Central bank credibility and the expectations channel: Evidence based on a new credibility index

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Abstract

This article investigates the relationship between central bank credibility and the volatility of the key monetary policy instrument. First, we propose a time-varying measure of central bank credibility based on the gap between inflation expectations and the official inflation target. While this new index addresses the main limitations of the existing indicators, it also appears particularly suited to assess the monetary experiences of a large sample of inflation-targeting emerging countries. Second, by means of EGARCH estimations, we formally prove the existence of a negative effect of credibility on the volatility of the short-term interest rate. In line with the expectations channel of monetary policy, the higher the credibility of the central bank, the lower the need to move its instruments to efficiently fulfill its objective.