

Inflation Targeting In Canada:

Objective, Execution, Sacrifice,
Benefits

What is inflation targeting?

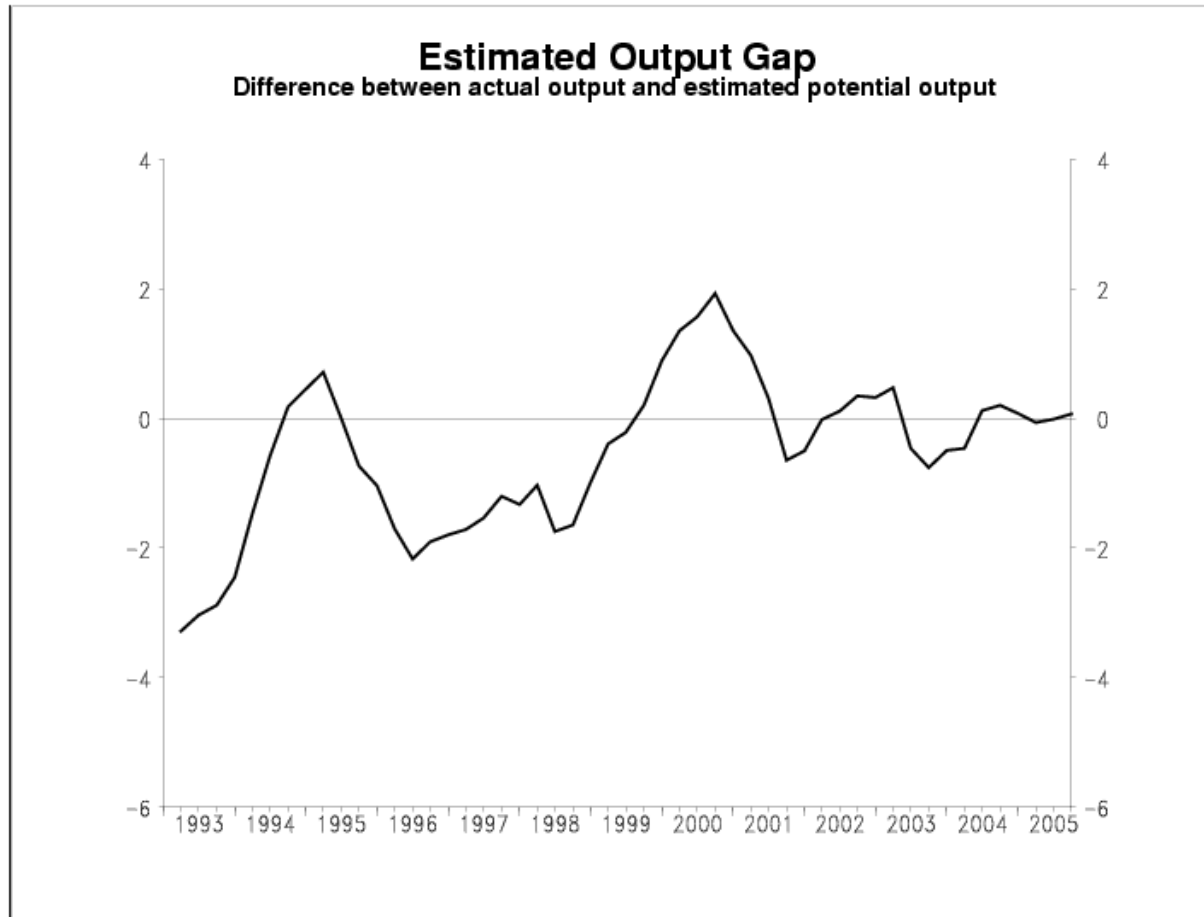
- Central Bank strategy of controlling inflation to a specified range.
- Uses the tools of monetary policy to achieve these ends.

(targeting of overnight interest rates → expansion/contraction of the money supply).

What is inflation targeting?

- Inflation measurement use core CPI as a target (excludes 8 most volatile components which account for 16% of total CPI)
- Targeting involves the interpretation of financial forecasts in order to determine a change in the overnight target rate.
- Can be seen in the output-gap projections
→ helps predict inflationary pressures

Output Gap



Monetary Policy: Background

- Became Popular in the 1970s
- 1978 - targets were set, M1 (aggregate money supply). Dropped in the early 80s.
- 1980s - consisted of monetary policy limbo
- 1987 – John Crow installed as governor of the Bank of Canada → led to inflation targeting.

The lead up: 1987 - 1991

- John Crow discussed in 1987 the idea of price stability as a goal of the Bank of Canada.
- Interpreted as setting a goal of 'zero inflation'.
- Not without controversy.
- Officially adopted in 1990 by the Bank of Canada and Department of Finance.

The lead up: 1987 - 1991

- Federal Budget for 1991 – Officially announced the adoption of inflation targets.
- Targets for inflation were to be jointly adopted by the Bank of Canada and the Government of Canada.
- Not without more controversy.

Targeting in practice

- Involves more than targeting the overnight rate.
- Inflation targeting requires commitment from both the Federal Government and Bank of Canada in order to be successful.
- Expectations and credibility play a large role in the targeting process.

Targeting in practice

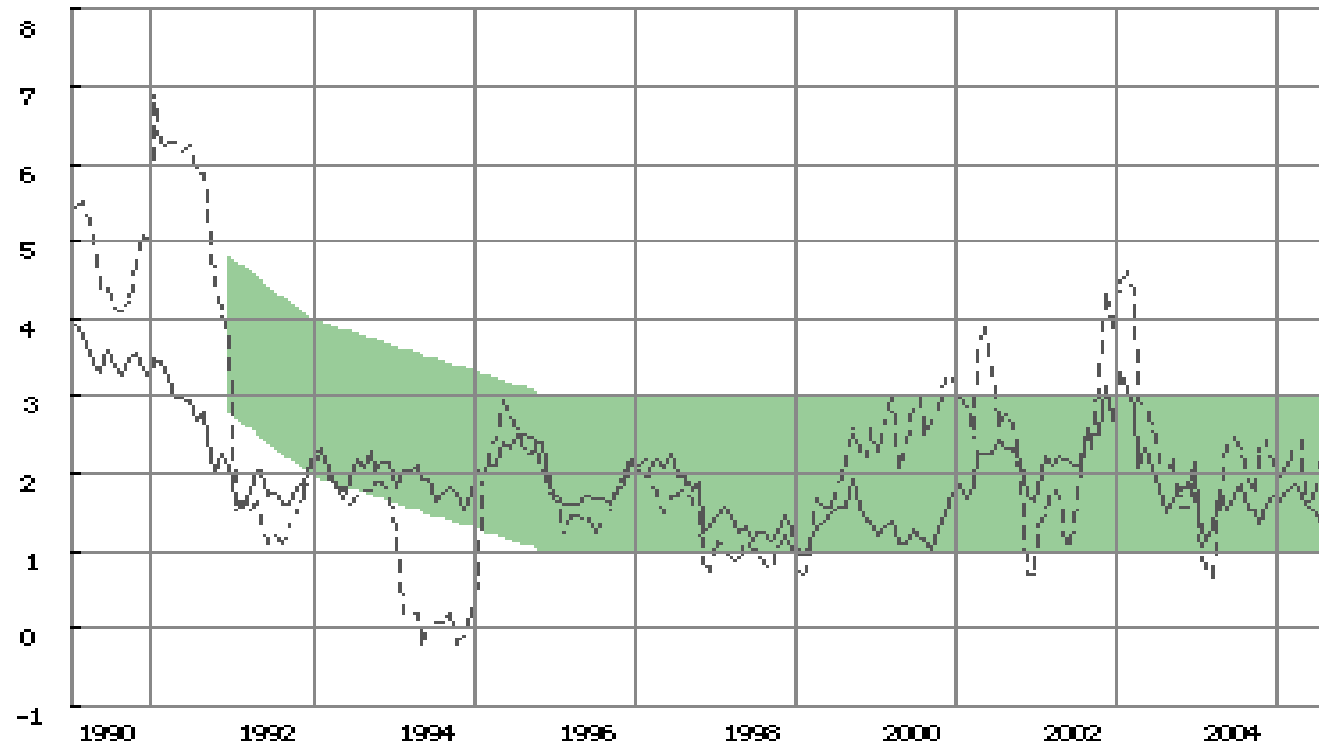
- Credibility from the Bank of Canada's perspective involves following through on what it says it will do.
- Credibility from the government's perspective requires a commitment to fight inflation in government policy.
- Example: civil service wage increases/freezes

Targeting in practice

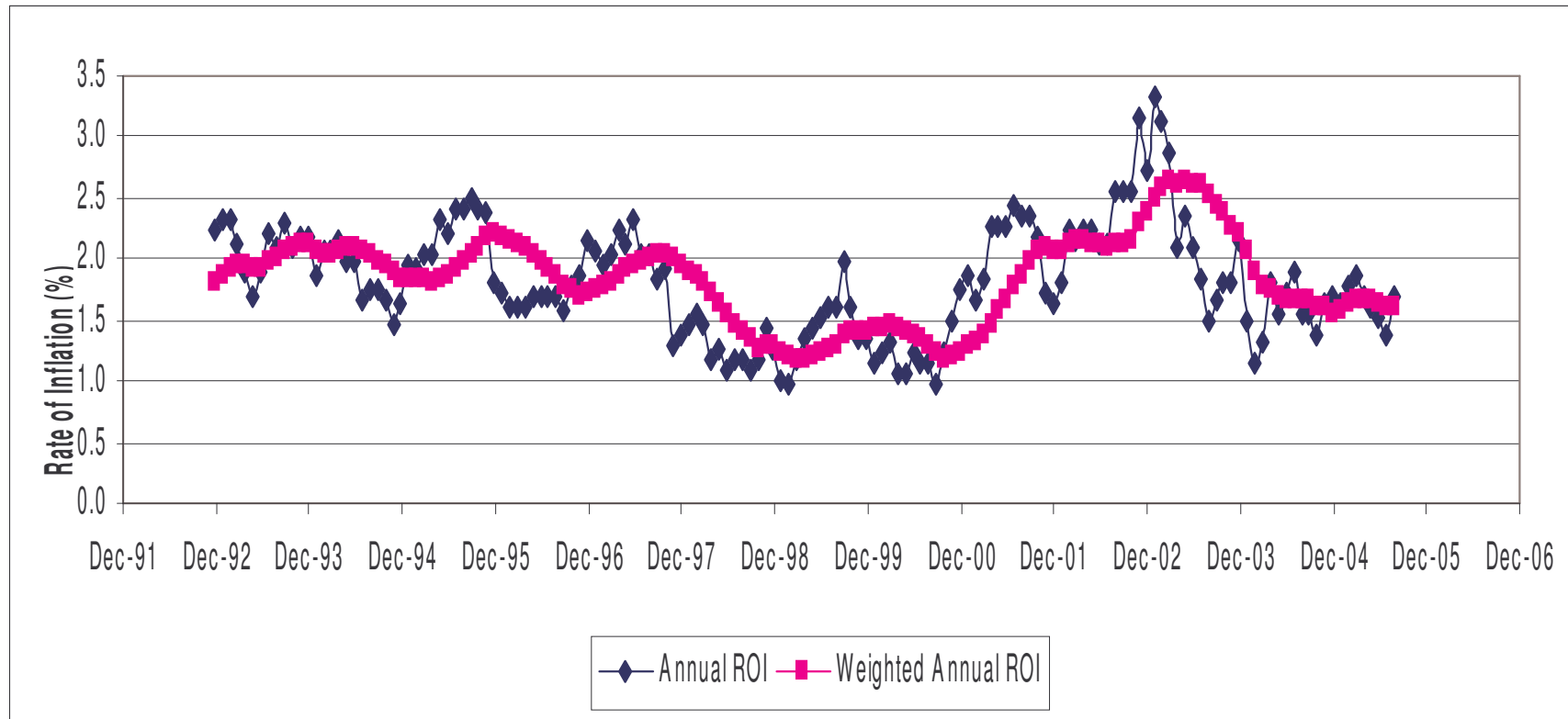
- Bank of Canada became very open and transparent about its policies, financial information, predictions.
- Very important to moderate the public's expectations on inflationary pressures.
- Transparency claimed to help achieve the goals of the targeting framework.

Inflation since 1990

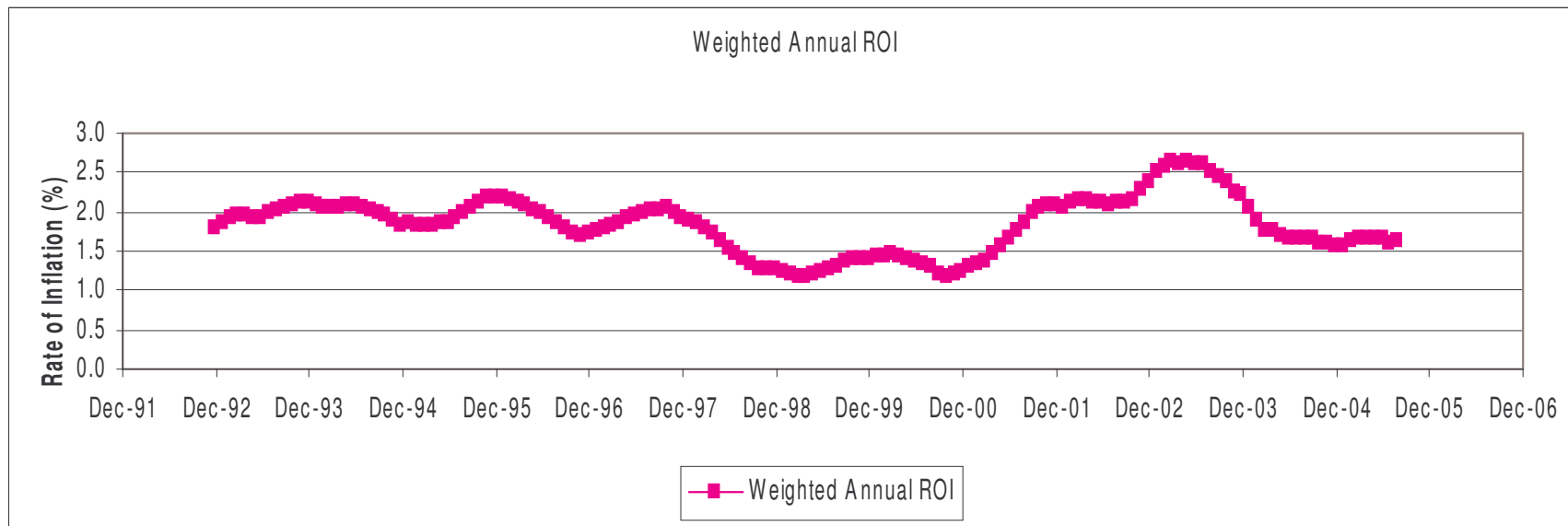
(source: BoC website)



Annual Inflation Rate



Weighted Annual Inflation



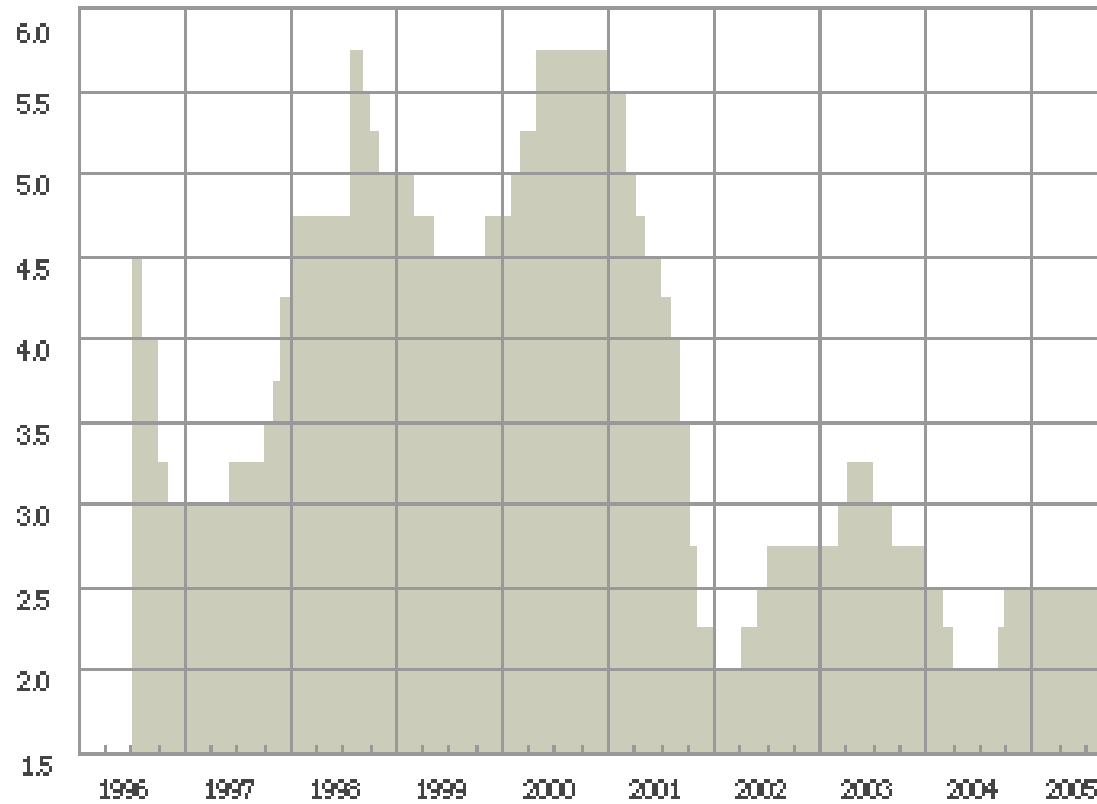
Inflation Targeting – Phase 1

- Initially set a target of 3% inflation by the end of 1992.
- Designed to be a target that was perceived to be achievable in the medium term (2 years).
- Subsequent targets were set on a decline until the target band was to be 2% +/- 1% starting in 1995.

Inflation Targeting: 1996 - Present

- After the initial adjustment period, targeting around the 2% mark was to regularly take place subject to renewals in 1995, 1998, 2001.
- Rate adjustments were announced regularly throughout each year. Since 2000, rate announcements have been set to fixed 8 days throughout the year.

Overnight Rate Targets Since 1996



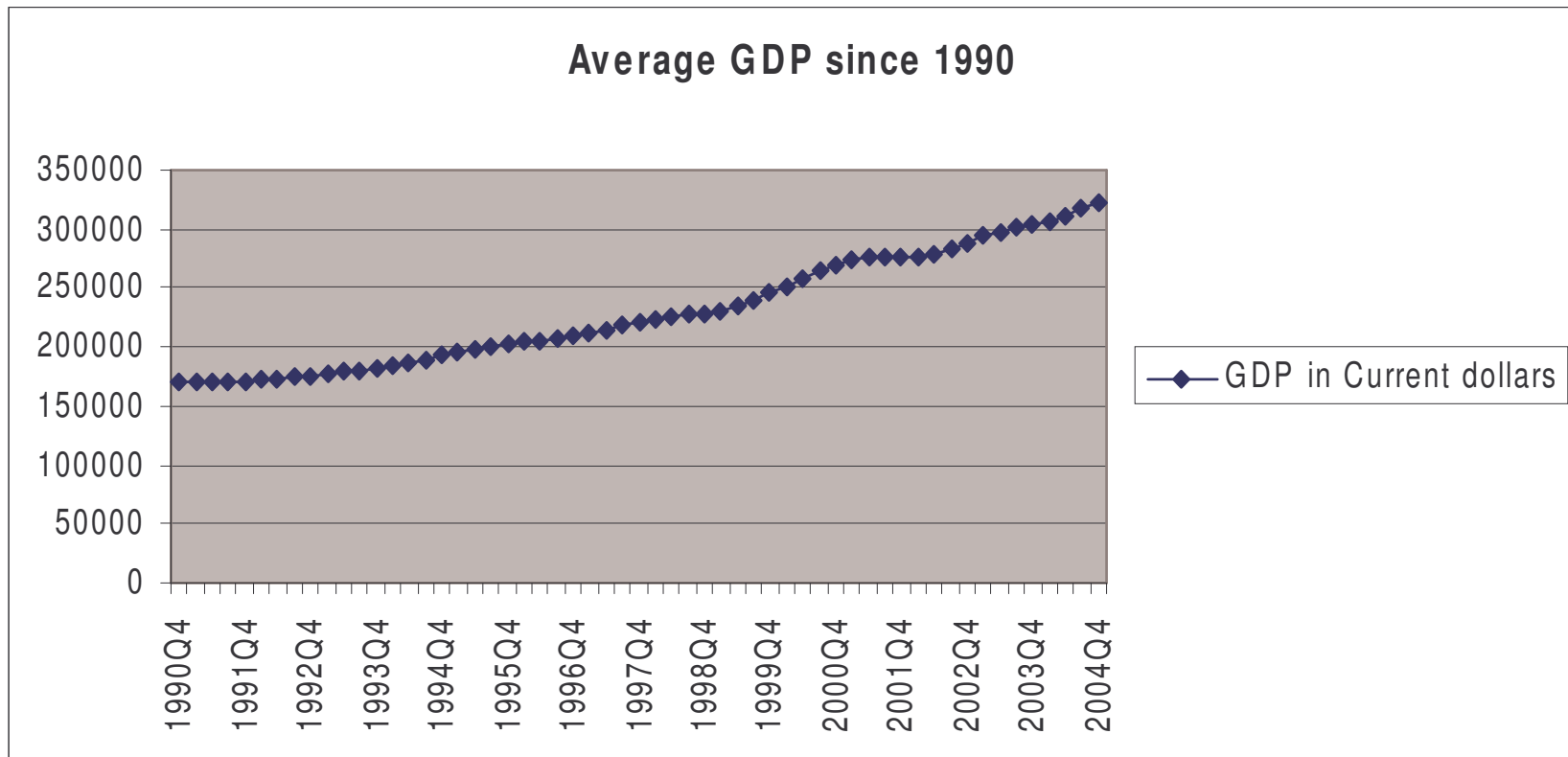
What have we seen ?

- Inflation targeting overall has been successful → achievement of the target core inflation range.
- Other effects of inflation targeting → unemployment rate, output change, exchange rate.

Inflation targeting – At what cost?

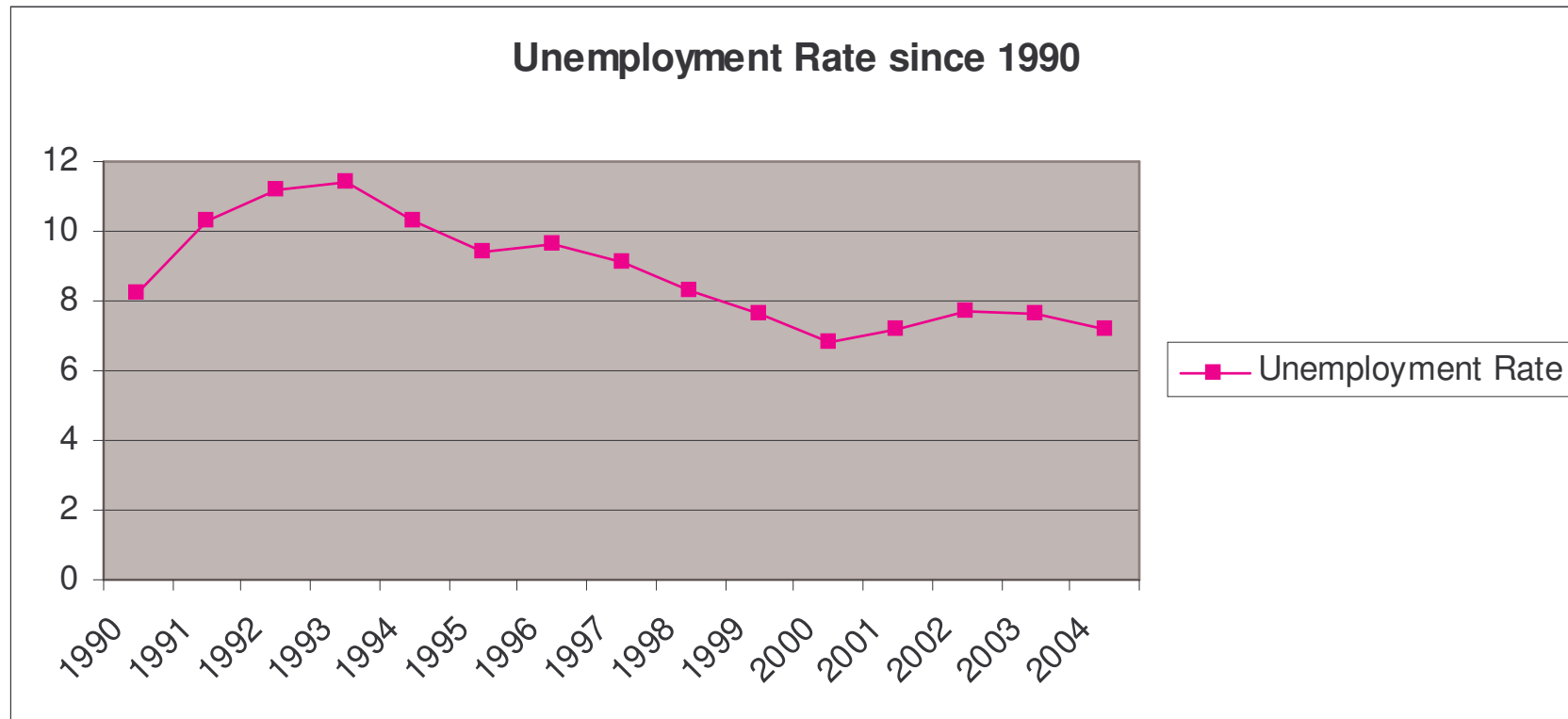
Canadian Economic Conditions Since 1990

Source: Statscan/CANSIMII database



Canadian Economic Conditions Since 1990

Source: Statscan/CANSIM



Economic Conditions 1990

- Inflation targeting was introduced during an economically turbulent period
 - Mounting federal deficit
 - High interest rates
 - High Canadian dollar
 - Large risk premiums
 - Beginning of recession

Economic Conditions 1990

- Argument made that inflation targeting caused a worsening of the recession.
 - Pierre Fortin
- US recovered quicker after the recession than Canada.
- Could other factors have caused this?
 - free Trade, technological change, political uncertainty, social policy, payroll taxes, minimum wage

Permanent Unemployment Level

- Argument put forward that we have accepted a permanently higher level of unemployment.
 - Differing views – is the 2% target wrong? Is explicit inflation targeting a problem?
 - Argument that we are too low on our long run Phillips Curve. → 3% inflation would achieve the optimal amount.

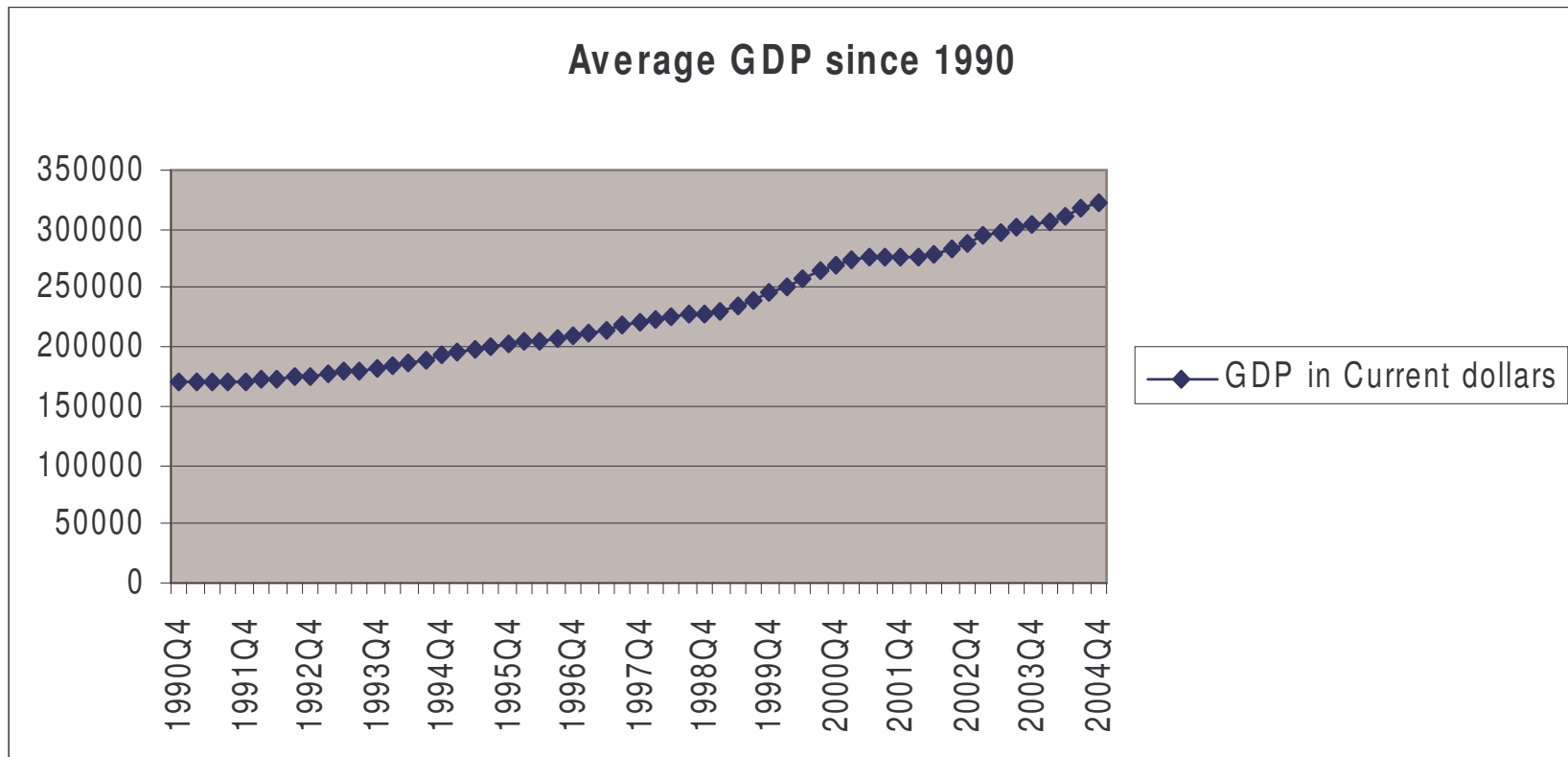
Output Cost

- By adjusting interest rates to curb inflation, not allowing for maximum output of the economy.
- Output is not operating at full capacity
- United States – Targets interest rates based on output and unemployment using inflation as an indicator → Argument they are having more success.
- Generally Inflation is around 4%

What have we gained?

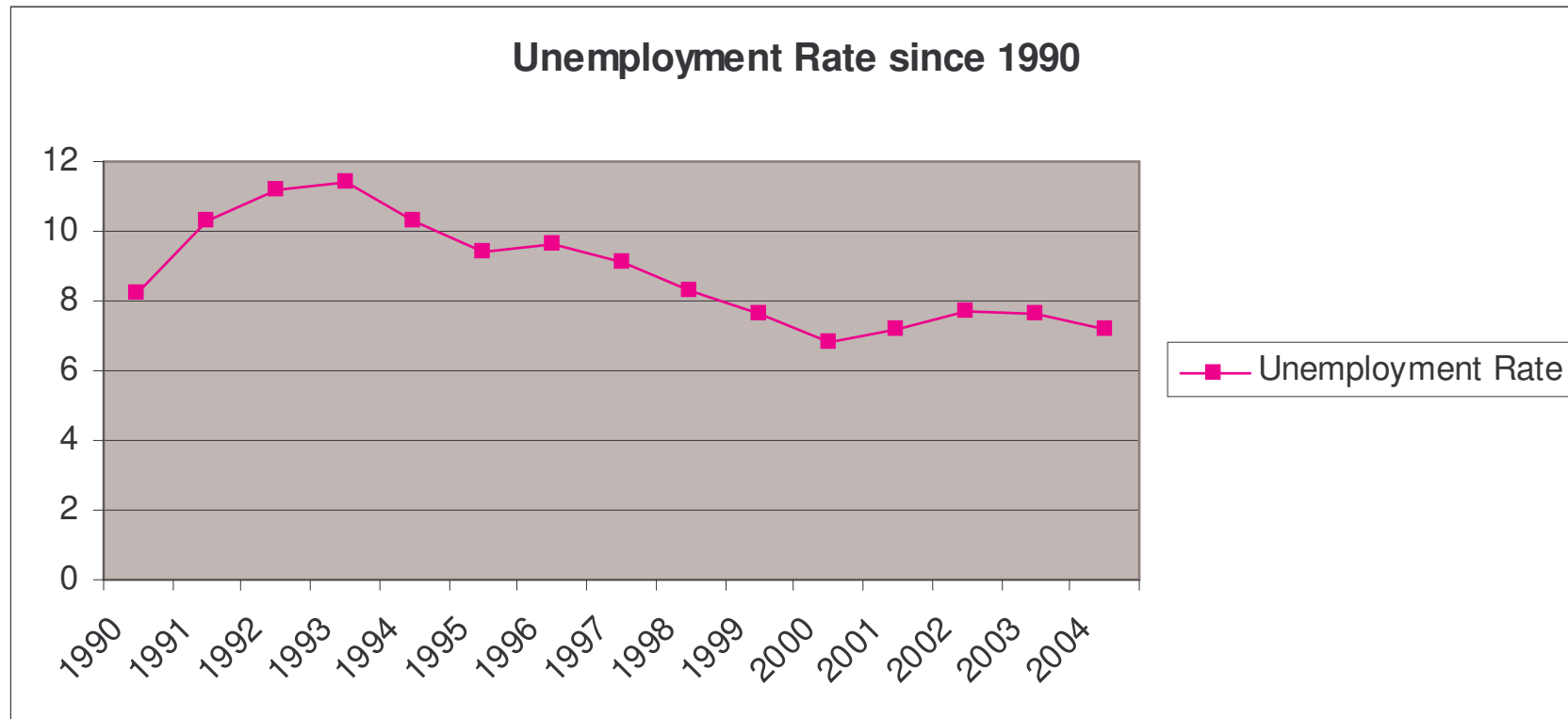
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Price Stability

- Theory says that price stability will lead to longer sustained growth. → allows investors to make long term decisions with steady inflation expectations.
- Inflation expectations are self-reinforcing. Can be seen to be self reinforcing → steady inflation allows for steady expectations → leads to steady inflation.
- Lower real and nominal interest rates lead to higher growth.

Dampening the Business Cycle

- Canadian economic performance has been less turbulent than the United States
- Recent example → North American boom (mid-late 90's), recession (2001/2002)
- Both were far less pronounced in Canada than the United States.

Sustainable Growth

- Overall, inflation targeting is supposed to make us better off by encouraging a steady growth pattern.
- Output sacrifice yes (full employment level of output vs. 2% inflation level of output), though stability may be worth it.