Intelligence MEMOS

From: Jeremy M. Kronick and William B.P. Robson

To: Canadians who don't remember inflation

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Re: **THE HIGH BAR TO REPLACE THE BANK OF CANADA'S 2-PERCENT TARGET**

Inflation in Canada has been low and stable for more than 20 years. A generation has grown to adulthood with no memory of what high, volatile inflation was like – it peaked at 12.5 percent in 1981, yielding mortgage rates as high as 20.5 percent. The financial crisis of 2008 and the recession that followed are much more recent, and traumatic, experiences. The fading of inflation into history, and the scrutiny central banks have been under since the crisis, may account for fresh interest in changing the Bank of Canada's mandate. It could target a higher inflation rate, for example. Or it could compromise the inflation target by pairing it with some other objective , perhaps related to financial stability, or economic growth.

However, replacing or compromising the 2-percent inflation target is a fraught proposal. The successes of targeting low inflation around the world, and particularly here in Canada, have been great enough to make the bar any change must clear exceedingly high.

What are these successes? Looking broadly around the world, countries that started targeting inflation in the 1980s, 1990s and 2000s have enjoyed lower and less volatile inflation, faster and less volatile economic growth, and lower unemployment rates – a correlation that many researchers think reflects the favourable impact of inflation-targeting on both private-sector and government behaviour. While demographic headwinds have held real GDP growth back in Canada since our targets began, inflation and unemployment have been lower, and the volatility of growth, inflation and unemployment have all been less.

These improvements have benefited people at all levels of income and wealth. Lower and less volatile unemployment is straightforwardly good for people more at risk of job loss, and lower inflation protects people who hold a greater proportion of their assets in cash, have less access to sophisticated investments, and do not have indexed pensions.

Why, then, the interest in raising or compromising the inflation target? One concern is that real interest rates may be lower for years to come – perhaps because older populations save more, or because a less materials-intensive economy requires lower capital investment. Low real interest rates and low inflation means low nominal interest rates. While many people like low nominal interest rates, they reduce maneuvering room for central banks, such as the Bank of Canada, that use short-term interest rates as their main monetary policy tool. We now know that central bank interest rates can be negative – but the prospect of charging depositors for holding money at central banks, or banks generally, justifiably makes people nervous.

Against that concern are the many costs of higher inflation – costs that many Canadians happily have not experienced directly. Inflation is an insidious tax. An increase in the inflation target would transfer massive amounts of wealth to people with indexed pensions – mainly public-sector workers – from private-sector taxpayers who do not. Income taxes become more onerous with inflation: apply a 50-percent tax rate to a nominal return that is mostly inflation, and real after-tax income falls. And higher inflation tends to be more volatile inflation – undermining people's ability to compare prices, negotiate compensation, and plan for the future.

No change in Canada's inflation target is imminent: the next renewal of the Bank of Canada's agreement with the federal government is set for 2021. And the alternative to a 2-percent target for year-over-year increases in the consumer price index is not necessarily a higher target for year-over-year increases in the consumer price index. A longer timeframe could be used while retaining the 2 percent goal. Some of the concerns about central bank flexibility to respond to a crisis might be addressable by lengthening the period for measuring inflation – to two years, say – or even targeting the level of prices directly, rather than its rate of change.

As we – especially those of us who have no direct experience of high and volatile inflation – think about potential changes, we should not forget the fraught experience of Canada before inflation targets, or the problems countries without inflation targets have faced. The 2-percent inflation target has been a success. The bar for change is correspondingly high.

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