Evolving Market Perception of Credibility of MNB's Inflation Targeting Regime

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The monetary policy strategy of inflation targeting has a good track record in maintaining price stability with relatively low macroeconomic sacrifice in various types of economies. Inflation targeting central banks can consider themselves successful when they manage market expectations in a way that leads to lower inflation in the long run. These expectations are formed by financial investors of the evolution of market prices of financial assets and the policy moves of the central bank as reacting to changing economic and market conditions. When investors see that a central bank acts in line with its strategy, they will think of that central bank as a credible one. Credibility is an asset for a central bank as expectations of the target variable become well-anchored to the target and fewer and smaller policy moves are required to reach this target. Credibility can be estimated by assessing the degree of predictability of the central bank's policy moves as reacting to evolving market conditions, and the predictability of changes in asset prices in the fixed income and foreign exchange markets as reacting to changing market perceptions of the central bank's inflation aversion. In order to get a more dynamic assessment of credibility, one can measure the perceived credibility as seen by investors in financial markets. In this context, the higher the market perception of its aversion to inflation as implied by market prices of financial assets the more credible an inflation targeting central bank becomes. From this perspective, central bank communication is crucial as it gives a firsthand feedback to market participants as to whether or not the central bank consistently follows the monetary strategy laid out for itself. Thus, communication can dynamically build or destroy credibility. In our paper, we introduce several approaches to estimate the credibility of the Hungarian inflation targeting (IT) monetary policy regime in the period from June 2001 to April 2009. In the first part, we apply simple methods to measure the predictability and gradualism of Monetary Council decisions, the consistency of its communication as well as give a statistical overview of inflation stationarity and asset price changes. We find - and we attempt to explain why - that predictability was mediocre, the consistency of communication was low and there was one turbulent period (October 2002-November 2003) when communication was confusing and asset price volatility was high. We also find that inflation became stationary after the introduction of IT in 2001. In the second part, we introduce two econometric models to capture the evolution of the market perception of credibility. One is an EGARCH model that looks for reasons explaining volatility in the most important asset price (3-month BUBOR). The other one is a model demonstrating how asset price reactions to news reflects changing market perceptions of the anti-inflation stance of the MNB, and is using novel econometric methodology (the Elliot-Müller test and the Müller-

Petalas procedure). While the results of the later tests are not robust, the EGARCH model points to the conclusion that communication was counter-productive.

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