

Project Description - The Determinants of Time-varying Inflation Target Credibility

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For many central banks, including the Federal Reserve and the European Central Bank (ECB), numerical inflation targets play a key role in the communication and the conduct of monetary policy. Monetary policy measures of the ECB, for example, have always been explained to the public by the ultimate goal of steering too-low or too-high inflation rates in the Euro area back to the target level of around 2%. Inflation targets clarify the meaning of price stability and may even anchor longer-term inflation expectations. However, inflation targets can only be effective if their credibility is sufficiently high, i.e., if enough people expect that monetary policy will actually achieve the target. Therefore, the evolution of inflation target credibility (ITC) perceived by consumers is of crucial importance for the effectiveness of monetary policy. The current project exploits a unique and ongoing survey of German consumers we designed to investigate the determinants of the time-varying credibility of the ECB's inflation target.

Containing more than 200,000 daily responses from about 130,000 German consumers covering the period starting in January 2019, our data set allows us to estimate the effect of positive as well as negative deviations of inflation from the ECB's 2% target on the credibility of the inflation target. We investigate the impact of personal characteristics, the inflationary environment and the behavior of the central bank on the evolution of inflation target credibility perceived by consumers. Advancing on Coleman and Nautz (2023a,b), however, we do not restrict the analysis to averages and shares but estimate probability models to exploit the full information contained in individual survey responses. This allows us to disentangle the effects of different personal characteristics on the perceived credibility of the inflation target. The research focus of the current project is, however, on the analysis of the determinants of the time-variation observed in inflation target credibility. Investigating the role of the inflationary environment and measures of monetary policy for the perceived credibility of the inflation target, the project aims to improve the expectations management of central banks and the communication of monetary policy to a heterogeneous public.

References:

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- Coleman, W. and Nautz, D. (2023b). Inflation Target Credibility in Times of High Inflation. *Economics Letters*, 222: 110930.