Policy Responses under Inflation Targeting: A VAR Analysis with Sign Restrictions

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This paper examines how inflation-targeting central banks of five countries (Australia, Canada, New Zealand, Sweden, and the UK) have dynamically responded to the underlying macro shocks. To this end, we apply VAR models with sign restrictions, but minimum restrictions on the policy responses. The results show that, not surprisingly, the IT countries strongly and persistently raise their policy rates in response to a positive demand shock, meaning that they have attempted to stabilize both output and price volatility when there was no trade-off between the two volatility. On the other hand, no country shows strong, persistent monetary tightening in response to unfavorable supply and oil price shocks. This suggests that, even under inflation targeting, the countries have paid much attention to the output stability as well as the inflation stability, and thus the IT countries are not characterized as *inflation nutters*, but as *flexible targeters*.