Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Canadians Worried About Inflation

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Re: **Inflation targeting ain't broke so let's not fix it**

Despite disappointment in the performance of many central banks, let's not lose sight of key lessons. First, inflation stinks, inflicting most harm on those who can afford it least. Second, central banks are the best institutions we have to make sure it goes away and doesn't come back. As we head into 2024 and inflation continues to fall, it's worth remembering why the world established central banks and low inflation targets in the first place.

Until the 1990s, central banks struggled to understand and implement counter-cyclical policies. The US Federal Reserve made the Great Depression worse, allowing the money supply to contract by 30 percent from 1930 to 1933. In a 2002 speech to honour the 90th birthday of Milton Friedman, the iconic monetarist who detailed that policy disaster, Ben Bernanke, soon to be Fed chair, confessed on its behalf: "Regarding the Great Depression, . . . we did it. We're very sorry . . . We won't do it again."

The Bank of Canada did not open its doors until 1935, the second full year of recovery from the Depression, in a country with a small – just under 11 million –mostly rural population served by a few banks with branches in different communities. The economic crisis had been severe, leading to significant criticism of the banking system, even though it had, unlike in the US, survived largely unscathed. The Bank's creation was swift: Parliament approved royal commission recommendations on July 31, 1933 and less than a year later the Bank of Canada received its charter. Trains ran on time in those days! Initially, the Bank was privately owned but in 1938 Mackenzie King's government made it a Crown corporation.

Like many other central banks, the Bank of Canada allowed inflation to spiral out of control in the 1970s in the wake of the 1973 oil price shock. From 1975-82 it tried to reduce inflation by targeting the "narrow money supply" (so-called M1: cash and chequing accounts). Its rationale was the monetarist belief that a direct link ran from money growth to inflation. Any connection there appeared to have disappeared, however, prompting the Bank to abandon the approach.

"We didn't abandon M1," governor Gerald Bouey famously said, "M1 abandoned us!"

From 1982-91, the Bank searched for a replacement target for M1 but failed to find one, while inflation and inflation expectations continued at uncomfortable levels.

In February 1991, this all changed with the arrival of inflation targets under Bank governor John Crow, and Brian Mulroney's government. The first set stepped down from 5 percent to 2 percent in 1995. The joint decision to target inflation directly and to step it down in this way was designed to anchor inflation expectations. Policymakers were concerned that, without explicit targets, shocks like the Gulf War (1990-1) and the introduction of the GST on New Year's Day 1991 would lead to a repeat of the 1970s.

So, how has the Bank of Canada done in its approximately three decades of targeting inflation?

From January 1996, when the target officially became two percent, until this past October, inflation averaged – drum roll, please – 2.1 percent, which is not bad. By comparison, in the same number of months from March 1962 to December 1990, it had averaged 5.9 percent.

But has success in fighting inflation come at the sacrifice of employment or economic growth? Using standard deviations to measure volatility or uncertainty, and excluding the COVID period because of its wild early data swings, the answer is no, in both cases. Consumption spending has been 50 percent less volatile during the inflation-targeting era, GDP growth 30 percent less volatile, and unemployment nearly 60 percent less volatile.

It is tempting to next compare pre- and post-targeting economic growth rates themselves. But doing so is complicated by the fact that they were declining for much of the period before inflation-targeting, which skews the results. Because slower growth has been the norm across developed countries it's better to compare growth rates in inflation-targeting countries against those in non-inflation-targeting countries, which yields evidence that favours inflation-targeting.

In our view, the evidence is clear: inflation targeting has been a historic success, even with recent history. Not everyone agrees, of course. One popular alternative is to retain targeting but increase the target to 3 percent, which November's rate of 3.1 percent essentially achieved. But part of why inflation has come back down after its recent flare-up is that inflation expectations remained anchored near the 2-percent target. If the Bank were to raise the target to three because getting back to two percent was hard, that would lead to expectations it might change the target again next time inflation overshot it. That would destabilize expectations.

From the 1960s through the 1980s, Canada's economic history was marked by high inflation and economic volatility. We learned from that and did something about it. The regime we introduced in the early nineties ain't broke – quite the opposite – so we shouldn't try to fix it.

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