Time for a 1% inflation target

The Bank of Canada should just use rates to target inflation

By Angelo Melino
January 27, 2011 – *Financial Post*

Inflation made the news this week when Canada's December consumer price index numbers showed a year-over-year increase of 2.4%, well above the Bank of Canada's 2.0% target. A longer-term debate has been brewing, however, as the inflation targeting regime approaches its 20th anniversary. The current monetary policy agreement between the Bank of Canada and the Department of Finance, which sets 2% as the target for annual growth in consumer prices, is set to expire at the end of 2011. What comes next?

After the last renewal of the agreement in 2006, the bank announced that it would consider lowering the inflation target, or switching from inflation targeting to price-level targeting — a framework wherein, should the bank miss its price-level target, corrective action would have to be taken to return the price level to its intended target path.

How strong is the case for such a change? The bank's researchers found, more or less consistently across a number of studies, particularly if the bank moved to a lower inflation target, that modest gains could be had. At one point, it looked very likely that the bank would push for a lower inflation target with the next renewal. Then came the recession.

The recession brought increased attention to the importance of financial stability and the difficulties of stabilizing an economy when interest rates are very low and cannot go below zero — the zero lower-bound problem. The Bank of Canada, like central banks elsewhere, set the short-term policy interest rate as near to zero as possible — 0.25% in practice.

Although the Canadian financial system weathered the latest crisis reasonably well, outcomes elsewhere were a wake-up call. The crisis raised the prospect of hitting the zero lower bound from a theoretical to a very real possibility, one that would be even more likely to occur if we lowered our inflation target. Accordingly, the bank shifted its attention to ask: What can monetary policy do to improve financial stability and reduce the chances of a future financial meltdown?

One response would be to put changes to the monetary agreement on hold until we understand better the implications of these two developments. I think that would be a mistake.

Strengthening financial stability will come first and foremost from improvements in regulation. Although there may be a role if this first line of defence fails, I believe the link between financial stability and the path of the policy rate is very weak. The bank can and should use its policy rate almost exclusively to target inflation and hence maintain the loonie's domestic purchasing power.

An increase in the estimated probability of hitting the zero bound seems to weaken the case for lowering the target, because of the problems created by having interest rates near zero. But the best guesses currently available do not overturn the conclusion that the Canadian economy would be better off with a target of 1% inflation rather than 2%.

The bank's 2% inflation target was originally proposed as a stop on the way to even greater price stability. Fear of the unknown and the lack of compelling evidence on the costs of inflation threaten to make the 2% target immutable. However, events are now militating against the status quo.

The consumer price index that the bank uses to measure inflation is subject to a number of biases as a measure of the true cost-of-living. The total size of the bias changes through time. The last time the bank studied the issue, it estimated that the CPI over-estimated the true cost of living by 0.6%.

Welcome improvements by Statistics Canada to the calculation of the CPI will reduce this bias, albeit by an unknown amount. But any reduction means that aiming at a measure of 2% CPI inflation as part of this year's renewal would amount to accepting a stealth increase in the true rate of inflation.

To offset the imminent changes to the CPI and to test its own research, the bank should move to a target of 1.5% over the next renewal period, with the expectation of a further reduction in the target to 1.0% at the subsequent renewal if events unfold as anticipated.

The bank's current inflation-targeting framework has worked very well. Only some real-world experience will help us decide if we should move the inflation target closer to zero or adopt more features of price-level targeting into our monetary policy framework. Even taking a few small steps would provide useful information. And that might help us make a bolder decision when the agreement comes up for renewal again.

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