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Price-Level Targeting – A Potential Improvement over Inflation Targeting: C.D. Howe Institute

Toronto, Sept. 29 – Price-level targeting could be an improvement over inflation targeting, especially when the central bank takes into account observational errors in tracking prices, according to a C.D. Howe Institute study released today. In *Getting it Right When You Might Be Wrong: The Choice Between Price-Level and Inflation Targeting*, economist Jean Boivin says that Canada's 2 percent inflation-targeting program works pretty well, but targeting the price level may work even better, especially if inflation and the price level might not be perfectly observed.

The author argues that there are good reasons to believe that the Bank of Canada does not perfectly observe the "true" inflation rate and price level when implementing policy, perhaps as a result of measurement errors or conceptual difficulties in defining these indicators. For example, the Consumer Price Index is, at best, an approximate measure of the true cost of living in Canada. The need to rely on imperfect information affects the relative merits of inflation targeting (IT) and price-level targeting (PLT).

When a central bank recognizes that inflation and the price level are not perfectly observed and makes allowance for that fact, a PLT regime might be superior to an IT regime, says Boivin, provided that the general public understands how such a regime works and bases its own decisions on that understanding.

Accordingly, concludes Boivin, the fact that inflation and price-level measures are indeed subject to the presence of observational errors might, in fact, be an additional argument in favour of PLT.

Jean Boivin is the Chair in Monetary Policy and Financial Markets at HEC Montréal and is currently Special Adviser at the Bank of Canada for the year 2009-2010. The views expressed in the study are his own, and not those of the Bank of Canada.

For the study, go to www.cdhowe.org

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Getting it Right When You Might Be Wrong: The Choice Between Price-Level and Inflation Targeting, C.D. Howe Institute Commentary No. 297, by Jean Boivin (September 2009). 17 pp; \$12.00 (prepaid, plus postage & handling and GST – please contact the Institute for details). ISBN-13: 978-0-88806-786-9; ISBN-10: 0-88806-786-0 .

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