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Flexible Yet Firm – How to Improve Inflation Targeting Regime: C.D. Howe Institute

Toronto, Aug. 27 – Canada’s inflation targeting regime could be improved with an optimal degree of flexibility for policymakers and a firmer, lower target band, according to a study released today by the C.D. Howe Institute. This flexibility should balance the need for active policymaking with the value of being committed to low inflation.

In *How Flexible Can Inflation Targeting Be? Suggestions for the Future of Canada’s Targeting Regime*, Queen’s University economist Thorsten V. Koepl examines 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.

He makes three specific suggestions for improving the regime when it comes up for review in 2011:

- The inflation target band should be moved down to 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 that pose a threat to financial stability could provide a rationale for lengthening this horizon, 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.

The study is available at www.cdhowe.org.

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How Flexible Can Inflation Targeting Be? Suggestions for the Future of Canada's Targeting Regime, C.D. Howe Institute Commentary No. 293, by Thorsten V. Koepl (August 2009). 21 pp; \$12.00 (prepaid, plus postage & handling and GST – please contact the Institute for details). ISBN-13: 978-0-88806-782-1, ISBN_10: 0-88806-782-1

Copies are available from: Renouf Publishing Company Limited, 5369 Canotek Road, Ottawa, Ontario K1J 9J3; or directly from the C.D. Howe Institute, 67 Yonge St., Suite 300, Toronto, Ontario M5E 1J8. The full text of this publication is also available from the Institute's website at www.cdhowe.org.