

Will Canada's Inflation Targeting Change?

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The Bank of Canada and Department of Finance renewed a five-year agreement on the 2% inflation target in 2006. This target has not changed since it was first established for December 1995, as part of the original agreement on inflation targets signed in 1991 (Chart 1). Amid this fourth renewal of the 2% target, the Bank of Canada committed to researching "the potential costs and benefits of targeting a lower rate of inflation or of pursuing a price-level target instead of an inflation target." It wasn't the case that the current inflation targeting regime wasn't successful; the Bank was questioning "whether the specific regime established in the 1990s will deliver the greatest contribution to economic performance and to the well-being of Canadians in the decades ahead." The Bank of Canada Review, published last week, was the latest instalment in this research agenda. Although economic research is, by nature, a more theoretical exercise (lots of model building), it can provide clues on how the results might be applied in practice.

On the target rate, the Review stated that "the earlier literature and recent studies at the Bank of Canada suggest that an inflation target lower than two per cent may be beneficial." Unfortunately, it's less obvious what the lower target should be, as it "varies from study to study." A common theme among many of these studies, however, is that optimal inflation is closer to zero. Note that this is zero in theory. In practice, the CPI tends to overstate "true" inflation or increases in the cost of living because of measurement biases, believed to be worth about 0.5%. Note also that other central banks have lower inflation targets than 2%, but not by much. The European Central Bank "aims at inflation rates of below, but close to, 2% over the medium term". The members of the Federal Open Market Committee recently began publishing their medium-term inflation projections, in the 1.7% to 2.0% range, which is the closest thing to an "official" Fed inflation target.

One aspect of inflation targeting (IT) is to "let bygones be bygones". Whether inflation was above or below 2% in the past, the target for future inflation would always remain 2%. However, this means that actual inflation could track above or below 2% over several periods. The success of Canada's current IT regime can be assessed by the fact that trend inflation has stayed relatively close to the target (Chart 2). In theory, however, even small deviations between trend and optimal inflation can matter materially.

CHART 1
CANADA'S 2% INFLATION TARGET
(y/y % chng)

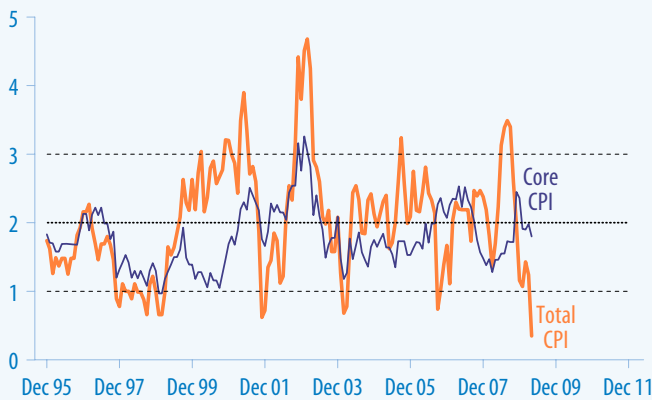
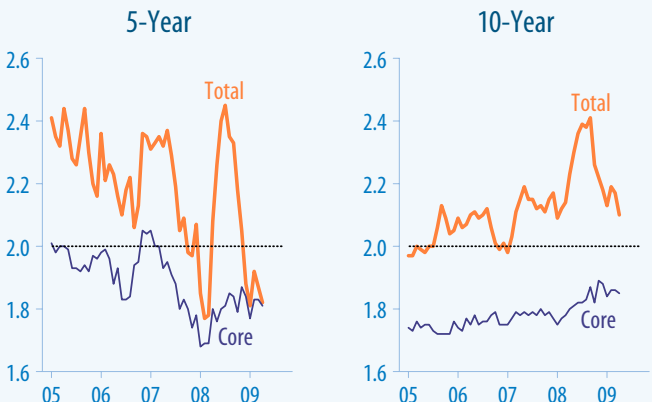


CHART 2
CLOSE TO TARGET
Canadian Inflation Trends (% : a.r.)



Price level targeting (PT), say for a 2% target, would shoot for a 2% annualized change in the price level over time so that if inflation was 1% in the past period, inflation of around 3% would be aimed for in the future period (of course, if inflation was 3% in the past, inflation of around 1% would be aimed for in the future). It's easy to see that a PT regime would elicit more stimulative monetary policy during "too-low" inflation runs, and more contractionary policy during "too-high" runs, than an IT regime, in addition to reducing uncertainty about the future price level. This would cause greater volatility in economic output and employment. If the initial shock that throws inflation off is not too large, PT can be *"a stabilizing tool and a possible source of improved economic welfare."* However, because the Canadian economy is susceptible to large shocks (think commodities), the Review goes on to say that *"it is not yet clear whether a price-level target would be preferable to our current inflation target."*

Interestingly, the Bank of Canada's April 21st policy rate cut to its effective lower bound of 0.25% is probably pumping the internal debate about how far below 2% the optimal inflation rate can be, along with the merits of price level targeting. One reason why all inflation-targeting central banks have kept their targets well above zero was out of concern that if the target was too low, the risk of reaching the lower bound for policy rates would rise. At the lower bound, the textbooks say (and Japan's "lost decade" experience seemed to show) that monetary policy becomes less effective. However, a grand experiment is now being conducted on the effectiveness of non-traditional monetary policy measures, with the Bank of Canada joining the Fed, Bank of Japan (again), Bank of England, and Swiss National Bank with policy rates at their lower bounds. To the extent that the varied credit and quantitative easing efforts along with policy rate commitments are deemed effective (and it's looking that way), a key argument against inflation targets being too close to zero is blunted.

Furthermore, theory would suggest that price-level targeting is more effective than inflation targeting at the lower bound for policy rates. In a PT regime, as economic growth and inflation decelerate, inflation expectations would necessarily accelerate (expectations would theoretically not change in an IT regime). This lowers real interest rates along the maturity spectrum and complements the efforts of non-traditional measures to lower term borrowing costs. However, this underscores another PT challenge. If significant inflation or deflation is required to bring the price level back on target, this could unhinge longer-run inflation expectations and cause even greater economic volatility.

Bottom line: Although research shows there are net benefits to lowering the inflation target below 2%, the Bank of Canada acknowledges there are transition costs that could outweigh the benefits. This, along with pinning down a "practical" optimal inflation rate, will require additional research. Meantime, the jury is still out with regard to the net benefits of price level targeting, let alone its transition costs. For financial market participants, until this research winds up in 2011, changes to Canada's inflation targeting regime should be considered only a remote possibility.

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