Intelligence MEMOS

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To: Policymakers in Ottawa

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Re: **Inflation Target – The Only Anchor Left**

As governments across the country continue to announce massive fiscal stimulus, fiscal anchors have been appropriately set aside. However, to keep investor confidence in Canadian dollar denominated debt high, the monetary anchor – low and stable inflation – must be protected.

Canada has benefited in many ways from having both a fiscal and monetary anchor over the past 25 years, not least of which through very low risk premiums. The fiscal anchor in Canada has largely shifted from whether the federal government runs a surplus or a deficit in a given fiscal year, to the debt to GDP ratio. Under current circumstances, the debt-to-GDP ratio, along with other fiscal anchors, have been set aside. With interest rates low, in the short-run at least, this is not a serious concern.

Things get more interesting in the medium term, especially given our dependence on foreign investors.

And that's where the monetary anchor comes into play.

The only anchor that maintains value in all circumstances is the Bank of Canada's inflation target. With the inflation target renewal coming up in 2021, it is important to remind ourselves why this target is so important, what it means for financing this stimulus, and why it might come under threat.

The Bank of Canada has been an inflation targeter since 1991, with the target constant at 2 percent – the midpoint between 1-3 percent – since 1996. The Bank must renew its inflation-control agreement with the federal government every five years, with the next renewal coming up next year. Because the target is agreed to by the government, in setting its fiscal policy, the Minister of Finance must take into account potential actions the Bank will have to take to hit the target.

Much has been written on the success of a low inflation target, both in Canada and abroad: the inflation rate itself and its variability has fallen, real GDP growth has increased with lower volatility, and there has been lower overall unemployment.

However, this success, and the Bank of Canada's mandate faces its toughest test as a result of all the COVID-related government spending.

In addition to taxation (a political non-starter at present), financing government deficits can be done in two ways: through the issuance of interest-bearing debt to the public, or through monetary financing, i.e., an increase in the central bank's balance sheet.

A crisis of this size makes the traditional approach of selling federal and provincial bonds to the public, both domestic and foreign, more difficult, as liquidity dries up with the public facing their own constraints. That leaves monetary financing.

During the crisis, the central bank blowing up its balance sheet has been required to meet the financial system's demand for liquidity and to resist deflationary pressures in the economy. With large parts of the economy shut down to deal with the health consequences of COVID-19 there are unlikely to be any of the usual inflation pressures. Additionally, by purchasing government debt, the Bank of Canada keeps borrowing costs low. And, in doing so, servicing that debt becomes much less expensive, giving the government more room to increase the debt-to-GDP ratio.

However, rising public debt, especially when financed by expansion of the Bank of Canada's balance sheet, increases the perceived risk of both inflation and fiscal unsustainability. This perception could require the Bank of Canada to have to work doubly hard in terms of more stringent monetary policy to demonstrate its commitment to the inflation target, as was required in the early 1990s.

This argues for continuation of a firm and transparent monetary anchor keeping the inflation target at 2 percent so that confidence is maintained in Canadian dollar debt.

Should the government feel it necessary to facilitate debt restructuring as the economy starts to recover, it is best done through fiscal policy rather than inflation, as the former can be applied in a more measured and targeted fashion than the latter. Moreover, inflation disproportionately hurts lower income folks who have less disposable income to cope with price increases.

The focus in a crisis of this magnitude is rightly on putting a floor on the fall in economic activity. Governments and the central bank have done just that. Their ability to do so is a result of the credibility of their anchors. It may take some time for the return of fiscal anchors. In the meantime, the monetary anchor can help take up the slack.

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