No good alternative to Bank of Canada's inflation target

By Barrie McKenna
November 1, 2016 – *The Globe and Mail*

Bank of Canada Governor Stephen Poloz says there is no good alternative to the central bank's 2-per-cent inflation target in spite of years of anemic economic growth and soaring mortgage debt.

"I recognize that after years of very low interest rates, the economic recovery in many economies remains weak," Mr. Poloz acknowledged in notes prepared for a speech Tuesday in Vancouver.

"But, to date, we have not seen convincing evidence that there is an approach that is better than our inflation targets."

Last week, the central bank renewed its policy of using the mid-point of a 1- to 3-per-cent inflation band – or 2 per cent – as the focus of monetary policy. The Bank of Canada was among the first central banks to strategically target inflation, beginning in 1991. It adopted a 2-per-cent goal in 1995.

And the policy has done its job, allowing Canadians to spend and invest with confidence, Mr. Poloz insisted.

Nonetheless, he said the target is not "set in stone," and would be reviewed again in 2021.

Inflation averaged 7 per cent between 1975 and 1991, and often swung wildly. Since then, inflation has averaged almost exactly 2 per cent.

During its review, Mr. Poloz said the bank considered both a higher target for inflation, as well as focusing on other economic indicators, such as economic growth or financial stability.

The bank ultimately rejected the idea of boosting the target to 3 per cent because it's confident it has a range of other unconventional tools, including negative interest rates, to deal with another economic slump, he said.

"A higher inflation target would mean higher nominal interest rates and more room to manoeuvre, on average, but also would entail imposing a higher inflation tax on the economy," he explained. "I think of this as paying dearly, every day, for insurance against the low probability risk that another very large macroeconomic shock could occur in the future."

He also said that pushing inflation up to 3 per cent "might be quite difficult to do."

Today's rock-bottom interest rates are great for borrowers and homeowners, who can load up on cheap debt. But they impose a cost on many savers, especially those on fixed incomes, whose investment returns are getting squeezed.

Mr. Poloz said the bank also rejected the idea of focusing more on financial stability, including the record high debt levels of Canadians. He said "macroprudential" polices, such as Ottawa's recent crackdown on access to mortgage insurance, are much better suited to deal with specific financial risks.

"Adjusting interest rates is a very blunt tool with widespread effects," he pointed out.

Mr. Poloz also said that the inflation target has caused the bank to be much better at communicating what it's doing. In the 1990s, the bank didn't have set rate-setting announcements, nor where there regular forecasts or frequent speeches by top officials. He pointed out that already this year senior officials have made 17 public addresses, compared to a handful a year in the 1980s.

"It has become clear over 25 years that it is easier to anchor inflation expectations when people understand what the central bank is doing, and why," he said.

And yet the Bank of Canada has sometimes befuddled financial markets since Mr. Poloz became governor in 2013 – most recently in the hours after the Oct. 19 rate announcement. Many analysts interpreted the statement to mean the bank was tilting towards a rate hike, but Mr. Poloz quashed the notion later, saying the bank had come close to cutting its key rate, which has been stuck 0.5 per cent for more than year.