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C.D. Howe Institute COMMENTARY

MONETARY POLICY

How Flexible Can Inflation Targeting Be?

Suggestions for the Future of Canada's
Targeting Regime

Thorsten V. Koepl



In this issue...

Ideally, the design of Canada's inflation targeting regime after 2011 will reflect an optimal degree of flexibility to help balance the need for active policymaking with the value of being committed to low inflation.

THE STUDY IN BRIEF

In Canada, inflation targeting is widely agreed to have been a success story, but questions about how the regime might be fine-tuned in 2011 remain open. This *Commentary* asks how much discretion an inflation-targeting Bank of Canada can be allowed without compromising the credibility of its low inflation goal, and suggests a two-pronged approach to refining its procedures. One prong strengthens the commitment to inflation control by tightening the explicit design of the targeting framework, and the other adds policy flexibility.

Three specific suggestions are developed:

- The inflation target should be moved down to, say, zero to 2 percent, and 2 percent should become a cap on inflation that triggers a policy reaction, once inflation threatens to breach this bound. These changes would strengthen the Bank's commitment to price stability and more firmly anchor the public's inflation expectations. They might also lead to the Bank taking a more proactive role in response to financial market developments.
- Policy flexibility should be enhanced by permitting variation in the time horizon over which the inflation target is regained after a deviation. Large shocks could provide a rationale for lengthening this horizon, for example, but should the Bank resort to such event-contingent flexibility, it should offer an explicit justification for doing so and commit to a specific path for returning to the target.
- Explicit inflation-forecast targeting should be adopted. This would improve the transparency of policy decisions and establish better communication between the Bank and the public. Such targeting would involve regularly updating a forecast time path for inflation and for the interest-rate changes needed to achieve it. The publication of such a conditional time path for future policy would help to anchor the public's inflation expectations more firmly, and also make it easier to monitor policy and hence hold the Bank of Canada accountable for any deviations from what seems optimal in the light of past and current circumstances.

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INDEPENDENT • REASONED • RELEVANT

The issue of flexibility is at the centre of any targeting regime used to conduct monetary policy. Such a regime is often described as a form of “constrained discretion” in that it is designed to constrain a central bank to achieve low and stable inflation, while allowing it some freedom to react in a discretionary, but transparent fashion to shocks that hit the economy.

But once a central bank has established low inflation, how much discretion can it really afford without compromising its reputation for low inflation?¹

In Canada, inflation targeting has been a success story since its inception in 1991. The targeting regime successfully reduced inflation, as measured by the consumer price index, to a level close to 2 percent. More important, the market perceived the commitment to this target as credible. By 1998, inflation expectations had started to fall well within the range of 1 to 3 percent in which the Bank of Canada intends to keep inflation in the medium run. And throughout the past decade, those expectations have remained well within this range (see Figures 1 and 2).² With inflation now credibly anchored at the 2 percent target, discussion has shifted toward the need to fine-tune Canada’s monetary policy regime.³ This *Commentary* revisits the question of how flexible inflation targeting should be, and derives implications for the review of Canada’s targeting regime in 2011.

Flexibility for a targeting regime comes in different forms. An important one concerns whether the central bank should pursue goals

other than inflation. The overriding opinion in the academic literature is that commitment to low and stable inflation either takes precedence over other goals (such as high output and employment) or is complementary to other goals (such as financial stability). But an equally important question is how best to implement and maintain such a commitment. Ideally, the design of Canada’s future targeting regime will reflect an optimal degree of flexibility. Details such as the horizon over which to achieve the target, or when deviations from the target are possible, can help balance the need for active policymaking with the value of being committed to low inflation.

These considerations suggest a *two-pronged approach* for fine-tuning Canada’s targeting regime. One prong is to put even more emphasis on keeping inflation under control and to signal this in a simple fashion by tightening the design of the targeting framework. The other prong is to add the *right flexibility* to the framework by providing room for discretion when it is most needed: a flexible horizon for achieving the target in response to large shocks.

This *Commentary* offers three specific suggestions for improving the Bank of Canada’s targeting regime.

- The level of the inflation target should be reevaluated. Moving the band down to, say, zero to 2 percent and emphasizing a cap on inflation at 2 percent seems to be an improvement over the current regime. A cap should be understood here as a trigger for a policy reaction, once inflation threatens to breach the upper bound of the band. This would strengthen the Bank’s commitment to price stability and anchor people’s inflation expect-

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- 1 Murray (2006), reviewing the performance of inflation-targeting countries over the past two decades, argues that flexibility in targeting has increased somewhat over time. This could be explained simply by the fact that such a regime has to be quite rigid initially in order to start anchoring inflation expectations at a low level. Notwithstanding, there remains the question of what degree of flexibility a well-established, mature targeting regime can afford.
- 2 Survey-based measures of long-term inflation seem to have stabilized at 2 percent (see, for example, Bank of Canada 2006). Spreads between real and nominal bonds also have shown less volatility, even though one has to be careful in interpreting this evidence as reflecting more credible monetary policy (see, for example, Christensen, Dion, and Reid 2004).
- 3 See Bank of Canada (2006) for an outline of the issues regarding the overhaul of the targeting regime in 2011.

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