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E S S E N T I A L   P O L I C Y   I N T E L L I G E N C E

MONETARY POLICY

Why the Bank of Canada Should Stick to Targeting Inflation

By
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- As the expiry date approaches for the Bank of Canada's five-year inflation-targeting mandate, the House of Commons Finance Committee is set to discuss options on modifying that mandate going forward. The two options the Committee has identified so far, namely targeting nominal GDP and full employment, should be non-starters.
- Better to consider the merits of two other approaches: (i) moving to a price-level targeting regime, which has drawbacks, or better yet, (ii) sticking to inflation targeting with, perhaps, a lower target than the current 2 percent.
- A reduction in the target rate of inflation would be a simple and sensible modification to an existing and well-understood system, and one that would slow the erosion in the value of Canadians' money.

The Bank of Canada's current five-year mandate for targeting inflation expires at the end of 2011. The question that has preoccupied monetary policy experts for many months is now coming to a head: should the Bank do what it has been doing for another five years, or should its mandate be modified in some way?[1]

The Bank currently targets CPI inflation – the growth rate of the Consumer Price Index – and aims to keep it close to 2 percent annually. It has done so successfully since 1995: inflation has wobbled around the target, but has averaged remarkably close to 2 percent. Despite this success, however, we should not be blind to possible improvements.

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1 The C.D. Howe Institute has published a series of insightful discussions by distinguished scholars relating to the renewal of the Bank of Canada's mandate, which are available at its website: cdhowe.org.

The House of Commons Finance Committee will hold meetings this month to examine the Bank's mandate and consider options to expand or modify it. The Committee is presumably open to many suggestions, but the only two it mentioned explicitly – targeting the growth rate of nominal gross domestic product (GDP) and targeting full employment – would not be improvements. Targeting either would make Canadian monetary policy worse, not better.

Targeting Nominal GDP

Nominal GDP is the dollar value of the goods and services produced in the economy; its annual growth rate is by definition the growth rate of real GDP plus the rate of inflation. Many outcomes would be consistent with, say, a 5 percent growth target for nominal GDP – 1 percent real growth plus 4 percent inflation, 2 percent real plus 3 percent inflation, and so on. Such a target appears to give the Bank of Canada more flexibility because it places less emphasis on keeping inflation constant and lets the Bank respond more to short-run changes in real GDP.

The main problem with targeting nominal GDP growth is that if the Bank of Canada adopted it, the Bank would be indifferent between any combination of real GDP growth and inflation that added up to the formal growth target, and inflation would be more variable than it is under the inflation-targeting system. And more variable inflation means more uncertainty in a world in which there is already more than enough: firms and workers would find it more difficult to determine sensible wages and prices. This added variability would also make it more difficult to anchor inflation expectations, an important aspect of controlling inflation.

It is also not clear that the Bank needs more flexibility. It currently has plenty of flexibility in its conduct of monetary policy. Following an economic shock, the time it now takes to return to 2 percent inflation is largely a policy choice, although the Bank says it strives to return to target within six to eight quarters. In other words, the Bank uses its discretion – it is not forced to take extreme actions in the attempt to keep inflation exactly at the target rate at all times. This same flexibility and discretion allows the Bank to continue targeting inflation while also paying close attention to any threats to the stability of Canadian's financial system, a concern that has become more important in recent years.

Targeting Full Employment

An even worse idea is for the Bank of Canada to target "full employment." This is a slippery concept, and not directly observable in the data. For economists and policymakers, full employment exists when resources like land, labour, and capital are fully utilized. Economists' theoretical models are based on the idea that inflation will be stable only when real GDP is at its full-employment level, so we use these models to back out estimates of the (unobservable) level of full-employment GDP. But there is plenty of disagreement about our macroeconomic models, and perhaps even more about the precise level of full employment. This imprecision makes full employment a bad choice for a central-bank target. How could we ever judge the success of policy actions?

A more important reason for not targeting full employment is that the Bank could never really expect to succeed. After decades of economic shocks and policy mistakes, central bankers have come to recognize two principles that now form the foundation of their monetary policies. First, high and volatile inflation is costly for economies, so aiming for low and stable inflation makes sense. Second, inflation is the only macro variable that central bankers can influence in a sustained and systematic way.

Monetary policy affects many things, for a while, including investment, employment and real output. But these short-run effects get unwound over time, leaving the long-run effects of monetary policy to fall only on nominal wages or prices, or their growth rates. Given this monetary reality, it makes a lot of sense for the Bank of Canada to target inflation, because it can control it over the long run – but not much sense for it to target things like real GDP or the unemployment rate, which it cannot control. Such real variables owe their long-run changes to factors well beyond monetary policy, like tax and labourmarket policies, the rate of technological progress, rates of fertility and labour-force growth, and a country's openness to international trade.

Weighing Options

So, if targeting nominal GDP growth and full employment are bad ideas, what kinds of improvements to Canadian monetary policy might make sense?

Economists inside and outside the Bank of Canada have been studying the possible benefits of switching from inflation targeting to price-level targeting. With a target growth path of the price level of 2 percent, such a system would require the Bank of Canada to ensure that shocks which pushed inflation above 2 percent would be followed by policy actions that held inflation below 2 percent for a while, and vice versa – so that deviations from the targeted price level got recouped. Under price-level targeting, Canadians would be more confident in the long-run path of average prices in the economy, but the main downside is that it could be confusing because an interval of higher-than-average inflation would need to be followed by one of lower-than-average inflation. In contrast, with the existing inflation-targeting regime, Canadians know that whatever shocks occur today, the Bank will design policies to return inflation to the constant 2 percent target.[2]

A different policy option would be to maintain the current system of inflation targeting but to reduce the target – for example, to 1 percent. Inflation would then be reduced, and the costs that accompany inflation would be lessened. Some Canadians might not care much about such a reduction, given that inflation is already quite low, but the increasing number of Canadians who have un-indexed retirement incomes would benefit considerably over their lifetimes.

Some economists argue that such a low inflation target would reduce the Bank of Canada's room to manoeuvre; with low inflation and thus low nominal interest rates, the Bank would be more likely to encounter a situation where its policy interest rate is very close to zero, making it difficult if not impossible to reduce the rate further should the need arise. But the last few years have shown that central banks still have ammunition even when their policy rate cannot be reduced further, and so the benefits of lower inflation may well outweigh this potential downside.

Canada's inflation-targeting system has been a great success over the past 20 years, with inflation lower and more stable than at any time in the past half-century. The House of Commons Finance Committee is to be commended for examining the Bank's mandate and thinking about improving it. But the options they have so far mentioned – targeting nominal GDP growth and targeting full employment – are easy to dismiss. The idea of price-level targeting is also intriguing, and may well offer some genuine benefits, but the risk of confusing the Bank's message about its primary objective is enough to give pause.

This leaves inflation targeting as the best option. The Bank of Canada should continue targeting the rate of inflation, either with the current 2 percent target or perhaps a lower one. Maintaining the current 2 percent target would be an understandable choice, given the Bank's solid track record with it. A reduction in the target rate of inflation would be a simple and sensible modification to an existing and well-understood system, and one that would slow the erosion in the value of Canadians' money. But this is no time to make bigger changes to the Bank of Canada's mandate.

2 See Melino (2011), Parkin (2009), and Ragan (2011) for discussions of possible costs and benefits of price-level targeting in Canada.

References

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