# *Intelligence* MEMOS

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To: Governing Council at the Bank of Canada

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Re: **Average Inflation Targeting: Is it Right for Canada?**

On August 27, the US Federal Reserve Board announced an important modification of its monetary policy framework, moving towards "average-inflation targeting" (AIT). As the Fed's announcement said: "following periods when inflation has been running persistently below two percent, appropriate monetary policy will likely aim to achieve inflation moderately above two percent for some time."

The obvious question for Canadian policymakers is whether the Bank of Canada should follow suit. Our answer is: Perhaps, but the bar for change should be set high.

As the name suggests, under "average-inflation targeting," a central bank's target would be the average inflation rate over a specified time, say three years. If inflation is below the two-percent target for any length of time, as it has been in recent years, the bank would aim to raise it above the target long enough to produce average inflation equalling the two-percent target over a set period.

Under the current inflation targeting (IT) regime, by contrast, deviations from the target are treated as bygones. If inflation falls below two percent, as it does now, the central bank aims to return it to target, but not subsequently overshoot so as to offset the past undershoot. If the bank succeeds, average inflation remains below the target.

If AIT is credibly implemented, it leads to very different inflation expectations. In the middle of a pandemic-induced recession, most people expect inflation to remain muted for some time. Under AIT, Canadians could expect that over the medium term the Bank of Canada would compensate for the current period of below two-percent inflation with a period above two percent. By contrast, under the current regime, the Bank would simply return inflation to two percent, with no offset for time spent below the target. In today's context, AIT would therefore be expected to produce more inflation overall.

In a recession, this can be beneficial. With more inflation, a given quoted or "nominal" interest rate represents a lower "real" (i.e., inflation-adjusted) interest rate. Assuming nominal interest rates don't rise under AIT, Canadians could reasonably expect real interest rates to be lower under this new regime than they would be under IT. Monetary policy is effective when it can modify spending decisions by both households and businesses by affecting real interest rates. When short-term nominal interest rates are as low as they can go and longer-term nominal rates are also very low, as they are now, the only available lever for changing real interest rates is through expected inflation.

Does this make AIT a panacea? Certainly not, and especially not in the form proposed by the Fed. A close reading of its announcement shows that it is not really switching to a rigorous AIT regime. Not being rigorous has critical consequences for credibility, something the Bank of Canada has certainly earned under its current IT regime.

First, the Fed did not specify the time over which the inflation rate will be averaged. Nor did the announcement say anything explicit with respect to the crucial question of symmetry, which would mean a period of higher-than-target inflation would be followed by a period in which the Fed aimed to push inflation lower than two percent. Without an ironclad guarantee of symmetry, average inflation could easily wind up being higher than target. As a result, inflation expectations could become un-anchored, making it more difficult to achieve the target in the long run. One of the main benefits of Canada's current IT regime – inflation expectations firmly centred on the two-percent target – would be lost. Any Canadian switch to AIT should require a symmetric target with a precisely defined length of time for the calculation of average inflation.

Should the Bank of Canada make this change?

In fact, Canada's IT regime already has some of the features of AIT. The Bank's official target is headline inflation, defined as the rate of change of the consumer price index over 12 months. Technically, this is the same as a 12-month moving average of monthly inflation rates. AIT would simply require a change from this 12-month moving average to a window of 24 months, 36 months, or some other length. For most of us, however, a fixed 12-month period is easier to grasp.

Inflation targeting has been one of the most successful economic policies of the past quarter century. The policy question is whether the Bank's struggles to hit the inflation target in the years following the financial crisis are sufficient reason to change its policy regime. A true AIT regime, avoiding the pitfalls of the Fed's announcement, could be beneficial, and is the least radical among different policy regimes being considered. However, the bar for change is and should be high.

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