Is the Bank of Canada's 2-per-cent inflation target too low?

By Glen Hodgson
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For the past four decades, fighting inflation has been a top policy priority, notably for countries with strong and independent central banks, such as Canada. However, since the 2008 financial crisis, the game has changed. Fear of deflation (a falling aggregate price level) has become the new immediate focus of monetary policy.

This prompts the question: Is a 2-per-cent target for inflation – adopted by the Bank of Canada 20 years ago – now too low?

Don't be surprised if some industrial countries, led by the U.S., tacitly – or even explicitly – accept an annual inflation rate of 3 to 4 per cent. They may aim to implement a monetary policy geared to a higher inflation target in an effort to stave off deflation, and recover their mojo for economic growth. And if Americans drift toward a higher anchor point for inflation, it will be hard for Canada to resist the forces of monetary gravity.

This idea is contrary to the entire philosophy of monetary policy as it has evolved over the past four decades, in Canada and elsewhere. In an effort to corral inflation, Canada adopted an explicit 2-per-cent inflation anchor in the early 1990s. This was a critical part of the country's strong macroeconomic performance in the 1990s and 2000s; furthermore, it helped the Canadian economy emerge from the financial crisis in better shape than most of its peers.

However, the monetary policy game appears to have changed. The International Monetary Fund (IMF) – arguably the world's most powerful financial institution – drew that conclusion at a November, 2013, conference it hosted, where some of the world's leading academic economists debated the role of monetary policy in the recovery from the 2008-09 financial crisis.

Some of the specific conclusions at the conference were conventional and unsurprising. For example, countries with stronger macroeconomic policies going into the crisis (such as Canada) were able to restore more quickly the conditions for sustained gross domestic product (GDP) and job growth. But in other important areas, fresh ideas were advanced on the building blocks for macroeconomic policy.

The first big idea is that a "liquidity trap" can, indeed, exist for a very long time, can impose heavy economic costs, and be hard to escape. A liquidity trap (as named by John Maynard Keynes in the 1930s) exists when there is no appetite to increase investment or consumption due to depressed economic conditions, even with interest rates near zero. Under these rare conditions, traditional monetary policy alone is not enough to kick-start an economy back to sustained growth.

As a result, what IMF chief economist Olivier Blanchard calls "unconventional monetary policy" – such as quantitative easing, or creating central bank credit – must be used, in tandem with active fiscal policy, to break out of the liquidity trap. That was exactly the policy course taken over the past five years, so the world's political leaders essentially got the macro policy prescription right when dealing with the 2008-09 global recession.

A second and even more radical idea emerging from the conference is intended to avoid the risk of a liquidity trap in the first place, by setting the target (or acceptable) inflation rate for an economy at higher than 2 per cent. The logic, and arithmetic, are simple: If the target inflation rate in industrial countries prior to the 2008 crisis had been higher, there would have been less risk of slipping into deflation and more scope to cut nominal interest rates.

Therefore, investors and consumers would have received a stronger price signal that it was the time to spend.

The idea of accepting a higher target rate of inflation may be sacrilege to some. Canadians would be understandably reluctant to give up our 2-per-cent inflation anchor, which has served our economy well for more than 20 years. However, we should also recognize that deflation is very dangerous. It depresses aggregate demand and can suck the energy out of an industrial economy for decades – as it did in Japan until quantitative easing was introduced there last spring.

The bottom line? The advantages of a 2-per-cent inflation anchor may need to be weighed against the current risks of deflation in industrial countries. For some, raising the inflation target a notch may be a reasonable and responsible policy compromise.

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