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e-brief

2 Percent Forever? Inflation Targets Need Fresh Scrutiny

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Inflation targeting began in Canada in 1991 to mixed reviews. No one then gave much thought to its chances of being still in place 15 years later, but it is, because it has worked: after two earlier decades of uncomfortably high and variable inflation, consumer price index (CPI) increases have averaged about 2 percent per year since 1991. Past success, however, is one thing; prospects are another — and these are a little troubling.

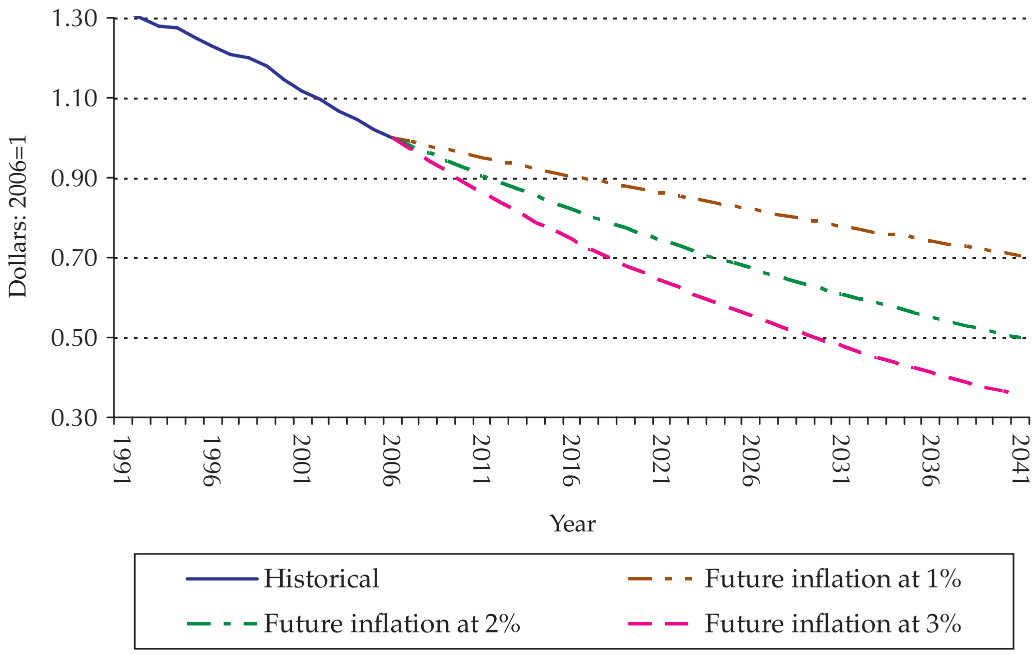
Monetary policy attracts attention when it creates disruptions in output, employment and inflation. When it gets things mainly right, people worry about other problems, which is surely why there has been almost no public discussion of this year's pending renewal of the 2001 inflation-control agreement between the Minister of Finance and the Bank of Canada.[1] An extension of existing arrangements with, at most, minor technical adjustments, seems to be taken for granted.[2]

Recall, though, that the current 2 percent CPI inflation target was initially conceived as a transitional step on the path to something called price stability, and has only by default acquired an aura of permanence. The current regime might embody the best way of running the country's monetary policy, or at least close to it, but perhaps it does not, considering the corrosive effect of even 2 percent inflation on the purchasing power of money (see Figure 1). It would be wise to have some systematic and serious discussion of the question.

1 Monetary policy is currently steered by a 2001 agreement between the federal government and the Bank of Canada, which specifies that the inflation-control target range will be 1 to 3 percent and that policy will aim at trend inflation of 2 percent. This agreement expires December 31, 2006, prior to which the Government and Bank are to review experience to determine the appropriate target for a subsequent period of unspecified length.

2 For example, Bank of Canada Governor David Dodge was recently quoted as saying, with reference to the impending renewal of Canada's inflation targets, "You would be surprised, I think, if we had major changes to the agreement." See Theophilis Argitis "Canada to keep out of exchange markets, wants others to follow." www.bloomberg.com; Sept. 18, 2006.

Figure 1: *The Purchasing Power of the (2006) Canadian Dollar*



Source: Statistics Canada, Prices Division; author's calculations.

The Original Promise: Progress Towards Price Stability

Inflation targeting was a stopgap measure in 1991. It was primarily intended to prevent a one-off jump in the cost of living — caused by the introduction of the goods and services tax (GST) — from becoming a wage-price spiral. It was also the joint creation of a Conservative government whose days in office were clearly coming to an end, and of a Bank of Canada that many outsiders wanted brought under tighter political control. Hence, the original program's promise to make further progress after 1995 towards price stability, defined as an inflation rate of "clearly less than 2 per cent," was none too credible. When then-finance minister Paul Martin and Bank governor Gordon Thiessen deferred that promise in 1993, it seemed a cheap price to pay for the acceptance of inflation targeting by the newly elected Liberal government. At the time, a reversion to the anything-goes monetary policies of the 1980s seemed otherwise in the cards.

But further deferrals of a decision in 1998 and 2001 have ensured that by now, what began as a temporary — almost makeshift — program has inadvertently become a seemingly permanent feature of Canada's economy. Its operation has been factored into the many rules of thumb that underlie wage-and-price-setting behaviour as well as saving and investment decisions. Further progress towards price stability, therefore, might be harder to achieve in 2005 than it would have been in 1995. For the authorities now to change the rules of the inflation-control game, without carefully preparing public understanding, would be risky. That is why a no-surprises renewal of the 2 percent target is sensible for this round. It is also why, if changes are contemplated for the future, as they should be, the case for them needs to be seriously discussed in public — starting now.

Targets are currently set for the inflation rate rather than the time path of the price level, so that when they are over- or under-shot, monetary policy treats these bygones as bygones. The Bank of Canada is not expected to correct past misses. This was a reasonable feature to build into the program in 1991, when it was uncertain just how well the Bank of Canada could do in keeping inflation on target, but permitting base drift in the price level creates extra uncertainty in long-term decision making. That said, over the last 15 years cumulative policy errors have not, in fact, been significant. Hence, formally adopting a price-level target in the near future would do little more than validate the continuation of past practice, and would not, in all likelihood, be disruptive.

The Pros and Cons of 1 percent

A 2 percent inflation rate is a far cry from anyone's (or at least any retiree's) idea of price-level stability: this seemingly low rate in fact reduces the purchasing power of a fixed-money income at a noticeable pace (see Figure 1 — over the duration of the current 'low inflation' regime, the dollar has lost a quarter of its purchasing power). This is why, in 1991, the ultimate goal of inflation clearly below 2 percent looked attractive, and why, considered in isolation, it still does.

There might be problems in reducing today's target to, say, 1 percent.[3] The last 10 years' experience has embedded deeply enough Canadians' expectations of inflation running at about 2 per cent into the indefinite future that unless those expectations, and their associated behavioural rules of thumb, can be modified by ex ante discussion and exhortation, an economic slowdown will be part of the process needed to change them. Further, we do not know whether a residual, long-run tradeoff between inflation and unemployment might be implicit in the Canadian economy's structure, were inflation to be run at half its current pace. Thus, if a 2 percent target looks too tentative for comfort in the abstract, a case that it is the best we now can do needs to be answered.

Monetary policy can pursue only one goal at a time, so a separate national currency supported by a flexible exchange rate is a prerequisite for any monetary policy regime that sets targets for domestic price-level behaviour. Even so, the future of the Canadian dollar was thoroughly debated only recently. The currency's recent appreciation brought renewed calls from those adversely affected to include, if only informally, the exchange rate among monetary policy's targets. It will be impossible to ignore this issue if inflation targets are opened up again to serious debate, because its very prominence in current discourse suggests that more Canadians take low and stable domestic inflation for granted than understand the role of exchange-rate movements in making its maintenance possible.

3 Given the practical need to work in round numbers to maintain policy transparency, 1 percent does seem to be the next feasible stopping point below 2 percent.

However, the cautionary point underlying the foregoing discussion is more general. Policy regimes become weaker and more prone to collapse under unexpected pressure when the public takes them so much for granted that it begins to forget why they were implemented in the first place and what makes them work. This may be happening to inflation targeting in Canada. Even if a serious debate about monetary policy were simply to confirm the desirability of the rather untidy arrangements currently in place, we would be better off for having had it. If such a debate were to reveal that we can do better, it would simultaneously alert the public to the changes in their own rules of thumb that they would need to make to cope with new arrangements, thus easing the transition to them.

For renewals of the program to date, Canada's 2 percent inflation target, unsatisfactory though it is in many respects, has been the only option available. No case or preparations had been made for doing anything differently. This fall's routine renewal of that target should break the mold. It should be the occasion for beginning a discussion of changes that might be made in three to five years, so that should any options be judged desirable, they are also viable.

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