BANK OF ISRAEL
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Revisiting the Inflation Target[1]

Key Points and Recommendations

- According to the Bank of Israel Law, 5770–2010, the Bank of Israel must maintain price stability as its primary goal. The price stability range, which is essentially the inflation target, is set by the government in consultation with the Governor.
- The current inflation target of 1–3 percent was defined by the government in 2000 and has been in effect since 2003 without change.
- Similar to leading central banks worldwide, the Bank of Israel conducted a comprehensive review of the inflation target, and this document outlines the conclusions on this issue.
- In practice, the inflation target regime has achieved its primary goal of price stability over time. The average annual inflation rate from 2003 to the end of 2023 was 1.5%, and medium-term expectations (3–5 years) were close to 2%, the midpoint of the inflation target. Long-term inflation expectations (10 years) have remained anchored within the 1–3 percent range, despite the actual inflation rate deviating from the target range for much of the time.
- The global importance of inflation targets has increased with the adoption of inflation targets in the US and other countries. A 2 percent inflation target is the leading international benchmark for inflation targets in advanced economies, despite significant professional debate on this issue that developed when interest rates were near zero.
- Currently, the midpoint of the range—2 percent—does not have a special status in defining the target in Israel. An alternative definition of a 2 percent target with a 1 percentage point band on either side could increase transparency and help anchor expectations. However, the current target allows for slightly more flexibility and is well-known to the public in Israel.
- Overall, after examining the advantages and disadvantages of alternative targets, we conclude that maintaining the existing inflation target—a range of 1–3 percent—that has been in place since 2003 is warranted.
- The decision on the inflation target is a long-term one, and should not depend on the inflation rate at the time of the decision. However, a periodic review and a validation of the inflation target help to strengthen the credibility of the regime.

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Introduction

The inflation target is the framework that forms the legal and practical basis for the Bank of Israel's monetary policy. As part of its strategic plan, and similar to other central banks worldwide, the Bank of Israel decided to revisit the inflation target.[2] Similar processes have taken place in several countries in recent years. In Israel, the process began when the inflation rate deviated below the target, and concluded with the inflation rate near the upper bound of the target. The decision on the desired definition of the target does not depend on the inflation rate at the time of the decision, which, as we have seen, can change significantly in a short period. The process of reviewing the target is based on extensive study and research, examining all considerations related to adopting different targets, accumulated international experience in their implementation, and our experience in implementing the existing target.

As part of the process, the Bank of Israel's Research Department wrote analytical papers and published a book of articles on the subject.[3] Dialogues were held with other central banks, an international academic conference was held, a local conference was held with various stakeholders, including the Ministry of Finance, manufacturers, and the Histadrut labor union, an open discussion was held with employees from different departments of the bank, written opinions were received from the professional community, and a survey was conducted to examine the public's knowledge and attitudes on inflation and price stability. All these form the basis for this document, which summarizes the insights arrived at through this process.

Background

The decision on the current inflation target, effective since 2003, was made in 2000 under the Bank of Israel Law of 1954. At the time, the law listed two main roles for the Bank of Israel: stabilizing the value of the currency "in Israel and outside Israel" and maintaining a high level of production, employment, national income, and capital investments.[4] In today's terms, the law reflected a dual mandate to maintain monetary stability (though not defined in terms of inflation) and real economic activity. Additionally, the law stated that the Bank should act "to achieve economic goals in accordance with government policy." Through this general clause, the government tasked the Bank of Israel in the 1990s with operating within a framework of gradually declining inflation targets as part of the disinflation process.

After a series of target reductions that established the convergence process to low inflation rates, the government decided in August 2000 that after two more reductions in 2001–2002, from 2003 onwards, the Bank of Israel should achieve an inflation target of 1–3 percent, with inflation referring to the annual change in the Consumer Price Index. This goal was defined alongside economic activity goals without a clear hierarchy between them.

In the new Bank of Israel Law enacted in 2010, the objectives and roles of the Bank of Israel were defined differently and more sharply. The primary goal according to the law is maintaining price stability, which is followed by supporting economic activity and financial stability. The law states

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[2] The decision was made as part of the Bank of Israel's strategic plan for 2019.

[3] See references to these documents in the Reading List at the end of this document.

[4] Section 3 in the Law.

that the government, in consultation with the Governor, will set the price stability target range. Since no government decision has been made on the matter since the law was enacted, the 2000 decision remains in effect and forms the basis for the bank's current policy. Given the extensive experience gained in managing monetary policy under inflation targets in Israel and worldwide, it is important to revisit the inflation target, as leading central banks worldwide have done.
In practice, the inflation target regime has achieved its primary goal of price stability over time.[5] Despite actual inflation deviating from the target range for much of the time, long-term inflation expectations remained anchored within the target range throughout the period.[6] This makes it an example of an exceptional success of a public policy that sets, strives for, and achieves long-term objectives. Today, a price stability target is taken for granted in the Israeli economy, but at the time, when international experience in the field was initial and limited to a few countries, and after the traumatic experience of the 1980s and the difficulties in reducing inflation in the 1990s, setting a low and fixed long-term inflation target was considered an ambitious and controversial step the success of which was in doubt. The success of the inflation target regime as a mechanism for stabilizing prices is global, and the fact that most OECD countries have such a target is evidence of this.

Principles of the Existing Inflation Target Regime

Definition of "Price Stability": Price stability is the Bank of Israel's primary goal. The law enacted in 2010 states that support for other objectives will only occur if the Monetary Committee believes that it will not harm the achievement of price stability over time. This is defined in the law as a situation where the committee expects, based on the policy it has set, that the inflation rate will be within the target range within a period not exceeding two years. In other words, indirectly, the law takes the approach that although the Bank's primary goal is to maintain price stability according to the set target, the Bank's additional objectives (particularly, economic activity considerations) allow it to adopt a policy that will result in short-term deviations from the target, as long as in the long term, inflation is expected to return to its target. This approach is commonly referred to as "Flexible Inflation Targeting."[7]

Definition of the Target: The target is defined as a range of 1–3 percent, without giving extra weight or mention to the midpoint of the target. The Monetary Committee has not clearly defined its interpretation of the range, and it has changed over time.[8] In particular, the committee has not clarified whether the range represents an "indifference band" or a range resulting from the volatility of inflation and the partial ability to control it (tolerance/variability band).

In practice, due to the lack of full control over inflation and uncertainty about its development, a policy aimed at the midpoint of the target can also stem from the desire to minimize the risks of

[5] The analysis in this document relates to the period ending at the end of 2023.
[6] See the analysis of inflation's behavior over time, particularly with regard to the target, in Yaron, Ribon, and Strawczynski (2022).
[7] See Svensson (2010), as well as the discussion in Box 3.1 of the Bank of Israel *Annual Report* for 2006.
[8] In July 2018, Bank of Israel Governor Karnit Flug announced that, "… The Committee does not aim specifically for inflation to be at the midpoint of the target when it talks about entrenchment." In contrast, in Governor Amir Yaron's acceptance speech, he said that the objective of policy is "… to stabilize the inflation rate at the midpoint of the target range."

deviation from the range, not just from a preference for a 2 percent inflation rate itself—similar to a driver keeping to the center of the lane to minimize the risk of collision on either side.

Models and empirical work by the Research Department often assume that the "target" is 2 percent in practice. For example, the DSGE model's reaction function assumes a specific inflation target, and empirical work examining deviations from the target is based on the assumption that it is 2 percent. However, an examination of the votes of the Monetary Committee members does not rule out the possibility that for some of them, the target was sometimes different.
The government decision of 2000 stated that an *expected* deviation of one percentage point from the target, i.e., inflation below 0% or above 4%, requires the bank to notify the government of the expected deviation, its causes, and its implications for policy. This mechanism reflected a symmetric approach to deviation from the target and what the government considered a "reasonable" deviation. In the 2010 Bank of Israel Law, the "tolerance" for deviation from the target was reduced and defined more sharply concerning *actual* inflation, not just expected inflation, and the Bank of Israel is required to explain deviations of actual inflation from its target (i.e., inflation below 1 percent or above 3 percent) if they persist for at least six consecutive months. Here, too, the principle of symmetry is maintained.

Boundaries and Focus of the Discussion

For practical reasons, the discussion here focuses on alternatives to the current inflation target that meet two conditions:

1. Targets compatible with the Bank of Israel Law;
2. Targets for which there is accumulated international experience.

The first condition arises from the fact that the current Bank of Israel Law is general enough to allow for a change in the price stability target through a government decision. The law states that the price stability target is the primary objective of the Bank, and we are not discussing this statement at all, but accept it as given.

The second consideration is that there are clear advantages to adopting a recognized regime that already exists. The risk of policy error in choosing a target that has not been tested in other countries is greater than the risk of choosing a common target. Moreover, there are additional advantages in managing policy within a globally accepted target that is clear and recognized by the public at home and abroad, including markets and international institutions.

Therefore, this paper does not discuss the possibility of setting a non-CPI-based inflation target, a price level target, or a nominal GDP target.[9] These are all proposals that have been raised in academic discussions but have not been adopted by any country.[10]

[9] See Benchimol (2022).
[10] The only international experience with adopting a price target was in Sweden in the 1930s. The professional opinion by Sokoler and Landskroner in response to a call for opinions published by the Bank proposes to replace the housing component with a component that reflects expenditures on new dwellings. However, this opinion also recommends not adopting such a change before major central banks such as the ECB do so. See Gamrasni and Kutai (2022).

Inflation Target Level

In recent years, theoretical arguments have been made in various contexts for raising the inflation target due to the decline in the natural interest rate and the increased likelihood of falling into a liquidity trap near the zero lower bound of interest rates.[11]

The advantage of a higher target is the greater distance from the zero lower bound on the central bank's interest rate. The higher the target, the more room there is to set a negative real interest rate to achieve the target for a positive nominal interest rate. A Research Department analysis[12] indicates that raising the target (i.e., the midpoint of the target range) from 2 to 3 percent would reduce the probability of encountering the zero lower bound from about 30 percent to 20 percent (given a natural interest rate of zero) and would reduce the average deviation of inflation below the target due to the policy constraint from 0.7 percentage points to 0.4 percentage points. Similar to interest rates, if nominal wages are assumed to be downwardly rigid, it is difficult to adjust real wages downward. A higher inflation target allows more room for downward real wage adjustment, thereby reducing volatility in activity.[13]

Despite this advantage of a higher target, and even though many central banks have encountered the zero lower bound, no central bank has yet adopted a target higher than 2 percent, following the many years of near-zero interest rates.[14] This is despite the fact that leading central banks—the Federal Reserve, the European Central Bank, the Bank of England, and the Bank of China—have recently reviewed and updated their targets.[15] Some banks addressed the zero lower bound in the target update by referring to a "temporary and asymmetric average target[16]" (FED), by fixing the target (BOC), or by raising it (ECB) to 2 percent and making it symmetric around this level, but have gone no further.[17]

A possible reason for the relatively small change in targets is that central banks, including the Bank of Israel, have learned to function well in a near-zero environment using additional policy tools such as bond and foreign exchange purchases, and several central banks have used negative nominal interest rates. Overall, the global convergence process to a 2 percent target,

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[11] See the analysis of the natural interest rate and changes in it in recent years in Ilek and Segal (2022).

[12] See Burstein and Cohen (2024).

[13] The opinion by M. Sarel, which was received in response to a public call that the Bank issued, is to adopt a multiyear target that is consistent with an inflation rate of 4 percent per year, in order to move further from the zero lower bound and to support growth.

[14] The target in Australia is 2–3 percent. This target has not changed since it was set in 1993. See Yaron, Ribon, and Strawczynski (2022).

[15] The ECB adopted a 2 percent target in 2021, while the previous target was up to 2 percent. This is an increase of some extent, but it is an increase to 2 percent, as stated.

[16] See the analysis of the monetary framework adopted by the FED in Binyamini and Segal (2024). The adjustment, as the FED announced it, means that following an extended period of inflation below the target and monetary interest rates around the lower bound, the FED will act to achieve inflation that will be slightly higher than the target by delaying and moderating the interest rate increases. In its announcement, the FED only discussed a case of inflation below the target.

[17] Kamps and Smets (2022) discuss the various factors that guided the ECB in its examination of its monetary policy framework and the conclusions that arose from it.

from both directions, continues. The Bank of Japan raised the target from 1 to 2 percent in 2013, and the ECB raised the target to 2 percent in 2021. Conversely, Norway lowered its target from 2.5 to 2 percent in 2018.

Additionally, higher inflation has disadvantages. First, inflation itself is a nuisance. The public does not want it, which is reflected in a dedicated survey we conducted.[18] The survey shows that the public sees inflation as an undesirable phenomenon and is sensitive to high inflation. Higher inflation may result in greater distortion of relative prices, assuming it is not possible to continuously adjust prices to market conditions. Raising the inflation target may also lead to increased inflation volatility, and uncertainty may harm economic activity. It is reasonable to assume that a higher inflation rate would contribute to increased inequality because the weaker segments are less protected in their wages and assets from the erosion caused by high inflation. Moreover, a higher inflation rate is expected to increase the frequency of price adjustments, making inflation more sensitive to economic conditions.[19]

The high price level in Israel and the government's policy objective to reduce it raise the possibility of lowering the target. A lower target could allow the Bank of Israel to not respond to ongoing structural changes that will work to lower prices, for example due to technological improvements, or if the government acts to implement such changes.[20] These are "one-off" price changes, and as long as they are not very frequent or very large, the possibility of deviating from the inflation target over certain periods makes it easier for policy to accommodate these price adjustments without lowering the target level.

The prolonged period during which the Bank of Israel's interest rate was near zero in the last decade alongside a continuous price decline environment, is a good example of the problematic nature of lowering the target, which would bias the inflation rate downward even without structural changes that work to lower prices. On the other hand, a lower target might have moderated the need for very accommodative monetary policy over time.

Beyond all these, the change itself in the target level (midpoint) has significant costs. Such a change requires adjusting public expectations—households and producers—to the new target, and the speed of adjustment depends on how credible the public thinks the new target is and how possible the public thinks it is for the central bank to act to achieve it.[21] These costs are expected to manifest in greater volatility and uncertainty in policy, at least in the short term, and consequently also in costs in terms of activity.

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[18] See Gamrasni and Nir (2022).

[19] See Ilek and Gamrasni (2024). More frequent price adjustments would allow for a more significant response to changes in the business cycle.

[20] The opinion by Zabezhinsky/Meitav Dash, in response to the public call that the Bank published, proposes to cancel the lower bound of the target for these reasons. Gamrasni and Kutai (2022).

[21] See Ilek and Chen-Zion (2024), which discusses the anchoring of expectations and adjusting them to a change in the target.

Therefore, in conclusion, it is appropriate, in our view, to keep the current inflation target midpoint of 2 percent, for several reasons: 1. A target or target midpoint of 2 percent is the most common among our main trading partners, even after many of them encountered the zero lower bound. 2. There are reasons for raising but also reasons for lowering the target, so the desired direction of change is not unequivocal.[22] 3. Changing the target itself has a "cost" – credibility may be damaged, and uncertainty about the future target will increase.

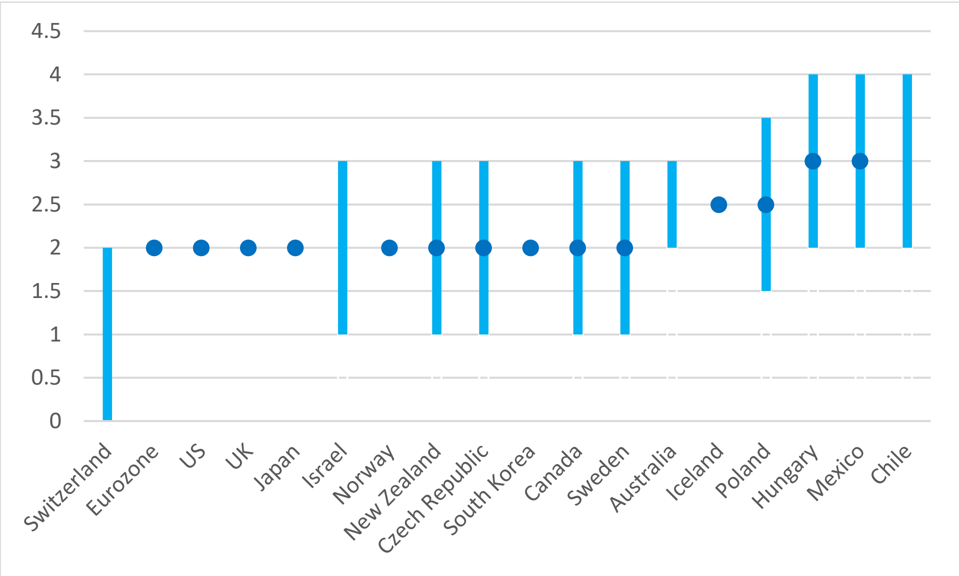
Defining the target

The list of alternatives that we examined includes the following options:

1. The existing target, a range of 1–3 percent
2. A target of 2 percent with a band of 1 percentage point in each direction
3. A point target of 2 percent

Both alternatives to the current situation are acceptable and well-known. It appears that a target with a band is typical of relatively small economies (Sweden, New Zealand, Czech Republic), while a point target characterizes larger economies (eurozone, Japan, England). However, this division is not precise, as Norway (point target) and Canada (target with a band) are examples of exceptions[23] (Figure 1).

FIGURE 1: Inflation Targets in Selected Countries



[22] There are advanced economies with a target midpoint that is lower than ours (Switzerland), and those that are higher than ours (Australia, Iceland). Given the cost of living problem in Israel and the fact that a change in the target requires a government decision, the political likelihood of raising the inflation target is doubtful. However, this assessment was not a consideration here.

[23] The AIT regime adopted in the US, which is discussed in Binyamini and Segal (2024), is a variation of a regime that sets a specific target level of 2 percent.

Since the first option describes our starting point, it is also the default. To adopt another alternative, it is necessary to point out the undesirable characteristics of inflation under the current regime, as well as the clear advantages of one of the alternatives, considering that there is also a cost to changing the definition of the target.

<u>Undesirable characteristics of inflation under the current regime:</u>

Despite the good results under the current target, it is possible that defining the target as a range without clear reference to the midpoint of the target has influenced several characteristics of the inflation environment in recent years that are not optimal:

1. Downward bias in actual inflation and short-term expectations relative to the center of the target.
2. Adaptive expectations/partial anchoring: Expectations respond to actual deviations from the target (Figure 2).
3. Upward bias in long-term expectations (Figure 3).

FIGURE 2: Annual Inflation and One-Year Expectations, 2003–2023 (percent)

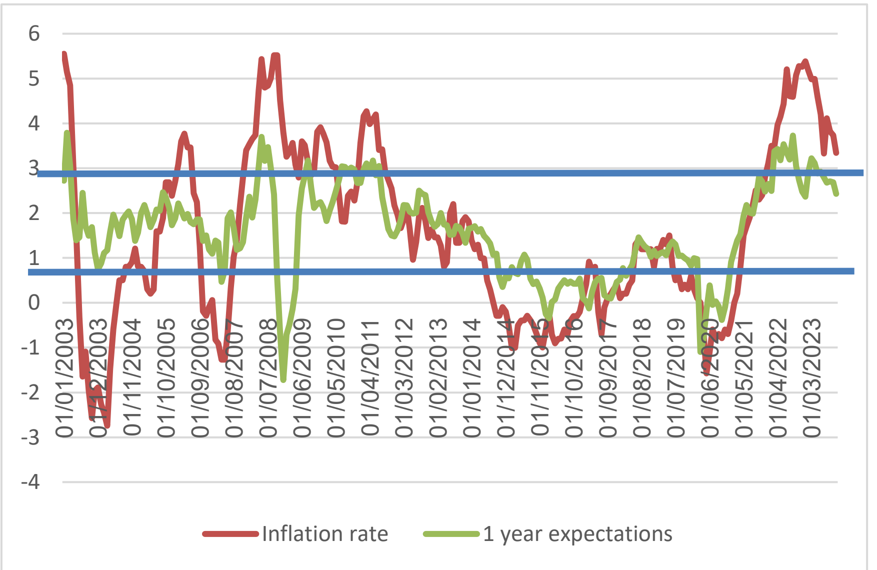
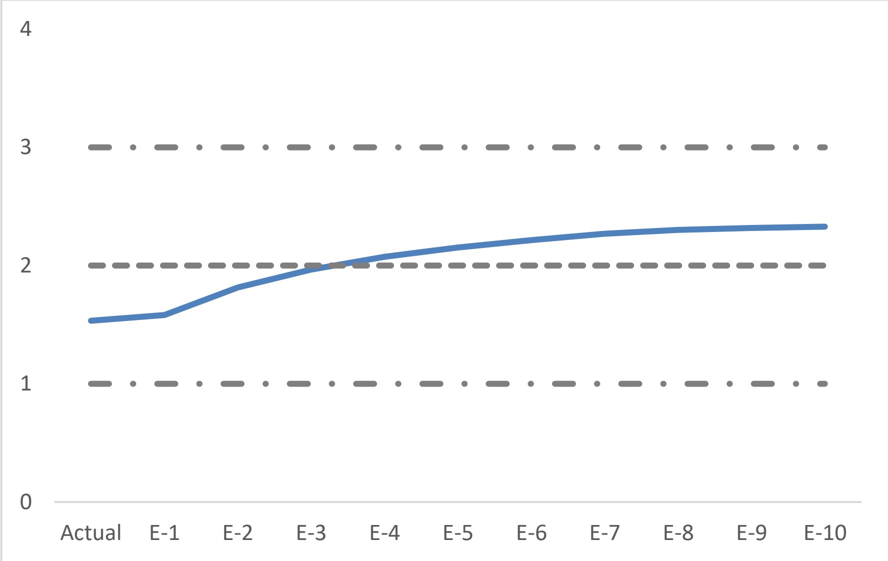


FIGURE 3: Actual Inflation and Expectations to Various Ranges, Years, 2003–2023 (average)



The downward bias of actual inflation and short-term expectations and the adaptive nature of short-term expectations may reflect the central bank's perception and the public's assessment that the target is achieved even when the inflation rate is at the lower end of the range. Of course, the ZLB constraint in recent years has also contributed to this. On the other hand, the upward bias of long-term expectations may reflect the assessment that in the long term, the bank aims for an inflation rate higher than the middle of the target.

In reviewing the data, actual inflation from 2003 to the end of 2023 averaged 1.5 percent per year—below the midpoint of the target—and was relatively volatile. Expectations for the coming year tend to follow the actual inflation trend (Figure 2) and are not fully anchored. (The correlation between annual inflation and one-year expectations is 0.68 for the period 2003–2023 and 0.92 for the years 2011–2023.) Medium-term inflation expectations converge to the midpoint of the target, and long-term expectations for 5–10 years even rise slightly above the midpoint, a phenomenon that may also reflect the inflation risk premium (Figure 3).

An analysis of medium-term expectations finds that they are mostly anchored around the target center in a 4-year moving-window average. However, 1–3 year expectations are not fully anchored around 2 percent, especially during periods when actual inflation deviated from the target, and they have an adaptive component.[24] An analysis of businesses' expectations for the coming year finds that they adjust upward when there is a positive inflation surprise.[25] Nevertheless, the magnitude of all undesirable characteristics is not large, and actual inflation as well as expectations are well-anchored within the target range, even if not exactly around the midpoint.[26]

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[24] Ilek and Chen-Zion (2024).

[25] Gorodnichenko, Melnik, and Kutai (2022). They also show that inflation expectations are downwardly correlated when there is a positive interest rate surprise.

[26] An opinion by Nies/Citi that was submitted in response to a public call that the Bank published attributes the lack of anchoring in mid-range expectations to a lack of clarity with regard to the previse target. Accordingly, his recommendation is to adopt a specific target of 2 percent.

The downward bias of inflation can be identified in the distribution of deviations from the range. Between 2003 and 2023, inflation was below the lower bound 44 percent of the time and above the upper bound only 27 percent of the time. An analysis of the distribution of inflation risks finds that since 2014, as the interest rates approached the zero lower bound, uncertainty around inflation indeed decreased compared to previous periods, but a downward bias in risks is evident.[27]

The inflation rate in Israel is relatively low compared to other countries with a similar inflation target (a midpoint of 2 percent), despite the fact that the zero lower bound problem similarly characterized the major blocs and other countries simultaneously.[28]

Comparison between the current and alternative targets

To assess whether either of the two alternative target definitions has an advantage over the current definition, we compare the characteristics of the existing target and the two alternative targets above across several parameters. The table ranks each regime according to the discussed parameter. (+) indicates strength, (0) neutrality, and (-) relative weakness. The table is indicative—without ranking the relative importance of the strengths and weaknesses of each regime with regard to the various parameters (Table 1).

Let's start with describing the advantages and disadvantages of a point (specific) target. A point target is the formulation expected to provide the best anchoring of expectations[29], as it unequivocally defines the policy objective, thus creating higher uniformity in the targets that committee members see before them. However, a point target provides the least flexibility for the Monetary Committee. Changing the current target definition to a point target is a relatively significant change, which is a disadvantage. A point target does not clearly define what constitutes a deviation from it and therefore does not align with the existing Bank of Israel Law, which requires the Bank to report in case of deviation from the target for more than six months. A point target, which does not clearly define what constitutes a deviation from the target, is not sufficiently transparent and may lead to a high rate of "false alarms" and a lack of clarity in policy management. Therefore, definitions that clearly define what constitutes a deviation from the target—the band or a point target with a range—are preferable. Moreover, it is evident that a point target is more common in large economies, such as the eurozone or the US, while in small and open economies, which are more limited in their ability to cope with external shocks, the tendency is to define the target within a range or band.[30]

[27] Zohar and Gorkov (2022).

[28] Some of the downward deviation in the inflation rate in Israel may be connected to the constant pressure to lower prices as a way of dealing with Israel's relatively high cost of living and to evidence of increased competition. Binyamini (2022) attributes the decline in inflation in the past decade to structural changes in the labor market and in the economy's foreign trade.

[29] However, it is worth nothing that the results in the empirical literature are not unequivocal, and there is no clear advantage to a point target over a point target plus a band.

[30] Kamps and Smets (2022). The central bank governors in Sweden, Switzerland, and the Czech Republic, in a panel discussion at a 2021 conference, also discussed how setting a target within a range enables the necessary flexibility in conducting policy in small open economies (Yaron and Strawczynski, 2022).

Table 1: Comparison of inflation targets, strengths and weaknesses

		1–3 percent range (current)	2 percent plus a 1 percentage point band on each side	Point target of 2 percent
1	Continuity	+	0	-
2	Transparency	-	+	0
3	Anchoring of expectations	-	0	+
4	Flexibility of action	+	0	-
5	Risk of hitting the ZLB	-	0	+
6	Flexibility of functioning at the ZLB	+	0	-
7	Consistent with the world	-	+	0
8	Consistent with the Bank of Israel Law	+	+	-
9	Consistent with a Committee	0	+	+
10	Risk of the change process	+	0	-
	Examples	Switzerland, Australia, Chile	Canada, New Zealand, Sweden, Czech Republic	UK, Japan, Norway, ECB

Based on these considerations, our assessment is that a point target of 2 percent is not desirable in Israel, and we are therefore removing this option from the discussion at this stage.

The two relevant options now before us are to keep the current target definition of 1–3 percent, or to define a midpoint target with a band of 1 percentage point around it. Both options have advantages and disadvantages, and the assessment of which is preferable also depends on subjective preferences and the importance attributed to each of the examined parameters.

The main trade-off between the two alternatives is transparency and anchoring expectations versus policy flexibility. A target of 2 percent with a band is more transparent because it clearly defines the point target to strive for, and is therefore also expected to better anchor expectations around 2 percent, especially in the medium and long term. Transparency and anchoring expectations are desirable because they facilitate the coordination of expectations among all market participants, particularly price-setters; reduce uncertainty that, in itself, is undesirable; and increase the effectiveness of monetary policy. In particular, in a situation of proximity to the ZLB, anchoring expectations makes it easier for the policy to be accommodative (as long as it remains credible). The previous section's discussion indicates that under the current definition, the anchoring of inflation expectations for the 1–3 year horizon, which is relevant for policy management, was not full. The band provides some flexibility for the 2±1 target in the short term, but this is a "tolerance band" and not an "indifference band."

Ilek and Chen-Zion (2024) present a brief review of the literature discussing the advantages and disadvantages of different target formulations. Their review concludes that there is no definitive preference for defining a target as a point, a range, or a point with a tolerance band. Alongside studies showing that a point target results in lower inflation variance and contributes to anchoring expectations, others present empirical evidence that a regime with a range (like in Israel) is characterized by more stable expectations, or that the type of target has no impact on anchoring expectations.

The performance of inflation regimes: International experience

Based on historical data regarding the behavior of actual inflation in countries with differently defined inflation targets, we examined whether there are differences in inflation characteristics according to the type of target definition.[31] Due to the significant change in the inflation environment in recent years, we present the results for the entire period, from 2011 to the end of 2023, and alternatively for the period ending in 2020. We also present results for the subgroup that includes only advanced economies, as we believe their experience, generally greater central bank independence, a longer tradition of price stability, and greater general trust in public institutions, is more relevant to Israel (Tables 2a and 2b).

The results emerging from the examination of the different targets are mixed, and no sharp conclusions can be drawn from them. The comparison of the different targets is based on a relatively small number of countries, and as always, it is difficult to draw "causality" from it, as it is clear that different countries try to choose targets that suit them in some sense, and not randomly. It seems that large economies tend to choose a point target, while small economies choose a range or band target. This bias weakens the validity of comparing results under a point target to those under other targets, as inflation in small economies is more influenced by global factors and exchange rates than it is in large economies. For this reason, and also because a point target is not desirable in Israel for other reasons, we will focus on comparing a range target (range) and a band target (band = mid±1 pp). In the data analysis, we also separated the group of advanced economies only.

Table 2a: Inflation characteristics by target type, 2011–2023, averages

Type	Standard deviation	Average deviation	Average absolute deviation	Percentage of months outside the target range[a]	Number of consecutive months outside the target range	Longest period outside the target range (months)
All countries in the sample						
mid±1 pp	3.3	1.0	2.1	54.8	7.1	36.7
Point	2.0	0.2	1.5	54.4	8.3	31.0
Range	1.9	0.0	1.5	60.3	7.8	31.8
Advanced economies only						
mid±1 pp	2.3	0.3	1.5	45.8	6.3	34.0
Point	2.0	0.2	1.5	54.4	8.3	31.0
Range	1.6	-0.4	1.3	65.1	7.3	33.3

[a] For a target defined as a point target, we examined the deviation from a band of one percentage point on each side of the point target, in order to enable a comparison with the other inflation target definitions.

[31] With thanks to Gal Katz for assistance in processing the data.

Table 2a: Inflation characteristics by target type, 2011–2020, averages

Type	Standard deviation	Average deviation	Average absolute deviation	Percentage of months outside the target range[a]	Number of consecutive months outside the target range	Longest period outside the target range (months)
All countries in the sample						
mid±1 pp	1.2	-0.4	1.1	45.7	5.9	32.9
Point	1.1	-0.5	1.1	46.9	6.7	24.0
Range	1.0	-0.7	1.1	55.6	6.8	28.3
Advanced economies only						
mid±1 pp	1.0	-0.6	0.9	35.8	5.0	27.0
Point	1.1	-0.5	1.1	46.9	6.7	24.0
Range	0.9	-1.0	1.2	62.2	6.3	33.3

[a] For a target defined as a point target, we examined the deviation from a band of one percentage point on each side of the point target, in order to enable a comparison with the other inflation target definitions.
The countries in the comparisons: The mid±1 pp group includes **New Zealand**, Czech Republic, **Canada, Sweden**, Mexico, Hungary, and Poland. The point group includes the **US, the EU, the UK, Japan, Norway, and Iceland**. The range group includes **Israel, Switzerland**, Chile, and **Australia**. The European Union is included in the group of economies with a point target, even though the target was defined as "up to 2 percent" until 2021. Advanced economies are highlighted in bold text.

A comparison of all countries with a range regime to those with a band regime does not show a clear advantage for either regime. For the period ending in 2023, and even the shorter period up to 2020, it appears that deviations from the target, according to the first three indicators on the left of the table above, are slightly smaller in a range regime than in a band target regime. However, it seems that in a range regime, the proportion of time inflation deviates from the target, whether from the range or the band around the target, is actually greater. Therefore, it is difficult to determine which target definition is preferable in terms of stabilizing inflation around the target. There does not appear to be a significant difference when including only advanced economies or the entire sample.

When using the advanced economies group only to analyze the comparison between range (Israel, Switzerland, and Australia) and band (Canada, New Zealand, and Sweden), there are differences, but it is not always clear which regime is preferable. The bias under the band regime is positive, while the bias in the range group is negative, and the proportion of time there is a deviation from the range is 46 percent under the band regime compared to a rate of 65 percent in the range group. These results, indicating the advantage of the band regime, characterize the entire sample period as well as the sub-period up to 2020—which does not include the inflation outbreak in many countries following the COVID-19 crisis.

The analysis of all countries (not just advanced economies) also shows that in economies with a range target without a midpoint, the likelihood of being outside the percentage point range in either direction from the midpoint is greater than in other regimes, and the average time spent outside this range is also longer than in other regimes. This result suggests that a target without an anchoring point at the midpoint of the range results in more periods where actual inflation does not meet the target.

Additional Considerations

Alongside the partial support for the argument that a point target or a target with a midpoint better anchors inflation, commitment to a specific target, even if only in the medium term, reduces the flexibility of policymakers. Less flexibility can be an advantage because it "ties the hands" of policymakers, thereby increasing their credibility and making it easier for them to act to achieve the target. On the other hand, more flexibility might not significantly harm the anchoring of expectations, as in the long term, the bank aims in any case for the midpoint of the target ("drives in the middle of the road"), but allows for a more moderate policy that does not necessarily aim for 2 percent when there are relatively large shocks. This ability to aim for a different inflation rate within the inflation target framework, considering economic activity or other considerations, without deviating from the target, is greater in the current framework. The current framework also allows for a policy that is essentially similar to the Fed's approach under the so-called AIT policy, without the need to change the policy framework, as it allows for aiming for slightly higher inflation (within the range) if necessary. It seems that the advantage of flexibility is not symmetrical. While a prolonged downward deviation in inflation, as was the case in the years leading up to the COVID-19 crisis, does not threaten price stability, a prolonged upward deviation, as we have been experiencing since mid-2022, may pose a greater risk to price stability and policy credibility.

Another difference between the two possible target definitions is related to the zero lower bound (ZLB) of interest rates, and here too, there is a certain trade-off. On the one hand, a target that provides a clear point of 2 percent reduces the probability of encountering the ZLB, relative to a range where the inflation rate can also approach 1 percent. On the other hand, assuming that we reach the ZLB, the current target allows for greater flexibility through forward guidance (FG) or a broader range for inaction, while a target with a focal point and band can impair flexibility and policy transmission in the ZLB environment.

The clearer and more explicit the target is, the more suitable it is for decentralized decision-making, as in such a situation, the difference between Committee members will reflect a difference in economic assessments and not a difference in the policy target itself. A clearer target also facilitates the communication of policy determined by a committee. It should be noted that the current inflation target was set when monetary policy was determined solely by the governor. In contrast, the current target allows for greater flexibility and a broader scope of action for the Committee.

Maintaining the current definition has a clear advantage in terms of continuity and minimizing risk in the process. A process that ultimately makes a "small" and insufficiently clear change in the target can actually contribute to public misunderstanding. A target of 2 percent with a band has the advantage of being the accepted target worldwide, especially in small open economies, as mentioned above. A band target without a midpoint is less common.[32]

[32] A narrower range target currently exists in Australia (2–3 percent), while the target in Switzerland is lower (0–2 percent). These are the only other advanced economies in which there is a range target with no midpoint. There are emerging economies with a range target, but such targets are higher.

Summary:

The current inflation target of 1–3 percent, established in 2000, has successfully fulfilled its primary purpose—supporting price stability over time—even if inflation deviated from the target most of the time. Therefore, solid reasons are needed to change it. It is our view that maintaining the current target definition within the range of 1–3 percent is warranted. Maintaining the current target definition around 2 percent is expected to contribute to strengthening the credibility of the long-term goals of monetary policy in the future.

Despite the success, several less desirable characteristics, even if of second order, can be identified in the inflation environment: the downward bias of inflation and expectations up to a few years relative to the midpoint of the target due to a response to actual inflation (adaptive expectations), and the upward bias in long-term expectations. A more transparent and sharper target may help reduce these characteristics and more strongly anchor the inflation environment. A target of 2 percent with a band of 1 percentage point on each side is more transparent and sharper than the current one, and is also suitable for a group decision where consensus on the target is desirable. However, the direction of the bias may also be influenced by the economic environment during the examined period, and the bias may be different in another period.

The global trend is to adopt more explicit targets. The Czech Republic marked the midpoint of the range as a target in 2006. New Zealand, which had a target identical to ours, adopted the midpoint in 2012 to better anchor expectations.[33] Sweden added the band around its point target in 2017, and South Korea, which had a range, adopted a point target of 2 percent in 2016. The prevalence of our range target, where there is no formal weight to the midpoint and which can therefore be interpreted as an "indifference band," is decreasing. In fact, no country currently has a target identical to ours. However, our range target allows for greater flexibility, and this flexibility has been useful in the past and may also be valuable in the future.

To justify changing the current target, it is necessary to have a high level of confidence that the advantages of a different target formulation outweigh the disadvantage of losing the inherent flexibility of the current target, as well as the risk and cost involved in the change itself. In our assessment, the likelihood that changing the target will lead to better outcomes is not high enough to justify a change at this time. Therefore, in our view, we conclude that maintaining the current target definition—a range of 1–3 percent—is appropriate. However, we suggest considering strengthening the Committee's commitment to the midpoint of the target through public statements, for example during deviations from the target that are accompanied by a decline in the anchoring of inflation expectations.

[33] These increased to around the upper bound of the range (3 percent), particularly following to 2008 crisis.

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