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| How are inflation targets set?[Roman Horváth](http://www.voxeu.org/index.php?q=node/6671)   [Jakub Matějů](http://www.voxeu.org/index.php?q=node/6672)  22 June 2011, VOX.EU *How are inflation targets set and why do they differ from country to country? This column suggests that macroeconomic characteristics such as inflation, inflation volatility, GDP growth, and foreign inflation matter for the process of inflation target setting. It also argues that central bank credibility is important but that the role of central bank independence and government political orientation is limited.*  In the last 20 years, inflation targeting has become the monetary policy of choice in about 30 industrialised and emerging economies. Inflation targeting is characterised by an explicit numerical target for inflation and the fluctuation band for inflation. Many commentators have focused on various aspects of inflation targeting; most notably, whether inflation targeting represents a successful monetary policy regime and whether inflation targeting should be modified after the recent financial crisis in a way to reflect greater financial stability considerations (Walsh 2009, Blanchard et al. 2010, Svensson 2011).  Still, very little attention has been given to the process of inflation target setting. Although the vast majority of policymakers believe that the inflation target for year-on-year inflation should be about 2%, inflation targets differ from country to country (see Figure 1) and are often revised.  **Figure 1**. Inflation targets for selected countries, as of 2010  http://www.voxeu.org/sites/default/files/image/FromMar2011/horvathfig1.gif  Source: Horváth and Mateju (2011).  An important question is which authority is responsible for setting the target; is it the central bank itself, the government, or both? In addition, there is very little systematic evidence on which factors matter for inflation target setting. In recent research (Horváth and Mateju 2011), we gather evidence on these two issues from official central bank and government publications, and from a questionnaire that we sent to about 20 inflation-targeting central banks.  We find that the most common practice is that inflation targets are set jointly by the government and the central bank. However, the practice when only one authority is responsible for setting the target is not rare. Government is solely responsible for setting the target in the UK and Israel, while the responsibility to set the target in the Czech Republic or Sweden belong to their central banks (see Table 1).  Although it is typically claimed that inflation targeting is characterised by a high degree of transparency, the amount of information about the process of inflation target setting and about the factors that authorities deem important differs largely from country to country. Some authorities only enumerate the benefits of low inflation, while other authorities discuss the inflation target determinants in great detail. Overall, the evidence suggests that the authorities seem to consider many factors when they decide about the inflation target. Inflation and economic growth are among the most frequently stated factors. Measurement error of CPI inflation, deflation risk, foreign inflation and the zero interest rate lower bound are the often mentioned reasons for targeting low but positive inflation, as Table 1 documents.  **Table 1**. Inflation target setting and its determinants   |  |  |  | | --- | --- | --- | | Country | Who sets the target? | Determinants of inflation targets | | Australia | Central bank and government jointly | Business cycle fluctuations | | Brazil | Central bank and government jointly | n.a. | | Canada | Central bank and government jointly | Costs of inflation, measurement error, wage rigidities, zero interest rate bound | | Chile | Central bank | Deflation risk | | Colombia | Central bank and government jointly | n.a. | | Czech Republic | Central bank | Past inflation, inflation expectations, price convergence, wage rigidities, zero interest rate bound, measurement error | | Finland | Central bank and government jointly | n.a. | | Israel | Government | Measurement error, wage and price rigidities, zero interest rate bound | | Mexico | Central bank | Foreign inflation | | New Zealand | Central bank and government jointly | Past inflation, foreign inflation, target expectations | | Peru | Central bank and government jointly | n.a. | | Poland | Central bank and government jointly | Economic growth, Maastricht inflation criterion for euro adoption | | South Africa | Central bank | n.a. | | South Korea | Central bank and government jointly | Past inflation, economic fundamentals, monetary policy flexibility | | Spain | Central bank and government jointly | n.a. | | Sweden | Central bank | Past inflation, costs of inflation, risks of deflation, measurement error | | Switzerland | Central bank | Measurement error | | Thailand | Central bank and government jointly | Foreign inflation, economic growth | | UK | Government | Sustainable growth |     Source: Horvath and Mateju (2011).  Although surveying official publications and analysing the responses from the questionnaire is supposedly good to start with, there may be more factors that play a role in inflation target setting. These factors may be predominantly of institutional or political nature such as central bank credibility or central bank independence. And, in the case of less independent central banks, it might be that government party orientation influences inflation target setting.  An important issue for econometric analysis is to account for the fact that   * inflation targets are typically set as a range rather than as a point, and that * not only do macroeconomic and other factors influence the inflation target, but also vice versa.   Accounting for these two issues, our results suggest that both a higher level and higher variability of inflation are associated with higher targets. The importance of inflation volatility highlights the concerns about the risk of deflation and the preference for higher inflation targets. Our results also show that policymakers consider economic growth important for setting the target. This somewhat contradicts the claims that the adoption of inflation targeting may be associated with increased output volatility and suggests that it is more reasonable to assume that actual inflation targeting is, in fact, flexible rather that strict. Finally, foreign inflation is positively associated with higher inflation targets, which supports the hypothesis that domestic inflation is largely driven by global forces. Our results also suggest that policymakers establish a wider target range for the inflation rate when the macroeconomic environment is less stable.  As regards the institutional factors, more credible central banks are found to set lower inflation targets. This is probably because they are more confident about maintaining the low inflation environment. We do not find that central bank independence and government party orientation help to explain the variation in inflation targets, possibly because inflation targeting central banks are already granted a sufficient degree of independence from government’s potential pressures.  To summarise, our research suggests that both the level and the range of inflation target correspond to domestic and foreign macroeconomic fundamentals and also that central bank credibility is vital for delivering low inflation. ReferencesBlanchard, O, G Dell’Ariccia, and P Mauro (2010), “[Rethinking Macroeconomic Policy](http://ideas.repec.org/a/mcb/jmoncb/v42y2010is1p199-215.html)”, Journal of Money, Credit and Banking, 42(s1):199-215. Horváth, R and J Mateju (2011), “[How Are Inflation Targets Set?](http://ideas.repec.org/p/fau/wpaper/wp2011_01.html)”, International Finance, forthcoming. 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