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MONETARY POLICY

The Roads Not taken: Why the Bank of Canada Stayed With Inflation Targeting

By
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- Sticking with the status quo was only one option under debate among monetary experts in the lead-up to renewal of the Bank of Canada's inflation-targeting mandate, which was announced by Finance Minister Jim Flaherty this week.
- Several other routes were available. Two of them – namely, targeting nominal GDP or targeting full employment – were arguably non-starters. Two other approaches, however, held more promise: (i) moving to a price-level targeting regime, or (ii) sticking with inflation targeting but with a lower, say 1 percent, target.
- Nevertheless, the renewal of the status quo keeps in place a coherent monetary policy regime that has served Canadians well.

The Bank of Canada's five-year inflation-targeting agreement with the Government of Canada expires at the end of this year, and the Bank and Minister of Finance Jim Flaherty on Tuesday announced its renewal. As many economists have been expecting, the status quo will continue. The Bank's policy will continue to be aimed at keeping the rate of Consumer Price Index (CPI) inflation at 2 percent. This decision keeps in place a coherent monetary policy regime that has served Canadians well and, since 1995, has kept inflation very close to 2 percent annually.

The renewal of the Bank's inflation-targeting mandate answers a question that has preoccupied monetary policy experts for a few years: should the Bank do what it has been doing for another five years, or should its mandate be modified in some way? For example, reducing the target rate of inflation, as many analysts have suggested, 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.

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Other observers have argued that the Bank of Canada should extend its mandate in less well-defined directions, such as to address economy-wide financial stability, or to target the growth rate of nominal gross domestic product (GDP), or to target full employment. These options, passed over in the new agreement, would not necessarily be improvements over the current system. In fact, targeting the growth rate of nominal GDP or full employment, which will be the subject of House of Commons Finance Committee hearings next week, would make Canadian monetary policy worse, not better.

Wrong Turns

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 might appear to give the Bank of Canada more flexibility because it would place less emphasis on keeping inflation constant, thereby letting the Bank respond more to short-run changes in real GDP.

The main problem with the Bank's targeting nominal GDP growth is that it would then be officially indifferent between any combination of real GDP growth and inflation that added up to the formal growth target. As a result, inflation would almost certainly be more variable than it is under an 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 extra 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 in order to do its job appropriately. It already 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; the Bank says it strives to return to target within six to eight quarters. In other words, the Bank uses its discretion – it is never forced to take extreme actions to return quickly to the inflation target. 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 rightly become more important in recent years.

Targeting Full Employment

An even worse idea is for the Bank of Canada to target "full employment." This slippery concept is not directly observable in the data, and never will be. Economists' theoretical models rest on the idea that inflation will be stable only when land, labour, and capital are fully employed, when GDP is then by definition at its full-employment level. But there is plenty of disagreement about our macroeconomic models, and perhaps even more disagreement about the precise level of full employment. This imprecision would make 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. 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. Over the long run, such variables are determined more by non-monetary factors such as tax and labour-market policies, rates of immigration and technological innovation, and the country's openness to international trade.

Alternate Routes

So, if targeting nominal GDP growth and full employment are bad ideas, what kinds of improvements to Canadian monetary policy might have been reasonable candidates for Minister Flaherty when considering the renewal of the agreement?

Price-Level Targeting

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, and this benefit should be taken seriously. But there is also a downside with this policy, and it relates to the Bank's communications and the extent to which its objectives are well-understood by the public. Price-level targeting 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 that is now well-entrenched in our minds, Canadians know that whatever shocks occur today, the Bank will design policies to return inflation to the constant 2 percent target. This simplicity is an important part of the success of inflation targeting.

Moving to a Lower Inflation Target

A different policy option for Minister Flaherty was to maintain the current system of inflation targeting but to reduce the target – for example, to 1 percent. Inflation would then be lower, and the costs that accompany inflation 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 was very close to zero, making it difficult if not impossible to reduce the rate further if needed. But the last few years have shown that central banks still have ammunition even when their policy rate cannot be reduced further. The truth is that this debate is still unresolved. Perhaps our experience over the next few years will convince us that the benefits of lower inflation outweigh this potential downside. Perhaps not.

Whether at 2 percent or lower, inflation targeting is still the best option. Together, the government and the Bank of Canada have chosen to continue with the status quo, justified in large part by the Bank's solid track record with it over the past two decades. While a reduction in the target rate of inflation would also have been a simple and sensible modification to an existing and well-understood system, this is no time to make bigger changes to the Bank of Canada's mandate.

The Bank of Canada and the Government of Canada have done well.

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