining this policy over time. The question we tackle is how costly it is to implement this policy in terms of the output gap y_t and what does it imply for the level of the policy rate i_t.

Our simple three-equation framework suggests that under rational expectations, the fact that $\pi_t = 0$ for all t implies that the conditional expectation of inflation, $E_t \pi_{t+1}$, must also be zero. Plugging $E_t \pi_{t+1} = 0$ in the Phillips curve (2) yields:

$$y_t = 0 \tag{4}$$

for all t. Thus, under rational expectations it is costless to fully stabilize inflation, the well-known result sometimes referred to as the "divine coincidence:" in the absence of cost-push shocks, the rational expectations solution of the new-Keynesian model implies that inflation stabilization goes in tandem with output stabilization.

Consider now the equilibrium path of the nominal interest rate that supports this outcome. Using $y_t = E_t y_{t+1} = E_t \pi_{t+1} = 0$, we can solve the Euler equation (1) for the equilibrium interest rate, to get:

$$i_t = 0 \tag{5}$$

for all t, which says that to achieve price and output stability, the government does not need to deviate the policy rate from its steady-state value (typically referred to as the natural or neutral interest rate). In other words, macroeconomic stabilization is not associated with a particularly dovish or hawkish monetary policy. As we will see next, this will cease to be the case under experience learning.

2.2 Stabilization Under Experienced Learning

To model experienced learning, we assume that if the economy suffered high inflation in the past, denoted $\pi^H > 0$, then inflationary expectations evolve over time according to the expression:

$$E_t \pi_{t+1} = \lambda^t \pi^H \tag{6}$$

Here, the inflationary episode occurs in period 0, and the parameter $\lambda \in (0, 1)$ denotes the rate of decay of the inflationary memory. The formulation with memory depreciation is in line with empirical studies that document "recency bias" in experience learning (Malmendier and Nagel, 2011; Magud and Pienknagura, 2024).

Let's now address the same question we answered in the economy with rational expectations, namely, how costly is it to stabilize the rate of inflation and what is the path of the policy rate consistent with this goal. Using $\pi_t = 0$ and $E_t \pi_{t+1} = \lambda^t \pi^H$ and plugging them to the Phillips curve (2), we see immediately that:

$$y_t = -\frac{\beta \lambda^t \pi^H}{\kappa} \tag{7}$$

This expression reveals that experienced learning imposes costs on inflation stabilization. Specifically, the output gap becomes negative for as long as the memory of a bad inflationary episode persists. The intuition behind this result is straightforward. In the New Keynesian framework, the current deviation of inflation from target equals the present discounted value of current and future marginal costs. If a prior inflationary experience leads people to believe that marginal costs will remain high in the future, the central bank must preemptively cool the economy to prevent inflation in the present. This requires inducing a negative output gap. The cost in terms of lost output depends on several factors: (a) the severity of the past inflationary exposure (π^H), with larger exposure amplifying the cost; (b) the recency of the exposure (smaller t), as more recent episodes weigh more heavily on expectations; (c) the persistence of the memory of the exposure (larger λ), which prolongs the economic effects of inflationary history; (d) the degree of price stickiness (smaller κ), with stickier prices exacerbating the output loss; and (e) the subjective discount factor: Even though experienced learning looks back in time (that is, it is backward-looking), the magnitude of the cost of inflation stabilization depends not only on the rate at which people discount the past, λ, but also on the rate at which people discount the future, β. This is because the former determines the expected size of marginal costs in the future, while the latter determines their present value. Thus, both backward- and forward-looking issues are relevant in equilibrium.

How does experienced learning affect monetary policy? To calculate the path of the nominal interest rate, i_t, consistent with strict inflation targeting, substitute in the Euler equation (1) the values of y_t, $E_t y_{t+1}$, and $E_t \pi_{t+1}$ implied by equations (6) and (7). This gives:

$$i_t = [\ 1 + \frac{\beta\sigma}{\kappa}(1-\lambda)]\ \lambda^t \pi^H > 0 \tag{8}$$

The nominal interest rate is above its steady-state level throughout the transition. Thus, under experience learning, inflation stabilization requires a more hawkish monetary policy stance relative to rational expectations if inflation is to be stabilized. The required tightening is more severe the larger the inflation exposure, π^H, the stickier prices are (the smaller κ is), and the more risk averse agents are (the higher σ is).

In other words, the issue arises when agents may have doubts in regard to the ability of an inflation targeting central bank to achieve its inflation goal, that is, when inflation expectations are not perfectly anchored and the central bank is committed to achieve inflation stabilization. This drives the central bank to be willing to pay the real cost (in terms of a recession) needed to keep inflation at its desired level. These dynamics highlight the role of path dependence and the importance of central bank credibility in the response of the central banks to deviations of expected inflation from target.

The rest of the paper studies empirically the relationship between past inflation (experienced learning) and the conduct of monetary policy. In particular, it focuses on studying how past inflation affects the central bank's response to inflation. In line with the simple model, results point to central banks in countries with a history of high inflation being more responsive to inflation deviations (more hawkish).

3 Econometric Strategy and Data

This section describes the empirical methods used to estimate central banks' monetary policy reaction function and the data sources used in the analysis and their limitations. As explained above, we take the advantage of the homogeneous framework for the conduct of monetary policy in the countries in our sample, namely inflation targeting, while exploiting the heterogeneity with respect to their past inflationary history and several other state variables.

3.1 Econometric Specification

To study IT central banks' monetary policy functions, we estimate Taylor rules through a panel approach.[5] The baseline specification takes the following form:

[5]Results stemming from country-by-country estimations are show in Annex B.

$$\begin{aligned} i_{c,t} = \alpha_c + \rho i_{c,t-1} + \beta \pi gap_{c,t} + \gamma Ygap_{c,t} + \\ \theta \Delta NEER_{c,t} + \mu \Delta NEER_{c,t-1} + \omega i_{US,t-1} + \varepsilon_{c,t} \end{aligned} \tag{9}$$

where $i_{c,t}$ is the policy rate in country c, at time t, α_c is a country fixed effect, $Ygap_{c,t}$ is the output gap in country c at time t, which is calculated using the HP filter, $\Delta NEER_{c,t}$ is the change in the nominal effective exchange rate in period t, $i_{US,t-1}$[6] is the monetary policy rate in the US at time $t-1$, and $\pi gap_{c,t}$ is the inflation gap in country c at time t. We use three alternative gauges of the inflation gap—one that calculates the deviation of contemporaneous headline inflation from the central bank's inflation target, another that computes deviations of contemporaneous core inflation from the target, and another that measures the deviation of one-year ahead inflation expectations from the inflation target. The latter is closer in spirit to the theoretical underpinnings behind the Taylor rule (Svenson, 1997). The inclusion of the output and inflation gaps follows the standard Taylor rule formulation. We augment the standard Taylor rule by including changes in the nominal exchange rate and by controlling for the US monetary policy rate, two important variables for small open economies (Ghosh et al., 2015), and the lagged interest rate to smooth for interest rate persistence. Note that, as is well known, the estimates of the Taylor rule from OLS panel estimations are expected to be biased. However, as shown by Carvalho et al. (2021) the bias is likely small, and OLS outperforms IV under realistic sample sizes.

In some exercises we also include the years as an IT for each central bank,[7] aimed at capturing the potential evolution in the conduct of monetary policy as central banks become more established inflation targeters. We also explore whether the years a central bank has under an IT regime affects the response of monetary policy to the inflation and output gaps by interacting each gap with the years as an IT.

To study heterogeneity in the conduct of monetary policy across IT central banks we estimate a variant of equation (9) which allows the coefficients for the inflation and the output gaps to vary with the country-specific variables, in particular, variables capturing inflation path-dependence. More precisely, we estimate the following equation:

$$\begin{aligned} i_{c,t} = \alpha_c + \rho i_{c,t-1} + \beta \pi gap_{c,t} + \gamma Ygap_{c,t} + \sum_{f \in F} z_c^f (\delta_f \pi gap_{c,t} + \tau_f Ygap_{c,t}) + \\ \theta \Delta NEER_{c,t} + \mu \Delta NEER_{c,t-1} + \omega i_{US,t-1} + \varepsilon_{c,t} \end{aligned} \tag{10}$$

Where z is a variable indicating whether fundamental $f \in F = \{$financial development, trade openness, capital account openness, central bank independence, past inflation$\}$ was high at the time of IT adoption.

[6]In some exercises we expand the baseline specification by replacing the US monetary policy rate with time fixed effect aimed at capturing global factors, beyond financial conditions, affecting all countries in our sample.

[7]This is controlled for in two ways—as a linear function of the years as an IT and as fixed effects.

3.2 Data

We rely on several data sources to conduct the econometric analysis discussed above. Data on inflation expectations come from consensus forecasts collected by Consensus Economics. These are survey-based inflation forecasts from professional forecasters. The number and type of forecasters considered in the surveys varies by country. But there are alternative ways to measure inflation expectations. Compared to household or firm surveys gauging inflation expectations, the data from consensus forecasts has the advantage that is consistently collected for a large sample of countries and is available for an extended time period. Moreover, there is evidence that household inflation expectations as measured in surveys could be sensitive to the way that survey questions are formulated and/or to inadvertent nudging and priming (Weber et al., 2022). Sampling and low response rates can also be an issue, particularly for firm surveys, for which the opportunity cost of responding is high.[8]

Data on inflation targets and policy rates are collected from the BIS, and in the case of targets, complemented using information reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). In the case of countries reporting a target band, we use the mid-point of the band as our gauge of the target.

Data on nominal effective exchange rates and inflation come from the IMF's International Financial Statistics (IFS). Output gaps are computed using quarterly real GDP information from national sources retrieved by using Haver analytics. Data are seasonally adjusted by either national authorities or, if not available, by using Haver's seasonal adjustment. The output gap is calculated using the HP filter.

Data used to explore cross-country heterogeneity in monetary policy responses come from several sources. To gauge a country's financial development we use the index proposed by Svirydzenka (2022) and Sahay et al. (2015). This is an index summarizing how developed financial institutions and financial markets are in terms of their depth, access, and efficiency. We proxy trade openness by using the trade over GDP ratio reported in the World Bank's World Development Indicators (WDI). Data on central bank independence comes from Romelli (2022, 2024). The index summarizes information on 6 dimensions of central bank independence: (i) governor and central bank board, (ii) monetary policy and conflict resolution, (iii) objectives, (iv) limitations on lending to the government, (v) financial independence, and (vi) reporting and disclosure. Capital account openness comes from the Chinn and Ito (2006)'s capital account openness (KA openness) index. In some exercises, we complement the KA openness index with data on foreign exchange rate interventions (FXI) from Adler et al. (Forthcoming), which allows to correct for the fact that countries with an open capital account may intervene, in some cases

[8]One potential drawback of surveys filled by experts is that their forecasts may not be reflective of those of the relevant economic agents (consumers, workers, firms). There are also potential biases introduced by incentives for respondents not to reveal their true beliefs (Coibion et al., 2018). Yet, empirical work suggests that expectations by professional forecasters and firms have better predictive power as far as current inflation is concerned relative to (median or average) household expectations (, IMF) and there are also biases in household and firm surveys, which may reflect the possibility that these agents pay less attention to policy announcements (Weber et al., 2022).

very frequently, in FX markets. We use the classification in Aslam et al. (2016) to identify commodity exporting countries.

Finally, and critical to this paper, data on past inflationary experience is constructed as follows. For each country, we compute the average inflation rate from either 1960, or the first year for which the country appears in WDI, to ten years before the adoption of the IT regime. Using this information, we compute two variables: one is a dummy variable taking value one if the country had an average historical inflation above the 75th percentile value in our sample (that is, above the 75th percentile of every observed country-year rate of inflation), and the other is a continuous transformation of the historical average inflation that compresses the distribution to account for countries that experienced hyperinflation. The transformation, which computes $\pi = \pi/(100 + \pi)$, has been used in Jácome and Pienknagura (Forthcoming) and Acemoglu et al. (2008). Again, inflation is classified as high in the latter computation for a country is above the 75th percentile of the entire country-year distribution in our sample.

Table 1 presents summary statistics for the key variables used in the analysis. Table 2 shows the sample of countries used in the analysis, which includes all countries with central banks following an inflation targeting framework, according to the AREAER, that adopted the regime prior to 2015.

4 Results

This section presents the three main empirical results of the paper. First, it explores differences in the reaction of policy rates to the three inflation gaps used in the analysis—the one using contemporaneous headline inflation, the one using contemporaneous core inflation, and the one using inflation expectations—and how Taylor rules differ across groups of countries. Second, the analysis turns to assessing the extent to which Taylor rules change over time. More precisely it studies whether countries with more established IT regimes, as measured by the time since adoption, conduct monetary policy in a different manner relative to countries that have adopted the regime more recently. Third, it presents an empirical exploration of how past inflationary history shapes monetary policy among IT central banks. Finally, it presents a battery of robustness exercises.

4.1 Drivers of Monetary Policy and Cross-Country Heterogeneity: The Legacy of Past Inflation

Before exploring the role of past inflationary history in shaping monetary policy, Table 3 presents results for the baseline Taylor rule estimations. Following the received wisdom of theoretical models of inflation targeting (Svenson, 1997), our results point to a larger elasticity of policy rates to inflation expectations gaps compared to observed headline and core inflation gaps. The coefficients corresponding to the expected inflation gap more than double those of the observed inflation gap (be it headline or core). Notice that they are not only statistically, but also economically significant: a one percent deviation of expected inflation from the target triggers, on average, a change in the policy interest rate of around 20-22 basis points—compared to less than 10 basis points for metrics of observed inflation. Moreover, results are robust to the inclusion of time fixed effects and a set of dummy variables capturing the number of years as an IT of the central bank. These suggest that, unlike in pure theoretical models, a central bank's reaction function includes mitigating the effects of possible second-round inflationary effect, as provided by observed inflation gaps. However, deviations of inflation expectations from the target carry a much larger interest rate reaction, as the role on Taylor rules is to anchor inflation expectations, the key nominal anchor of inflation targeting central banks. This also relates to Taylor rule response to supply or demand shocks (which we specifically control for in the robustness checks' section), as in theory the central bank should only react to demand shocks, but still cares for inflation expectations not de-anchoring when a supply shock hits the economy. Moving forward, we will stick to using the expected inflation gap as the baseline—results with the observed inflation gap are available from the authors upon request.

Moreover, the estimated impacts of controls in Table 3 are aligned with basic economic intuition and in line with recent work estimating Taylor rules (Guerra et al., 2025). We find strong persistence of policy interest rates, as given by the positive and highly significant coefficient of the lagged interest rate. We also observe the autoregressive nature of changes in the nominal effective exchange rate, which shows some easing of interest rates on impact, followed by an increase in the policy interest rate the following quarter. Our findings are also supportive of the role of the global financial cycle (Rey, 2015), in that policy rates move in tandem with US interest rates. Moreover, the use of Taylor rules in inflation targeting countries shows the importance of deviations of output from its potential, with the central bank tightening interest rates when observed output is larger than potential output (that is a positive output gap that would result in inflationary pressures). That said, the magnitude of the latter's coefficient is much smaller than that of the expected inflation gap.[9]

Next, we assess whether the estimated Taylor rules vary with the level of income. As mentioned, AEs and EMDEs in our sample vary along several dimensions that may shape their monetary policy response to deviations from the inflation target and to the output gap. We find that the response of policy interest rates to expected inflation gaps is positive and statistically significant in both income groups in our baseline specification (Table 4, columns 1-3). Of interest, note that within EMDEs, those that adopted an inflation targeting regime earlier (prior to 2005) are found to respond more forcefully to deviations in the expected inflation gap—the Taylor rule coefficient is about two times that of late adopters among EMDEs and also compared to AEs, reporting close to 40 basis point change for any one percentage point deviation of expected inflation from its target. The stronger response by EMDEs that adopted the IT regime earlier is also found in alternative specification that control for time fixed effects and years as IT fixed effects. Moreover, the size and statistical significance of the coefficient for EMDEs that adopted

[9] Note that in the textbook Taylor rule, the central bank's response to the inflation gap should be greater than one to ensure determinacy of inflation expectations. In our formulation, which includes the interest rate's lag, this entails that $\beta/(1+\rho)$ should be greater than one. Table 3 shows that this is in fact the case of the inflation expectation gap.

the IT regime earlier do not vary much in the different specifications, something that does not hold for AEs and other EMDEs. The stronger response of early IT adopters to the expected inflation gap is presumably linked to differences in their inflationary history, as they comprise countries like Brazil, Peru, and Poland, among others, that experienced bouts of very high inflation in the 1980s, potentially translating in a stronger need to react to inflation expectations deviations. The link between the country's inflationary history and a central bank's monetary policy response, a key contribution of this paper, is studied in more detail later in this section.

We turn to exploring the stability of the inflation gap and output gap coefficients. One would expect that as central banks build their credibility over time, they would need a smaller change in the policy interest rate for a similar size inflation gap shock.[10] Put differently, more established central banks, one would expect, would have smaller inflation gap coefficients to the extent they build credibility over time. To test for this, we interact the expected inflation and output gaps with the number of years that a central bank has been conducting its monetary policy under an inflation targeting framework.

Our results show that the response of the interest rate to the expected inflation gap does not systematically vary over time (Table 5). In fact, a longer track record of consistent inflation targeting does not translate to smaller interest rate movements for similar expected deviation gaps. Table 5 shows that, although the coefficient is, as expected, negative, it is also quite small and not statistically significant, triggering the existence of what we label the credibility puzzle. This, so called, credibility puzzle holds under different configurations of fixed effects and regardless of whether we control years as IT linearly or through fixed effects.[11] It also holds when, in addition to the interaction terms described above, we include the interaction between the inflation and the output gaps and the years as IT squared. Though the latter is negative, as expected, pointing to some credibility progressive effect being factor into the response of the central bank to expected inflation shocks, when the all the fixed effects are put in place this coefficient becomes not significant, reinforcing the existence of the credibility puzzle.

We further explore the link between credibility/anchoring and policy rates' response to deviations from target by interacting the expected inflation gap with two additional measures of credibility/anchoring. The first is a backward-looking metric, which gauges how close inflation has been to the target over the past eight quarters (two years). We implement this by calculating an eight-quarter rolling variance of the inflation gap, thus putting more weights to large deviations. The second is one of the components of the anchoring index proposed by Bems et

[10] As in Benati and Surico (2009) and Baxa et al. (2013).

[11] One could argue that our findings are driven by the fact that our estimates rely on approximately 35 years of information at best, and that it may take longer for credibility to start shaping monetary policy in a systematic way. However, analysis about the behavior and institutional setting of the Deutsche Bundesbank highlight the preponderant role that the hyperinflation of the 1920s played. For example, Clarida and Gertler (1997) argue that the hyperinflation of the 1920s was a key factor shaping the design of the central bank in the 1950s and how they conducted monetary policy in the following years. The shadow of Germany's hyperinflation is also supported by the findings in Braggion et al. (2024), who find that individuals living in German regions that suffered more from the inflation of the 1920s have almost a century later higher inflation expectations relative to individuals in other regions. This supports our point that "inflationary memory" is persistent.

al. (2021).[12] In particular, we use the component that measures the responsiveness of medium-term expectations to short-term inflationary shocks as an alternative measure of credibility of the central bank. The expectation is that when these dimensions lean towards low credibility/anchoring (there is higher deviation from target or a higher pass-through from short-term inflationary shocks to medium-term expectations) the policy rate will respond more forcefully to the expected inflation gap in order to keep inflation expectations close to the target, and vice versa. Results in Table 5, column 9 show that while the coefficient for the interaction between the inflation gap in t and the rolling variance of the inflation gap over the past two years is positive, it is not statistically significant. Similarly, column 10 shows that the interaction of the inflation gap with Bems et al. (2021)'s measurement of anchoring is negative but not significant. To be sure, the anchoring index in column 10 is only available for a subset of countries and periods compared to our analysis in columns 1-8. Thus, in column 11 we re-estimate the specification in column 8 for the same sample as in column 10 and find that results hold. In sum, our results show that the relationship between the policy rate and either time as an IT or different metrics of credibility anchoring goes in the expected direction but is not statistically significant.

What lies behind the stronger response of EMDEs that adopted the IT regimes earlier and, more broadly, the credibility puzzle? One plausible factor behind these findings is a past with high inflation levels. Many inflation targeting countries carry an inflationary past. After stabilizing prices through alternative means (be it exchange rate bands, pegs, crawling pegs, crawling bands, etc.), inflation targeting helped these countries manage their monetary policy in an effective manner (de Gregorio, 2024).

To study systematically the role played by past inflation in explaining differences in Taylor rules across countries, we extend our baseline specification by interacting the inflation and output gap coefficients with a dummy variable that takes value one if the country experienced high inflation in the past (see Section 3 for details). We find that countries that have an inflationary past exhibit larger (and statistically significant) policy rate responses to deviations in expected inflation relative to the target compared to countries that did not suffer high past inflation (Table 6). Countries with a high inflationary past change their interest rates by an additional 26 basis point—such that the overall effect is close to 50 basis points in such countries—making it an economically significant effect. Interestingly, we find no systematic evidence of differences in the response to the output gap. Further, note that the coefficient for countries with an inflationary past is more than double that of other countries, reaffirming the economic significance of the legacy of past inflation. Note that this implies that, conditional on the credibility metric (as

[12]The literature has developed indices of central bank credibility and anchoring (see Bems et al. (2021)). One problem with these indices for the purpose of this paper is that anchoring is partly related to the deviation of inflation expectations relative to the target, i.e. the expected inflation gap. Thus, we pursue a simpler exercise which assumes that credibility and anchoring increase as time under an IT regime passes. This amounts to interacting the expected inflation and output gaps with the years the central bank has as an IT. As a robustness exercise, we also explore how the response of the policy rate to the inflation gap varies with one of the subcomponents of the index proposed by (Bems et al., 2021)—the responsiveness of long-term expectations to short-term inflationary shocks. This measure is less related to the expectations measure we use to construct our expected inflation gap.

in Table 5), the average central banker in a country with high past inflation aims at keeping inflation expectations anchored, even if, as discussed in Section 2, that may imply a short-run economic activity cost in order to gain the longer-term benefits of preserving inflation expectations anchored.

Our result is not driven by our definition of the high past-inflation dummy, as the link finding that higher inflationary history results in a stronger response of the policy rate to deviations from the target is also found when we use the average past inflation in levels (Table 7). Columns 1-2 show results when we only interact the expected inflation gap with average past inflation, while in columns 3-4 we also interact average past inflation with the output gap. Results confirm our main findings—a higher value for average past inflation is linked to a higher coefficient for the expected inflation gap.

One possible channel through which past inflation affects the contemporaneous conduct of monetary policy is higher inflation persistence. This may arise, for example, when an inflationary past results in wage indexation tied to past inflation or to the nominal exchange rate relative to a hard currency. If this is the main channel through which past inflation affects monetary policy contemporaneously, we would expect the interaction between the expected inflation gap and inflation persistence to be positive and significant and the coefficient for the interaction between the expected inflation gap and the average past inflation level to be non-significant.

Table 7, column 5, shows that inflation persistence does not explain the higher policy rate response to deviations from target seen in countries with a history of past high inflation. We extend the specification in Table 7, column 4, by adding a gauge of inflation persistence and its interaction with the expected inflation gap.[13] The latter interaction is positive but not statistically significant, while the coefficient for the interaction of the expected inflation gap with the average past inflation remains positive and significant. Note that the sample in column 5 is smaller than the one in column 4, which raises the possibility that the findings in 5 are sample specific. Results in column 6 show that the link between past inflation and the coefficients of the Taylor rule documented in column 4 holds in the smaller sample used in column 5. Next, we explore whether the timing of past inflation matters for the heterogeneity of the Taylor rule's coefficients. For example, Malmendier and Nagel (2016) point to the presence of a recency bias, whereby agents put more weight to recent individual experiences when forming inflation expectations. To explore whether such pattern is also seen in the relationship between estimated Taylor rules and a country's past inflation, we calculate average (transformed) inflation 10 to 25 years prior to the adoption of IT (recent) and average inflation from the beginning of the data to 25 prior to the adoption of IT. Results in column (7) show that in the case of Taylor rules, inflationary episodes that occurred long before the adoption of the IT have a stronger effect on the Taylor rule coefficients relative to more recent ones, suggesting that the shadow cast by past high inflation on monetary policy can be long.

[13]We construct a measure of inflation persistence as follows. For each country we estimate the elasticity of one-year ahead inflation expectation to contemporaneous inflation on a 20-quarter rolling basis. The estimated coefficient is then used as the gauge of persistence in the regressions in Table 7, column 5.

4.2 Discussion

Our results point to the importance of having a legacy of high inflation (we can also label it inflationary memory), which, all else equal, results in a stronger reaction of the central bank—a larger increase in interest rates in response to any movement in the inflation expectations' gap. What are possible explanations of these results? On the one hand, our results are related to the literature that analyzes the impact on inflation expectations of individuals based on their experience. For example, as in Magud and Pienknagura (2024), who show that for a cross-country sample of emerging and advanced economies, individuals that have been exposed to longer spells of high inflation have stronger aversion to inflation. It also connects, on the policy side, to Malmendier et al. (2021), who show how policymakers in the US who were exposed to higher inflation when they were younger, tend to vote more hawkishly in FOMC meetings. This is also aligned with Rogoff (1985), as it is optimal to have a more inflation-conservative central banker to mitigate inflation. Probably, our findings are a combination of all such examples, as central banks internalize individuals' preferences (including a country's inflationary memory) into a successful monetary policy framework.

In turn, these findings challenge two important tenets of the received wisdom of inflation targeting. One is that the theoretical framework behind inflation targeting rests on assuming full credibility. However, full credibility is not supported precisely by the existence of the credibility puzzle. One could argue that longer data series could eventually result in the disappearance of the credibility puzzle. This may well be the case, which calls for a re-estimation of our results in the future. But, anecdotally, the German Bundesbank aversion to inflation as a consequence of Germany's hyperinflation in the 1920s—and the transfer of it thereafter to the European Central Bank—seems to suggest that the credibility puzzle may outweigh the passing of time, and that the strength of containment of inflation never dies away.

The other tenet is the assumption of no path dependence. The fact that the inflationary past plays such an important role in the interest rate reaction function of a central banks to current inflation gap shocks speaks to the importance of internalizing past events in models. Central banking in inflation targeting countries is clearly history-dependent, something that has typically been ignored in theoretical models of inflation targeting. So, even though IT works through anchoring expectations of future inflation, past inflation also matters for the effectiveness of monetary policy.

Yet, an inflationary past may relate to other variables that may affect the conduct of monetary policy. With this in mind, we explore the robustness of our results in the next section.

4.3 Robustness checks

This section explores the robustness of our main result—i.e., that countries that experienced high levels of inflation historically react more strongly to the expected inflation gap relative to those that did not. More broadly, it also tests alternative specifications for the Taylor rule.

Note that a history of high inflation may affect structural variables that are important for the effectiveness and conduct of monetary policy. For example, exposure to high inflation may undermine the development of domestic financial markets, especially those in domestic currency, and, relatedly, make countries less prone to have an open capital account as fears of depreciation may be present. In Jácome et al. (2025) we describe in detail the extensive heterogeneity among inflation targeting countries.

The latter includes the level of financial development and the depth of capital account openness (that is, financial integration to global capital markets), as well as how open to international trade the countries are. Deep financial markets make the transmission of monetary policy more effective, as changes in the central bank's policy rate have a strong effect on long-run interest rates in the financial system—thus having a greater impact on consumption and investment and, hence, on inflation and output. In contrast, shallow financial markets tend to impair the transmission mechanism of monetary policy, weakening its impact on inflation. Advanced economies also enjoy fully open capital accounts. While cross-border capital flows could, in principle, create exchange rate volatility, its impact is attenuated when financial systems are well developed and, thus, a well-functioning market of derivatives is in place that allows market participants to hedge against large foreign currency volatility. To the extent that emerging market economies do not have a deep market of derivatives, large changes in capital inflows and outflows induce foreign exchange volatility and, depending on the central bank credibility, large exchange rate depreciations can have an adverse effect on inflation.

In addition, an important characteristic of emerging markets and developing countries with IT regimes is that several of them are large net commodity exporters. Being a net commodity exporter may condition monetary policy decisions because recurrent terms of trade shocks have an impact on output, the exchange rate and, sometimes inflation—although the latter hinges on the exchange rate pass-through that, in turn, depends on the credibility of the central bank (Carrière-Swallow et al., 2021)—, especially if the shock is of considerable scale and duration. Thus, the need for inflation targeting countries to have flexible exchange rate regimes. Moreover, central banks in commodity exporting countries could even face non-trivial policy trade-offs when confronting simultaneously an adverse terms of trade shock and tightening monetary conditions in the U.S. The former inflicts a negative effect on output and, hence, suggests loosening monetary policy, whereas the latter advice implementing a tightening stance to tackle capital outflows and exchange rate depreciation, which may have an impact on inflation expectations. Finally, central bank independence and transparency are fundamental pillars of inflation targeting. Yet central bank independence and transparency vary across countries. Specifically, central banks in emerging markets are more independent but less transparent than in advanced economies. Central banks are probably more independent because of their previous history of high inflation, which was often associated to the governments' use of central banks to finance their coffers and to serve their short-term political agenda, in particular during electoral cycles.[14]

Table 8 shows results for an extension of the regression in Table 6. More precisely, in

[14] Additional details about the institutional arrangement of different inflation targeting countries are presented in Jácome et al. (2025), which updates the description in Hammnond (2012).

addition to including the interactions of the expected inflation and output gaps, we control for interactions of each of the gaps with dummies capturing whether the country had a high level of the specific variable at the time of IT adoption—financial development, trade openness, capital account openness, and central bank independence.[15] For example, the dummy for high financial development takes value 1 if the country had a value of the FD index which lied above the average value in our sample. A similar definition applies for other variables.

Results of this exercise confirm the relevance of a country's inflationary past even after controlling for additional country-specific characteristics (Table 8, columns 1). If anything, the difference between countries with past high inflation and those with no inflationary history in the response of the policy rate to deviations from the target of expected inflation becomes larger and remains statistically significant. Similar conclusions hold when we control for the different set of fixed effects described earlier (columns 2-4). Further, results are unaffected when we adjust the de jure measure of openness (from Chinn-Ito, KA openness) by the magnitude of interventions in foreign exchange markets (column 5)[16] or when we replace the high trade openness dummy with a dummy taking value one if the country is a commodity exporter (column 6).[17] The latter exercise takes into account the fact that these countries' economies are more susceptible to fluctuations in commodity prices.

Note also that many of these variables affect the response of policy rates to expected inflation gaps. In fact, having deeper financial markets or more independent central banks marginally reduce the reaction of policy interest rates to expected inflation gap shocks, as given by the negative interaction term of these variables and the expected inflation gap (Table 8). The same is true for integration to international financial markets (that is, the openness of the financial account), once we correct the de jure measure by taking into account FXI. Initial levels of trade openness do not appear to weigh on the parameters of the Taylor rule, as the coefficient of this interaction is not statistically significant.

Next, we modify the specification used in Table 8 by interacting the expected inflation and output gaps with the level of the country-specific variables of interest at the time of IT adoption. The results of this exercise, shown in Table 9, confirm the findings of Table 7—the coefficient for the interaction between the expected inflation gap and the average past inflation level is positive, statistically significant, and the magnitude of the coefficient is higher than those presented in

[15]Unsustainable fiscal imbalances driven by fiscal dominance often contribute to inflationary processes, and typically translate into higher inflation expectations. The link between fiscal policy and inflation expectations is documented, for example, in David et al. (2025), and Brandao-Marques et al. (2024) However, we do not control explicitly for fiscal dominance but for an index of legal central bank independence, in which central bank financing to the government is the most important criteria incorporated to that index. More generally, because there is consensus about the need of avoiding fiscal dominance when adopting an inflation targeting framework to strengthen its price stability commitment, countries have adhered to this fundamental principle.

[16]We correct the Chinn-Ito index by, first, computing the absolute value of FX interventions as a share of GDP and defining whether, in a given quarter, a country has high intervention, defined by the quarterly median value for our sample. Then we construct our adjusted measure of capital account openness as the average between the Chinn-Ito index (which lies between 0 and 1) and one minus the FX intervention dummy. Intuitively, if the country has high de jure openness and low FX intervention, it will be featured as having high de facto openness.

[17]We use the definition of commodity exporters in Aslam et al. (2016) for EMDEs. For AEs, we classify Australia, Canada, Norway, and New Zealand as commodity exporters.

Table 7. In contrast, and consistent with what was shown in Tables 7 and 8, the coefficient for the interaction of past inflation and the output gap is non-significant. Results are robust to the inclusion of time and year of IT adoption fixed effects and to the interaction of the gaps with a commodity exporter dummy.

Results in Table 9 are robust to the use of contemporaneous country-specific variables. Table 10 expands the specification in 9 by interacting the contemporaneous values of the key country-specific characteristics we consider with each of the gaps and adding these variables as additional, self-standing, controls. Results of these alternative exercise confirm the results in Table 9; the coefficient for the interaction of the expected inflation gap and past inflation remains positive and statistically significant.

We turn to studying the robustness of our Taylor rule specification in Table 3 to different periods of analysis, samples, and specifications. In particular, we explore whether there are significant breaks over time (especially after 2020 and the COVID shock), robust to outliers, whether there is evidence of non-linearities or asymmetries, and whether estimated coefficients are robust to the inclusion of other controls (Table 11). First, one may wonder if the COVID shock affected these results.[18] To test for this, we re-estimate the specification in Table 3 using only the pre-COVID years. Columns (1) and (2) in Table 11 show that the baseline results are not affected by this limited sample. Also, given possible outlier data, we re-estimated the baseline model excluding Turkey and Russia, two countries where monetary policy has been recently affected by high inflation and political developments. Results in columns 3 and 4 show that the exclusion of these countries does not affect the findings in Table 3. Next, we check the robustness of results to the inclusion of years as IT linearly (as opposed of including fixed effects). Column 5 shows that this change does not affect the estimated coefficients for the expected inflation and output gaps. Column 6 presents results for an extended specification that allows the coefficient for the expected inflation gap to vary depending on the sign of the gap. In particular it adds an interaction between the expected inflation gap and a dummy taking value one if the gap is positive. Note that the coefficient for this additional variable is non-significant and small in magnitude, suggesting that there are non-significant asymmetries in the Taylor rule for the average country in our sample.

Importantly, we also check whether the inclusion of changes in commodity terms-of-trade (Table 11, column 7) or the ratio of the output gap and inflation volatilities (Table 11, column 8) affect our coefficients. The former variable takes into account the fact that commodity prices, and more broadly terms-of-trade, can pass-through to inflation, thus affecting our measures of the inflation gap and potentially shaping monetary policy. The latter aims at indirectly capturing the differences in the slope of the Phillips curve jointly with an IS curve, a dynamic that may affect monetary policy, given that, in principle, policy rates should only respond to demand shocks, but not supply shocks if inflation expectations are properly anchored. Results show that the inclusion of these variables does not affect the estimated coefficients of the Taylor rule. Next,

[18] Guerra et al. (2025) Taylor rules for 5 IT countries in Latin America (Brazil, Chile, Colombia, Mexico and Peru) and document differences the estimated coefficients after COVID.

column 9 assesses potential non-linearities. In particular, it includes both the expected inflation gap and its square value. Our results indicate no evidence of non-linearities, as the coefficient for the squared term is small and statistically insignificant.

Finally, Table 12 explores the role of regional shocks and time varying fixed effects on the estimated monetary policy reaction functions. The inclusion of regional fixed effects takes into account the fact that there may be shocks (e.g., terms-of-trade shocks or natural disasters) that are not controlled in the regressions and may affect many countries in specific regions simultaneously or not (beyond global shocks). As was the case in Table 3 and Table 11, we present estimates that do not control for years as IT, include this variable linearly, and then as fixed effects. Results in Table 12 show that results remain broadly robust. The coefficients for the expected inflation and output gaps remain positive and significant, with the former being substantially larger in magnitude, albeit lower than in the baseline estimation. Moreover, columns (4)-(6) show that the link between the coefficients of the Taylor rule and past episodes of high inflation are unaffected by the inclusion of the region-time fixed effects. Finally, columns (7) and (8) control for fixed effects at the country-period level. The periods considered are 5 year intervals. These fixed effects are aimed at addressing the potential change in the neutral rate in each country that could bias our estimates.[19] Results show that the inclusion of such fixed effects does not affect our estimates of the baseline model nor those from the model that allows the coefficients to respond to a country's past inflationary experience.

5 Conclusion

Inflation targeting, a monetary policy regime that was adopted for the first time about 35 years ago, has become widespread among central banks in AEs and EMs, and is a central pillar in DSGE models. Despite many important similarities among IT central banks, this paper documents important differences in the conduct of monetary policy. Moreover, it shows that when it comes to explaining monetary policy heterogeneity, exposure to historical episodes of high inflation is a key determinant. After providing a theoretical model to account for the importance of path dependence and central bank credibility, our empirical findings show that, on average, central banks that adopted an IT framework respond preponderantly to deviations of inflation expectations from the target rate. However, for a given expected inflation gap, central banks in countries with a history of high inflation adjust their policy rate in a more aggressive way. Such response potentially explains the fact that the coefficient for the expected inflation in the Taylor rule does not appear to fall over time nor to be lower in central banks with greater inflation expectations' anchoring, a fact that we label the credibility puzzle. Thus, despite the persistent construction of credibility as they conduct their monetary policy over time, central banks, especially those with past high inflation experiences, continue to react as strong as in the past to inflation expectations shocks regardless—probably due to fears of the return of unanchored inflation.

[19]For example, Laubach and Williams (2003) document secular changes in the neutral interest rate in the US.

While not formally tested in this paper, there are at least two potential explanations for our findings. First, it is possible that policy makers themselves, i.e. central bank board members, are scarred by their own experiences with high inflation and have a strong preference for price stability. Another possibility is that policy makers in countries with an inflationary memory internalize the impact that such history has on price and wage dynamics and thus need to respond more aggressively to deviations from target to break a potential inflationary spiral. Both these explanations would be consistent with recent evidence that shows that individuals that experienced past high inflation express a stronger preference for price stability (Magud and Pienknagura, 2024).

Regardless of the factors underlying our findings, the seeming persistence of inflationary memory and its impact on monetary policy has important implications both from a policy and economic modelling perspective. On the former, it raises the possibility that inflationary history may affect not only the conduct of monetary policy, but also the transmission of monetary policy. This, which is not explored in this paper, is an important avenue for future research.

From a modeling perspective, and this being the main contribution of the paper, it points to the importance of incorporating path dependency and less-than-perfect credibility in theoretical models, as these appear to be important empirical considerations, which have been missing in the standard inflation targeting model, with non-trivial implications.

A Tables

Table 1: Summary Statistics

	Average	St. Dev.	Min	Max
Policy rate	4.78	3.65	-0.5	26.5
NEER (change)	-0.53	7.96	-56.59	33.81
Inflation gap (observed)	0.59	2.87	-7.91	28.86
Inflation gap (expected)	0.26	1.01	3.79	11.58
Output gap	-0.003	2.33	32.35	10.38

Note: Summary statistics exclude data for Turkey.

Table 2: Sample of Countries

Advanced Economies	Emerging Markets
AUS (1993), CAN (1992) CZE (1997)	ALB (2009), BRA (1999), CHL (1999)
GBR (1992), ISR (1997), KOR (2001)	COL (1999), DOM (2012), GEO (2009
NOR (2001), NZL (1989), SWE (1993)	GTM (2005), HUN (2001), IDN (2005)
	IND (2015), KAZ (2015), MDA (2013)
	MEX (2001), PER (2003), PHL (2002)
	POL (1998), PRY (2013), ROU (2005)
	RUS (2015), SRB (2006), THA (2000)
	TUR (2006), ZAF (2000)

Note: Year of IT adoption in parenthesis.

Table 3: Taylor Rule Estimation: Expected Inflation versus Observed Inflation

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate	(5) Policy rate	(6) Policy rate	(7) Policy rate	(8) Policy rate	(9) Policy rate
Policy rate (t-1)	0.8692***	0.8960***	0.8723***	0.8518***	0.8866***	0.8627***	0.8678***	0.9084***	0.8719***
	(0.0345)	(0.0205)	(0.0323)	(0.0452)	(0.0278)	(0.0415)	(0.0463)	(0.0233)	(0.0410)
NEER change	-0.0220*	-0.0250*	-0.0196*	-0.0225*	-0.0262*	-0.0202*	-0.0323***	-0.0391***	-0.0294***
	(0.0124)	(0.0139)	(0.0110)	(0.0127)	(0.0144)	(0.0112)	(0.0123)	(0.0129)	(0.0110)
NEER change (t-1)	0.0243**	0.0219**	0.0203**	0.0251**	0.0228**	0.0210**	0.0251**	0.0241**	0.0205*
	(0.0099)	(0.0104)	(0.0100)	(0.0098)	(0.0103)	(0.0100)	(0.0101)	(0.0114)	(0.0104)
US Pol. rate (t-1)	0.0735***	0.0630***	0.0748***	0.0604***	0.0524***	0.0642***			
	(0.0278)	(0.0204)	(0.0269)	(0.0219)	(0.0184)	(0.0219)			
Output gap	0.0651***	0.0777***	0.0687***	0.0693***	0.0826***	0.0732***	0.0839***	0.0907***	0.0841***
	(0.0147)	(0.0214)	(0.0151)	(0.0165)	(0.0224)	(0.0158)	(0.0172)	(0.0243)	(0.0168)
Inflation gap (observed inf)	0.0926***			0.0998***			0.0773		
	(0.0320)			(0.0378)			(0.0514)		
Inflation gap (core inf)		0.0903**			0.0945*			0.0706	
		(0.0410)			(0.0483)			(0.0598)	
Inflation gap (expected inf)			0.2207***			0.2253***			0.1845*
			(0.0714)			(0.0782)			(0.0950)
Constant	0.4245***	0.3295***	0.4002***	0.3439	0.1885	0.2780	0.2299	-0.3500	-0.0095
	(0.1270)	(0.0801)	(0.1257)	(0.2950)	(0.3099)	(0.2904)	(0.4655)	(0.3990)	(0.3523)
Implied $\beta/(1-\rho)$	0.7085**	0.8689**	1.7281***	0.6732***	0.8333**	1.6406***	0.5849*	0.7708	1.4405**
	(0.2405)	(0.4026)	(0.5342)	(0.2056)	(0.3457)	(0.4755)	(0.3259)	(0.5823)	(0.6632)
Sample	All	All	All	All	All	All	All	All	All
Time FE	NO	NO	NO	NO	NO	NO	YES	YES	YES
Years as IT FE	NO	NO	NO	YES	YES	YES	YES	YES	YES
Number of countries	32	28	32	32	28	32	32	28	32
Observations	2,612	2,366	2,617	2,612	2,366	2,617	2,612	2,366	2,617
Adjusted R-squared	0.896	0.909	0.900	0.899	0.911	0.903	0.910	0.923	0.914

Note: Driscoll-Kraay standard errors in parenthesis.
*** $p<0.01$, ** $p<0.05$, * $p<0.1$

Table 4: Taylor Rule Estimates by Income Levels

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate	(5) Policy rate	(6) Policy rate	(7) Policy rate	(8) Policy rate	(9) Policy rate
Policy rate (t-1)	0.8888***	0.8476***	0.8960***	0.8885***	0.8367***	0.8957***	0.9109***	0.8711***	0.8891***
	(0.0204)	(0.0590)	(0.0312)	(0.0234)	(0.0641)	(0.0411)	(0.0160)	(0.0512)	(0.0468)
NEER change	0.0164	-0.0064	-0.0734***	0.0178	-0.0050	-0.0764***	-0.0006	-0.0108	-0.0779***
	(0.0158)	(0.0113)	(0.0197)	(0.0158)	(0.0110)	(0.0203)	(0.0107)	(0.0134)	(0.0230)
NEER change (t-1)	-0.0064	0.0084	0.0653***	-0.0080	0.0100	0.0651**	-0.0042	0.0072	0.0620**
	(0.0110)	(0.0085)	(0.0242)	(0.0113)	(0.0081)	(0.0247)	(0.0079)	(0.0099)	(0.0270)
US Pol. rate (t-1)	0.0804***	0.0806	0.0648*	0.0754***	0.0531	0.0268			
	(0.0225)	(0.0511)	(0.0369)	(0.0215)	(0.0500)	(0.0445)			
Output gap	0.0375**	0.0851***	0.0602***	0.0365**	0.0854***	0.0635***	0.0192	0.0941***	0.0650***
	(0.0146)	(0.0265)	(0.0141)	(0.0177)	(0.0283)	(0.0133)	(0.0176)	(0.0284)	(0.0230)
Inflation gap (expected inf)	0.1823***	0.3993***	0.1834*	0.1640***	0.4117***	0.1753*	0.0413	0.3246***	0.1698
	(0.0465)	(0.0878)	(0.0929)	(0.0410)	(0.0901)	(0.0925)	(0.0559)	(0.0859)	(0.1136)
Constant	0.1239***	0.5627**	0.4581**	0.1596	-0.1946	0.5460	-0.2299	-0.4725	2.5723***
	(0.0472)	(0.2578)	(0.1771)	(0.2002)	(0.4463)	(0.4638)	(0.2004)	(0.5220)	(0.4786)
Sample	AEs	EMDE, early	EMDE late	AEs	EMDE early	EMDE late	AEs	EMDE early	EMDE late
Time FE	NO	NO	NO	NO	NO	NO	YES	YES	YES
Years as IT FE	NO	NO	NO	YES	YES	YES	YES	YES	YES
Number of countries	9	10	13	9	10	13	9	10	13
Observations	1,010	927	680	1,010	927	680	1,010	927	680
Adjusted R-squared	0.960	0.916	0.849	0.961	0.925	0.859	0.976	0.949	0.875

Note: Early refers to countries that adopted the IT regime prior to 2005, while late refers to IT adoption on or after 2005. Driscoll-Kraay standard errors in parenthesis.
*** $p<0.01$, ** $p<0.05$, * $p<0.1$

Table 5: The Credibility Puzzle

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate	(5) Policy rate	(6) Policy rate	(7) Policy rate	(8) Policy rate	(9) Policy rate	(10) Policy rate	(11) Policy rate	(12) Policy rate
Policy rate (t-1)	0.8670***	0.8685***	0.8654***	0.8655***	0.8597***	0.8608***	0.8675***	0.8677***	0.8678***	0.8842***	0.8948***	0.8917***
	(0.0337)	(0.0334)	(0.0409)	(0.0408)	(0.0416)	(0.0413)	(0.0415)	(0.0414)	(0.0401)	(0.0163)	(0.0244)	(0.0250)
NEER change	-0.0198*	-0.0198*	-0.0293***	-0.0294***	-0.0205*	-0.0205*	-0.0303***	-0.0304***	-0.0311***	-0.0321***	-0.0183	-0.0185
	(0.0109)	(0.0110)	(0.0105)	(0.0105)	(0.0112)	(0.0113)	(0.0107)	(0.0107)	(0.0109)	(0.0106)	(0.0127)	(0.0125)
NEER change (t-1)	0.0208**	0.0206**	0.0215**	0.0215**	0.0216**	0.0214**	0.0217**	0.0217**	0.0221**	0.0188*	0.0108	0.0103
	(0.0100)	(0.0101)	(0.0103)	(0.0104)	(0.0101)	(0.0102)	(0.0103)	(0.0103)	(0.0105)	(0.0104)	(0.0113)	(0.0112)
US Pol. rate (t-1)	0.0781***	0.0750***			0.0682***	0.0639***						
	(0.0279)	(0.0275)			(0.0228)	(0.0224)						
Output gap	0.0686***	0.0941***	0.0798***	0.0995***	0.0726***	0.1030***	0.0838***	0.1044***	0.1021***	0.0819***	0.0877***	0.0877***
	(0.0151)	(0.0201)	(0.0163)	(0.0201)	(0.0152)	(0.0217)	(0.0167)	(0.0206)	(0.0348)	(0.0194)	(0.0171)	(0.0286)
Inflation gap (expected inf)	0.3294***	0.3228***	0.3210***	0.3164***	0.3253***	0.3177***	0.2984***	0.2940***	0.4039***	0.2522***	0.3230***	0.4479***
	(0.1140)	(0.1123)	(0.1101)	(0.1096)	(0.1008)	(0.0986)	(0.1125)	(0.1119)	(0.1254)	(0.0676)	(0.0768)	(0.1559)
Inflation gap (expected inf) x years as IT	-0.0066	-0.0062	-0.0084	-0.0081	-0.0062	-0.0057	-0.0072	-0.0069	-0.0282			-0.0136
	(0.0053)	(0.0053)	(0.0062)	(0.0062)	(0.0052)	(0.0052)	(0.0066)	(0.0065)	(0.0188)			(0.0120)
Output gap x years as IT		-0.0018		-0.0017*		-0.0022*		-0.0018*	-0.0014			-0.0001
		(0.0012)		(0.0009)		(0.0013)		(0.0010)	(0.0045)			(0.0021)
Inf. gap (expected inf) x years as IT squared									0.0009			
									(0.0005)			
Output gap x years as IT squared									-0.0000			
									(0.0001)			
2-year inf. gap var. (t-1)										-0.0105		
										(0.0069)		
Output gap x										-0.0021		
2-year inf. gap var. (t-1)										(0.0017)		
Inflation gap x										0.0002		
2-year inf. gap var. (t-1)										(0.0003)		
Sensitivity to ST shocks											0.0032	
											(0.0305)	
Output gap x											0.0050	
Sensitivity to ST shocks											(0.0111)	
Inflation gap x											-0.0548	
Sensitivity to ST shocks											(0.0680)	
Sample	All	All	All	All	All	All	All	All	All	All	All	All
Time FE	NO	NO	YES	YES	NO	NO	YES	YES	YES	YES	YES	YES
Yeas as IT FE	NO	NO	NO	NO	YES	YES	YES	YES	YES	YES	YES	YES
Number of countries	32	32	32	32	32	32	32	32	32	32	22	22
Observations	2,617	2,617	2,617	2,617	2,617	2,617	2,617	2,617	2,617	2,374	1,246	1,246
Adjusted R-squared	0.901	0.901	0.913	0.913	0.903	0.903	0.915	0.915	0.915	0.918	0.935	0.935

Note: The inflation gap is computed using inflation expectations. Sensitivity to ST shocks refers to the sensitivity of medium-term inflation expectations to short-term shocks. Driscoll-Kraay standard errors in parenthesis.
*** p<0.01, ** p<0.05, * p<0.1

Table 6: History Matters

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate
Policy rate (t-1)	0.8595***	0.8471***	0.8479***	0.8604***
	(0.0327)	(0.0410)	(0.0410)	(0.0418)
NEER change	-0.0203*	-0.0208*	-0.0207*	-0.0302***
	(0.0109)	(0.0111)	(0.0111)	(0.0107)
NEER change (t-1)	0.0202**	0.0209**	0.0208**	0.0213**
	(0.0097)	(0.0096)	(0.0096)	(0.0102)
US Pol. rate (t-1)	0.0893***	0.0801***	0.0799***	-0.1045
	(0.0269)	(0.0226)	(0.0227)	(0.0664)
Output gap	0.0676***	0.0722***	0.0638***	0.0739***
	(0.0154)	(0.0165)	(0.0146)	(0.0156)
Inflation gap	0.1951**	0.2006**	0.2007**	0.1677*
	(0.0819)	(0.0861)	(0.0858)	(0.1004)
Output gap x Pre-IT high inflation dummy			0.0264	0.0348
			(0.0215)	(0.0223)
Inf. gap x Pre-IT high inflation dummy	0.2601**	0.2694**	0.2672**	0.2412**
	(0.1178)	(0.1178)	(0.1176)	(0.1214)
Constant	0.4149***	0.3494	0.3451	0.8788***
	(0.1247)	(0.2761)	(0.2785)	(0.2941)
Sample	All	All	All	All
Time FE	NO	NO	NO	YES
Yeas as IT FE	NO	YES	YES	YES
Number of countries	32	32	32	32
Observations	2,617	2,617	2,617	2,617
Adjusted R-squared	0.902	0.905	0.905	0.916

Note: The inflation gap is computed using inflation expectations. Driscoll-Kraay standard errors in parenthesis.
*** $p<0.01$, ** $p<0.05$, * $p<0.1$

Table 7: History Matters: Pre-IT inflation in levels and the role of inflation persistence

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate	(5) Policy rate	(6) Policy rate	(7) Policy rate
Policy rate (t-1)	0.8641***	0.8499***	0.8507***	0.8620***	0.9027***	0.9108***	0.9006***
	(0.0322)	(0.0418)	(0.0418)	(0.0426)	(0.0287)	(0.0342)	(0.0227)
NEER change	-0.0200*	-0.0205*	-0.0205*	-0.0290**	-0.0321**	-0.0325**	-0.0320**
	(0.0109)	(0.0110)	(0.0110)	(0.0111)	(0.0158)	(0.0159)	(0.0129)
NEER change (t-1)	0.0208**	0.0216**	0.0216**	0.0205*	0.0233	0.0233	0.0225*
	(0.0099)	(0.0098)	(0.0098)	(0.0105)	(0.0157)	(0.0160)	(0.0134)
US Pol. rate (t-1)	0.0912***	0.0813***	0.0817***	-0.1208*	0.1554***	0.1619***	-0.1247*
	(0.0290)	(0.0236)	(0.0237)	(0.0701)	(0.0450)	(0.0390)	(0.0749)
Output gap	0.0698***	0.0747***	0.0621***	0.0693***	0.0672***	0.0651***	0.0672***
	(0.0166)	(0.0180)	(0.0165)	(0.0160)	(0.0229)	(0.0209)	(0.0152)
Inflation gap (expected inf)	0.0600	0.0495	0.0505	0.0277	0.0003	0.0770	0.1940***
	(0.0842)	(0.0869)	(0.0869)	(0.1052)	(0.1339)	(0.0954)	(0.0410)
Output gap x Pre-IT inflation			0.0405	0.0506	0.0429	0.0447	
			(0.0271)	(0.0307)	(0.0315)	(0.0325)	
Persistence measure					-0.2036		
					(0.2331)		
Inf. gap x Pre-IT inflation	0.5890**	0.6544**	0.6497**	0.5887**	0.3296***	0.3105**	
	(0.2402)	(0.2508)	(0.2496)	(0.2672)	(0.1179)	(0.1516)	
Inf. gap x Persistence measure					0.1980		
					(0.2559)		
Output gap x Pre-IT inflation, recent							0.0006
							(0.0211)
Output gap x Pre-IT inflation, late							0.1073*
							(0.0561)
Inf. gap x Pre-IT inflation, recent							-0.2392
							(0.3436)
Inf. gap x Pre-IT inflation, late							0.2895**
							(0.1340)
Constant	0.4161***	0.3897	0.3804	0.9604***	-0.5049	-0.6696***	0.9428***
	(0.1262)	(0.3001)	(0.3010)	(0.3123)	(0.3346)	(0.2517)	(0.3152)
Observations	2,513	2,513	2,513	2,513	1,872	1,872	2,166
Number of groups	31	31	31	31	30	30	26
Sample	All	All	All	All	All	All	All
Time FE	NO	NO	NO	YES	YES	YES	YES
Yeas as IT FE	NO	YES	YES	YES	YES	YES	YES
Adjusted R-squared	0.899	0.903	0.903	0.914	0.904	0.904	0.917

Note: The inflation gap is computed using inflation expectations. Driscoll-Kraay standard errors in parenthesis.
*** p<0.01, ** p<0.05, * p<0.1

Table 8: Historical inflation dummy and other state variables (at the time of IT adoption)

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate	(5) Policy rate	(6) Policy rate
Output gap	0.0979***	0.0964***	0.1104***	0.1112***	0.0739***	0.0956***
	(0.0288)	(0.0287)	(0.0303)	(0.0298)	(0.0137)	(0.0315)
Inflation gap	0.3498***	0.3443***	0.2823**	0.2833**	0.2875***	0.3689***
	(0.1031)	(0.1032)	(0.1163)	(0.1086)	(0.0572)	(0.1087)
Inf. gap x	0.3189***	0.3517***	0.3192**	0.3433***	0.2838**	0.2039**
Pre-IT high inflation dummy	(0.1114)	(0.1129)	(0.1226)	(0.1237)	(0.1130)	(0.0968)
Output gap x	0.0465	0.0512	0.0545	0.0622	0.0140	0.0439
Pre-IT high inflation dummy	(0.0381)	(0.0402)	(0.0388)	(0.0400)	(0.0310)	(0.0411)
Inflation gap x	-0.2598***	-0.2791***	-0.2353***	-0.2343***	-0.1677***	-0.2029***
High initial FD dummy	(0.0711)	(0.0772)	(0.0698)	(0.0731)	(0.0587)	(0.0765)
Output gap x	0.0125	0.0239	0.0065	0.0075	0.0028	0.0098
High initial FD dummy	(0.0171)	(0.0207)	(0.0165)	(0.0178)	(0.0178)	(0.0188)
Inflation gap x	0.0499	0.0618	0.0756	0.0705		0.0475
High trade openness dummy	(0.1225)	(0.1155)	(0.1106)	(0.1091)		(0.1006)
Output gap x	-0.0869**	-0.0884**	-0.0751*	-0.0764**		-0.0573
High init. trade openness dummy	(0.0431)	(0.0398)	(0.0401)	(0.0375)		(0.0350)
Inflation gap	-0.1605*	-0.1509*	-0.1095	-0.1177	-0.1179	-0.1629**
High init. CBI dummy	(0.0898)	(0.0861)	(0.0890)	(0.0882)	(0.0941)	(0.0789)
Output gap	-0.0033	-0.0036	-0.0073	-0.0096	0.0019	-0.0066
High init. CBI dummy	(0.0271)	(0.0284)	(0.0279)	(0.0298)	(0.0280)	(0.0303)
Inflation gap x	-0.0545	-0.0333	-0.0705	-0.0287	-0.0949	
High initial KA dummy	(0.0929)	(0.0894)	(0.0819)	(0.0942)	(0.0858)	
Output gap	-0.0726***	-0.0622***	-0.0769***	-0.0699***	-0.0755***	
High initial KA dummy	(0.0212)	(0.0168)	(0.0191)	(0.0171)	(0.0159)	
Inflation gap					0.1190	
Commodity exporter dummy					(0.1017)	
Output gap x					0.0819**	
Commodity exporter dummy					(0.0351)	
Inflation gap x						-0.3823**
high initial KA dummy (modified)						(0.1488)
Output gap x						-0.0146
high initial KA dummy (modified)						(0.0266)
Constant	0.4675***	0.4692	1.0859**	0.7410	0.7049	0.9742**
	(0.1451)	(0.2920)	(0.5268)	(0.4534)	(0.4589)	(0.3968)
Sample	All	All	All	All	All	All
Time FE	NO	NO	YES	YES	YES	YES
Yeas as IT FE	NO	YES	NO	YES	YES	YES
Number of countries	29	29	29	29	29	29
Observations	2,375	2,375	2,375	2,375	2,375	2,171
Adjusted R-squared	0.896	0.900	0.909	0.912	0.912	0.917

Note: Regressions also include the lagged policy rate, changes in the NEER and its lag. For simplicity these coefficients are not shown. The inflation gap is computed using inflation expectations. Driscoll-Kraay standard errors in parenthesis.
*** p<0.01, ** p<0.05, * p<0.1

Table 9: Historical inflation (levels) and other state variables (at the time of IT adoption)

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate
Output gap	0.0503***	0.0694***	0.0365***	0.0581***
	(0.0145)	(0.0210)	(0.0126)	(0.0182)
Inflation gap	-0.1698	-0.1796	-0.0912	-0.1105
	(0.1959)	(0.2088)	(0.1685)	(0.1843)
Inf. gap x Pre-IT high inflation	0.9993***	0.9199***	0.7753***	0.7281***
	(0.3408)	(0.3515)	(0.2572)	(0.2730)
Output gap x Pre-IT high inflation	0.0217	0.0248	0.0072	0.0131
	(0.0336)	(0.0337)	(0.0252)	(0.0253)
Inflation gap x FD index (initial)	-0.9502*	-0.8942*	-0.7494	-0.7242
	(0.5393)	(0.5022)	(0.4811)	(0.4628)
Output gap x FD index (initial)	0.3642***	0.3226**	0.2455**	0.1909*
	(0.1242)	(0.1252)	(0.1055)	(0.0990)
Inflation gap x trade openness (initial)	0.0039	0.0034		
	(0.0047)	(0.0047)		
Output gap x trade openness (initial)	-0.0025***	-0.0025***		
	(0.0008)	(0.0009)		
Inflation gap x CBIE index (initial)	1.0326***	1.0590***	1.0217**	1.0405***
	(0.3699)	(0.3737)	(0.4013)	(0.3837)
Output gap x CBIE index (initial)	0.2700**	0.2371**	0.1226	0.1011
	(0.1132)	(0.1037)	(0.0846)	(0.0860)
Inflation gap x KA index (initial)	0.5651**	0.5267**	0.5535	0.5253
	(0.2582)	(0.2375)	(0.3578)	(0.3301)
Output gap x KA index (initial)	-0.1618***	-0.1512***	-0.1846***	-0.1682***
	(0.0581)	(0.0565)	(0.0621)	(0.0593)
Inflation gap x Commodity exporter dummy			0.1621*	0.1439
			(0.0899)	(0.0932)
Output gap x Commodity exporter dummy			0.0478	0.0425
			(0.0344)	(0.0358)
Constant	0.4408	0.2728	0.4213	0.3522
	(0.2906)	(0.3919)	(0.2842)	(0.3975)
Sample	All	All	All	All
Time FE	NO	YES	NO	YES
Yeas as IT FE	YES	YES	YES	YES
Number of countries	31	31	31	31
Observations	2,513	2,513	2,513	2,513
Adjusted R-squared	0.906	0.916	0.906	0.916

Note: Regressions also include the lagged policy rate, changes in the NEER and its lag. For simplicity these coefficients are not shown. The inflation gap is computed using inflation expectations. Driscoll-Kraay standard errors in parenthesis. *** $p<0.01$, ** $p<0.05$, * $p<0.1$

Table 10: Historical inflation (in levels) and other state variables (contemporaneous values)

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate
Output gap	0.0667	0.0751	0.0402	0.0522
	(0.0583)	(0.0557)	(0.0518)	(0.0527)
Inflation gap	0.4499**	0.5904***	0.4451**	0.5593***
	(0.1927)	(0.2020)	(0.1873)	(0.1864)
Inf. gap x Pre-IT inflation	0.9726***	0.8819**	0.8766***	0.7889**
	(0.3291)	(0.3631)	(0.3173)	(0.3531)
Output gap x Pre-IT inflation	0.0343	0.0425*	-0.0023	0.0085
	(0.0275)	(0.0252)	(0.0362)	(0.0305)
Inflation gap x FD index	-0.4366*	-0.6144**	-0.3999	-0.5695**
	(0.2420)	(0.2356)	(0.2558)	(0.2463)
Output gap x FD index	0.0642	0.0478	0.0646	0.0486
	(0.0560)	(0.0558)	(0.0561)	(0.0553)
Inflation gap x Trade over GDP	0.0039	0.0034		
	(0.0047)	(0.0047)		
Output gap x Trade over GDP	-0.0004	-0.0004		
	(0.0004)	(0.0005)		
Inflation gap x CBIE index	-0.3184	-0.3930	-0.2679	-0.3376
	(0.2338)	(0.2498)	(0.2323)	(0.2435)
Output gap x CBIE index	0.0347	0.0474	0.0474	0.0559
	(0.0668)	(0.0667)	(0.0659)	(0.0673)
Inflation gap x KA index	0.0692	0.0370	0.0348	-0.0044
	(0.1449)	(0.1572)	(0.1468)	(0.1576)
Output gap x KA index	-0.0654**	-0.0707**	-0.0896***	-0.0935***
	(0.0286)	(0.0286)	(0.0274)	(0.0297)
Inflation gap x Commodity exporter dummy			0.0705	0.0842
			(0.0829)	(0.0847)
Output gap x Commodity exporter dummy			0.0494*	0.0466*
			(0.0261)	(0.0247)
Constant	0.2866	0.2847	0.2829	0.8124
	(0.4507)	(0.6716)	(0.4506)	(0.7140)
Sample	All	All	All	All
Time FE	NO	YES	NO	YES
Yeas as IT FE	YES	YES	YES	YES
Number of countries	28	28	28	28
Observations	2,059	2,059	2,059	2,059
Adjusted R-squared	0.920	0.931	0.920	0.931

Note: Regressions also include the lagged policy rate, changes in the NEER and its lag. For simplicity these coefficients are not shown. The inflation gap is computed using inflation expectations. Driscoll-Kraay standard errors in parenthesis. *** p<0.01, ** p<0.05, * p<0.1

Table 11: The effects of the COVID shock, outliers, inflation gap direction, terms-of-trade and non-linearities

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
VARIABLES	Policy rate	Policy rate	Policy rate	Policy rate	Policy rate	Policy rate	Policy rate	Policy rate	Policy rate
Policy rate (t-1)	0.8139***	0.8310***	0.8793***	0.8556***	0.8701***	0.8719***	0.8964***	0.9034***	0.8720***
	(0.0480)	(0.0509)	(0.0436)	(0.0443)	(0.0406)	(0.0410)	(0.0167)	(0.0229)	(0.0422)
NEER change	-0.0128	-0.0209**	-0.0217**	-0.0201**	-0.0282**	-0.0294***	-0.0197**	-0.0322***	-0.0294***
	(0.0102)	(0.0093)	(0.0103)	(0.0100)	(0.0108)	(0.0110)	(0.0093)	(0.0119)	(0.0110)
NEER change (t-1)	0.0100	0.0108	0.0149	0.0100	0.0203*	0.0206*	0.0031	0.0179*	0.0205*
	(0.0068)	(0.0072)	(0.0098)	(0.0078)	(0.0105)	(0.0105)	(0.0071)	(0.0104)	(0.0104)
US Pol. rate (t-1)	0.0343								
	(0.0255)								
Output gap	0.1187***	0.1049***	0.0766***	0.0697***	0.0796***	0.0841***	0.0912***	0.0808***	0.0841***
	(0.0254)	(0.0232)	(0.0154)	(0.0184)	(0.0161)	(0.0167)	(0.0211)	(0.0165)	(0.0167)
Inflation gap (expected inf)	0.3314***	0.3010***	0.1857*	0.2675***	0.1882*	0.1932**	0.2417***	0.1047	0.1832**
	(0.0777)	(0.0891)	(0.0969)	(0.0604)	(0.0973)	(0.0887)	(0.0456)	(0.0792)	(0.0737)
Years as IT					0.0054				
					(0.0124)				
Inflation gap x 1(inflation gap>0)						-0.0092			
						(0.1211)			
Δ Commodity ToT (t-1)							0.0640***		
							(0.0237)		
ratio of inflation to output gap volatilities								0.0572*	
								(0.0298)	
Inflation gap squared (expected inf)									0.0000
									(0.0038)
Constant	0.8888***	0.7159	-0.0569	0.0600	0.7391*	-0.0066	0.0492	1.0723***	-0.0110
	(0.2908)	(0.4685)	(0.3693)	(0.3415)	(0.4419)	(0.3502)	(0.3960)	(0.3345)	(0.3603)
Sample	Pre-2020	Pre-2020	Exc. Russia	Exc. Turkey	All	All	All	All	All
Time FE	NO	YES	YES	YES	YES	YES	YES	YES	YES
Years as IT FE	YES	YES	YES	YES	NO	YES	YES	YES	YES
Number of countries	32	32	31	31	32	32	31	32	32
Observations	2,117	2,117	2,583	2,546	2,617	2,617	1,944	2,286	2,617
Adjusted R-squared	0.920	0.929	0.923	0.930	0.912	0.914	0.946	0.921	0.914

Note: The inflation gap is computed using inflation expectations. Driscoll-Kraay standard errors in parenthesis.
*** p<0.01, ** p<0.05, * p<0.1

Table 12: Region-specific time-varying shocks and Country-period fixed effects

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate	(5) Policy rate	(6) Policy rate	(7) Policy rate	(8) Policy rate
Policy rate (t-1)	0.8739***	0.8739***	0.8771***	0.8591***	0.8591***	0.8611***	0.8192***	0.8043***
	(0.0382)	(0.0382)	(0.0383)	(0.0378)	(0.0378)	(0.0381)	(0.0486)	(0.0493)
XR depreciation	-0.0254**	-0.0254**	-0.0268**	-0.0263**	-0.0263**	-0.0275**	-0.0324***	-0.0317***
	(0.0120)	(0.0120)	(0.0121)	(0.0119)	(0.0119)	(0.0119)	(0.0121)	(0.0121)
XR depreciation (t-1)	0.0169	0.0169	0.0169	0.0176	0.0176	0.0177	0.0175	0.0181
	(0.0123)	(0.0123)	(0.0120)	(0.0122)	(0.0122)	(0.0119)	(0.0113)	(0.0112)
Output gap	0.0566***	0.0566***	0.0637***	0.0492***	0.0492***	0.0545***	0.0774***	0.0667***
	(0.0156)	(0.0156)	(0.0157)	(0.0155)	(0.0155)	(0.0157)	(0.0173)	(0.0169)
Inflation gap (expected inf)	0.1686*	0.1686*	0.1633*	0.1532	0.1532	0.1479	0.2354**	0.2159*
	(0.0998)	(0.0998)	(0.0971)	(0.1036)	(0.1036)	(0.1008)	(0.1142)	(0.1236)
Output gap x Pre-IT high inflation dummy				0.0240	0.0240	0.0283		0.0382
				(0.0208)	(0.0208)	(0.0211)		(0.0266)
Inf. gap x Pre-IT high inflation dummy				0.2498**	0.2498**	0.2504**		0.2239*
				(0.1144)	(0.1144)	(0.1145)		(0.1169)
Years as IT		0.0031			0.0018			
		(0.0094)			(0.0091)			
Constant	0.7352**	0.6908**	-0.2392	1.4916***	0.7889***	-0.0740	0.9663**	1.1113***
	(0.2963)	(0.2812)	(0.3704)	(0.3280)	(0.2804)	(0.3537)	(0.3795)	(0.3595)
Observations	2,617	2,617	2,617	2,617	2,617	2,617	2,617	2,617
Number of groups	32	32	32	32	32	32	150	150
Sample	All	All	All	All	All	All	All	All
Region-time FE	YES	YES	YES	YES	YES	YES	NO	NO
Country-period FE	NO	NO	NO	NO	NO	NO	YES	YES
Years as IT FE	NO	NO	YES	NO	NO	YES	YES	YES
Adjusted R-squared	0.932	0.932	0.933	0.934	0.934	0.935	0.834	0.836

Note: The inflation gap is computed using inflation expectations. Country-period fixed effects are such that we allow the country fixed effects to vary every 5 year-period. Driscoll-Kraay standard errors in parenthesis.
*** p<0.01, ** p<0.05, * p<0.1

B Results from Country-by-Country Taylor Rules

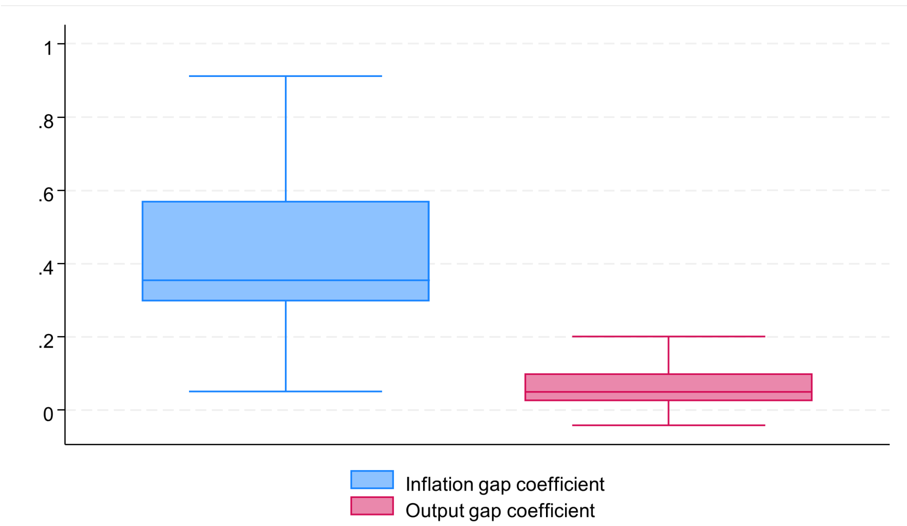
To further explore the relationship between a central bank's monetary policy reaction function (Taylor rule) and country-specific variables and past inflationary history, this Annex presents results from country-by-country regressions. In particular, we estimate the following Taylor rule for each IT country in our analysis:

$$\begin{aligned} i_{c,t} &= \alpha_c + \rho_c i_{c,t-1} + \beta_c \pi gap_{c,t} + \gamma_c Ygap_{c,t} + \\ &\theta_c \Delta NEER_{c,t} + \mu_c \Delta NEER_{c,t-1} + \omega c i_{US,t-1} + \varepsilon_{c,t} \end{aligned} \tag{B.1}$$

As in the main text, $i_{c,t}$ is the policy rate in country c, at time t, $Ygap_{c,t}$ is the output gap in country c at time t, with output detrended through the HP filter, $\Delta NEER_{c,t}$ is the change in the nominal effective exchange rate in period t, $i_{US,t-1}$ is the monetary policy rate in the US at time $t-1$, and $\pi gap_{c,t}$ is the inflation gap in country c at time t. For simplicity, we focus on the results using the inflation gap constructed using inflation expectations.

Figure B.1 plots the distribution of all the coefficients β_c and γ_c. Note that, as in Table 3, the coefficient for the inflation gap is significantly higher compared to the coefficient for the output gap. Moreover, the estimated coefficients from the panel regressions lie on the lower end of the inter-quartile range in both cases.

Figure B.1: Distribution of Taylor Rule Coefficients from Country-by-Country Estimations



Notes: Figures show the cross-country distribution of both the output gap and inflation gap coefficients stemming from country-by-country estimations of equation B.1.

Importantly, our finding that past inflationary history shapes a central bank's monetary policy is robust to the use of the country-specific estimates from (B.1). Table B.1, columns 1 and 4, show results from a regression of the inflation gap and the output gap coefficients, respectively, on the average inflation rate experienced by a country prior to the adoption of the IT regime. Consistent with results in Tables 6-7, we find that the inflation gap coefficient is strongly correlated with average past inflation, while the output gap coefficient is not. We further test the robustness of this result, columns 2 and 3 show results of a regression of the inflation gap coefficient on past inflation and additional controls, both their values at the time of IT adoption and also the average value from the time of IT adoption to the latest year. In both cases, the inclusion of these controls does not affect the magnitude nor the statistical significance of the relationship between the inflation gap coefficient and past inflation. A similar exercise shows that the output gap remains unrelated to past inflation (columns 5 and 6).

Table B.1: Country-specific Estimates and Past Inflationary History

Dep. Variable	Inflation Gap Coeff.			Output Gap Coeff.		
	(1)	(2)	(3)	(4)	(5)	(6)
Pre-IT inflation	0.995***	1.021***	1.002***	0.150	0.175	0.144
	(0.317)	(0.336)	(0.329)	(0.115)	(0.173)	(0.125)
Initial FD index		-0.0746			0.200	
		(0.502)			(0.166)	
Initial trade over GDP		-0.00173			-9.23e-06	
		(0.00193)			(0.000707)	
Initial KA index		0.0181			-0.0197	
		(0.170)			(0.0644)	
Initial CBIE index		-0.223			0.0105	
		(0.319)			(0.188)	
Average FD index			-0.00109			0.00192
			(0.016)			(0.00403)
Average trade over GDP			-5.68e-0.5			1.46e-0.5
			(0.000121)			(4.93e-0.5)
Average KA index			0.00791			-0.00256
			(0.0127)			(0.00387)
Average CBIE index			-0.00423			-0.0387
			(0.0168)			(0.0104)
Constant	0.237***	0.486	0.265	0.0427***	-0.0332	0,0841
	(0.0542)	(0.348)	(0.197)	(0.0145)	(0.151)	(0.0905)
Observations	28	28	28	28	28	28
R-squared	0.415	0.441	0.436	0.091	0.151	0.135

Note: Figures show the cross-country distribution of both the output gap and inflation gap coefficients stemming from country-by-country estimations of equation B.1. Bootstrapped standard errors in parenthesis.
*** p<0.01, ** p<0.05, * p<0.1

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