Implicit Exchange Rate Target
An Application To Hungary

Peter Karádi
karadip@mnb.hu

The paper argues that in small and open economies, like Hungary, an unobservable and changing exchange rate target of the central bank can be an important determinant of the interest rate rule and the exchange rate developments. As the exchange rate, in these countries, is an important channel of the monetary transmission, it provides incentives for the central banks to influence its development. The regularly updated expectation of this target, in turn, may influence the exchange rate expectations of the market participants. According to the empirical evidence of the fear of floating hypothesis, many central banks do really use its interest rate policy, and verbal and direct interventions to guide the exchange rate developments and, thereby, the expectations.

The paper applies unobserved variable method (Kalman filtering) to simultaneously estimate the (expected) exchange rate target in a system consisting of an interest rate rule with an exchage rate gap, and of a generalized UIP equation. The results support the validity of the framework, show significant interest rate reaction to the exchange rate gap and provide an estimated UIP equation with a highly persistent premium shock, where the (estimated) exchange rate target has substantial effect on the current exchange rate. It also provides estimated exchange rate targets broadly in line with expert judgment. The model can be used to gain estimated interest rate and exchange rate responses to exchange rate target (monetary) and UIP premium shocks. The framework also identifies some reasons why unexpected interest rate moves have stronger exchange rate effects: it makes the market participants update their previous beliefs about the central bank's exchange rate target.