INFLATION TARGETING

During the 1990s, many countries have chosen to adopt some kind of a flexible exchange rate regime which reduces the vulnerability to exchange rate attacks and gives their Central Banks a certain degree of leeway to conduct an independent monetary policy. For putting such a policy into operation, two targets could be pursued alternatively: a monetary growth target and an inflation rate target. Due to the instability of money demand a monetary target is often regarded as impractical. In a recent IMF working paper (Carare and Stone, 2003) 42 countries are analysed which have chosen a certain form of inflation targeting.

The authors distinguish three main forms of inflation targeting: "eclectic inflation targeting", "full-fledged inflation targeting", and "inflation targeting lite". The table below characterises some aspects of the way in which inflation targeting is performed in a selection of countries. (The table leaves out mainly the non-European transition and developing countries which are, however, covered in the named study.)

Eclectic inflation targeting is seen to be at work in the monetary policy of the European Central Bank, in Denmark and Switzerland as well as in Japan and the US. These countries have long since maintained low inflation rates, and their financial markets are highly developed. This leads to a high credibility of their anti-inflation policies what enables them to realise low inflation rates even without full transparency and accountability with respect to an inflation target. The leeway monetary policy gains can be used to smooth output fluctuations. (Whether this leeway, provided by eclectic inflation targeting, is sufficiently used by the ECB, is another question, see e.g. Sinn (2003). One could also ask whether, e.g., the ECB's policy is correctly characterised by eclectic inflation targeting.)

Full-fledged inflation targeting is seen to exist in Sweden, the UK, Norway, Czech Republic, Australia, Canada, New Zealand. In these countries financial stability, the development of financial markets, and thus the level of credibility is not as high as in the countries with eclectic inflation targeting. They commit clearly to their inflation target and underline the commitment by a transparent monetary policy framework. This reduces the time inconsistency problem a Central Bank faces but, at the same time, reduces also the leeway of monetary policy to stabilise aggregate output. New Zealand was the first country (1989) to adopt this type of monetary policy.

Inflation targeting lite is observed only in emerging economies (only partially covered in the table). These countries have not gained sufficient credibility to maintain low inflation rates without credible and transparent commitment. Thus, they are candidates for full-fledged inflation targeting. On the other hand, many of these countries are repeatedly exposed to shocks (real and financial, external and internal) which give output stabilisation a high priority. Thus, a transparent commitment to inflation targeting would limit greatly their ability to react to shocks. The trade-off between higher stability of the price level and gaining credibility on one hand, and lower exposure to shocks on the other hand leads to somewhat higher inflation rates coupled with more flexibility to smooth output fluctuations.

In terms of the well-known alternative of a discretionary vs. rules-based monetary policy, one can characterise the policy of *inflation targeting* lite as one with a high degree of discretion, whereas the policy of *full-fledged inflation targeting* is highly rules-based. *Eclectic inflation targeting* takes a middle position in this respect.

R. O.

References

Carare, A., Stone, M.R. (2003) "Inflation Targeting Regimes", IMF Working Paper WP/03/9

Sinn, H.-W. (2003) "New Inflation Targets for the ECB", Ifo Viewpoint No 45, May 2003

Inflation Targeting

	Inflation targeting	Year of adoption	Target	Comments	Point target or target range	Inflation targeting announcement made	Target horizon for inflation targets
Euro Zone (1)							
Austria Belgium Finland France Germany Greece Ireland Italy Luxembourg Netherlands Portugal Spain	Eclectic inflation targeting	2002	below 2%	The primary objective of the ECB is the maintenance of price stability over the medium term. Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. The Governing Council has also clarified that, in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term. (1)			
EU countries but without Euro countries							
Denmark (2)	Eclectic inflation targeting			No inflation target but exchange rate target vis-à-vis the Euro			
Sweden (3)	Full-fledged inflation targeting	1993	1 – 3%	Tolerance rate of +/–1% around the target	Point target with range	Central Bank	Indefinite horizon
United Kingdom (4)	Full-fledged inflation targeting	1992	2%		Point target	Government	Indefinite horizon
European non-EU countries							
Norway (5)	Full-fledged inflation targeting	2001	2.5%		Point target	Government	Indefinite horizon
Switzerland (6)	Eclectic inflation targeting			The Swiss National Bank defines price stability with 2%.			
New EU-member countries							
Cyprus (7)	No			No inflation target but exchange rate target vis-à-vis the Euro			
Czech Republic (8)	Full-fledged inflation targeting	1998	2 – 4%	Inflation target of 3% from January 2006 until adoption of the Euro	Target range of 2 percentage points or less	Jointly by government and central bank	Annual targets, but announced several years in advance.
Estonia	No						
Hungary (9)	Full-fledged inflation targeting	2001	5% for December 2005	Tolerance rate of +/- 1% around the target	Point target with range	Jointly by government and central bank	Annual Targets, but announced several years in advance

Continued Inflation Targeting

	Inflation targeting	Year of adoption	Target	Comments	Point target or target range	Inflation targeting announcement made	Target horizon for inflation targets
Latvia (10)	No			Price stability			
Lithuania (11)	No			No inflation target but exchange rate target vis-à-vis the Euro			
Malta (12)	No	No inflation target but fixed exchange rate with a basket of currencies: Euro (70%), US$ (20) and GDP (10%).					
Poland (13)	Full-fledged inflation targeting	1999	2.5%		Target range of 2 percentage points or less	Central bank	Annual targets
Slovakia (14)	No			No inflation target but aiming on a low inflation in order to join the Euro			
Slovenia (15)	No			No inflation target but aiming on a low inflation in order to join the Euro			
Other countries							
Australia (16)	Full-fledged inflation targeting	1993	2 – 3%		Target range of 2 percentage points or less	Jointly by government and central bank	Indefinite horizon
Canada (17)	Full-fledged inflation targeting	1991	2%	Inflation control target range: 1 – 3%	Target range of 2 percentage points or less	Jointly by government and central bank	Indefinite horizon
Japan	Eclectic inflation targeting						
New Zealand	Full-fledged inflation targeting	1989	1 – 3%		Target range of more than 2 percentage points	Jointly by government and central bank	Indefinite horizon
United States	Eclectic inflation targeting			Maximum sustainable growth with low inflation			

Country sources: (1) European Central Bank, – (2) Danmarks Nationalbank, – (3) Sveriges Riksbank, – (4) Bank of England, – (5) Norges Bank, – (6) Swiss National Bank, – (7) Central Bank of Cyprus, – (8) Czech Central Bank, – (9) Magyar Nemzeti Bank (Central Bank), – (10) Central Bank of Latvia, – (11) Bank of Lithuania, – (12) Central Bank of Malta, – (13) National Bank of Poland, – (14) National Bank of Slovakia, – (15) Bank of Slovenia, – (16) Reserve Bank of Australia, – (17) Bank of Canada.

Sources: Carare, A., Stone, M.R. (2003).