Inflation targets don't make for gripping debate

By Bruce Little
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You might call it the debate that isn't.

For the past few years, Canadians have argued endlessly over what to do with the growing federal surplus — cut taxes, spend more or pay down debt.

But when it comes to another big policy decision that affects all our lives, there has been barely a peep.

The Bank of Canada's inflation-control target has been around for so long now — a full decade — that it's easy to forget that the goal is not etched in stone.

It expires at the end of this year. Last week, one of the bank's long-time critics, Pierre Fortin, revived an old fray by arguing that a different target could reduce unemployment on a permanent basis.

Mr. Fortin's timing is spot-on. Sometime before December, the central bank and the government have to decide whether to extend the inflation target in its current form (keeping inflation between 1 and 3 per cent) or amend it.

To date, the target has been renewed twice, both times with virtually no public debate over its merits.

When launched, the targets were intended to run until 1996. In December, 1993, a then-new Finance Minister Paul Martin agreed to the first extension (to the end of 1998) when he appointed Gordon Thiessen as governor of the bank. In February, 1998, another renewal (to the end of this year) was slipped into Mr. Martin's annual budget.

The second renewal was preceded by a low-key debate that never got much beyond a tiny community of experts, nearly all of whom can be found either at the Bank of Canada, a few university economics departments and a handful of think tanks.

Mr. Fortin, who teaches economics at Universite du Quebec a Montreal, led a small critical charge, using his 1996 presidential address to the Canadian Economics Association as the launch pad. A few months later, the C.D. Howe Institute organized a conference of experts to discuss targets and later published the results. Several argued that Mr. Fortin's conclusions were based on weak data.

This time, even though a deadline is fast approaching for a new decision on targets, little was said until last week, when Mr. Fortin renewed the argument.

Using new data, he came to conclusions very similar to those he reached in 1996. If the government is going to set a target for inflation, the 1-to-3-per-cent band is too low. A better choice would be 2-to-4 per cent, but he'd settle for a target in between as "a fine compromise for now."

Mr. Fortin's views are set out in a paper, Inflation Targeting: The Three Percent Solution, published by the Institute for Research on Public Policy and available at www.irpp.org.

He argues that the long-term tradeoff between unemployment and inflation is rather more complex than often thought. Over the long haul, he says, Canada's lowest sustainable unemployment rate is 5.3 per cent, but that can only be achieved if inflation is allowed to climb to 2.8 per cent annually.

That would put his "ideal" rate close to the mid-point of the new band, not near the top — which would make too many people nervous.

The higher band would also prevent the Bank of Canada from letting inflation decline as low as it has.

"If, as has been the case in Canada since 1992, the central bank holds inflation at 1.5 per cent instead of allowing it to increase into the 2.5-to-3-per-cent range, the national unemployment rate remains at the 7-per-cent level [roughly where it has been for the past year] and is prevented from declining to 5.3 per cent," Mr. Fortin says.

As he sees it, Ottawa has a very narrow inflation window open to it. If the inflation rate rises much above 4 per cent, or falls much below 2 per cent, the result is higher unemployment.

"A great deal of excess unemployment has been needed" to keep inflation so low over the past nine years, he adds.

"The inescapable conclusion is that 1.5-per-cent inflation is much too low and 7-per-cent unemployment much too high."

Mr. Fortin isn't even sure if an official target for keeping inflation under control is needed at all; the United States "has done very well in the 1990s without one." Still, he is realistic enough to concede that abandoning an official target might upset the financial markets and "may not be feasible politically."

But at least, he argues, the government should "avoid the twin mistakes of setting a rigid long-term target or of setting any target of less than 2 per cent."

Important as it is, this is not the stuff of gripping public debate such as taxes or government spending, which anyone can grasp. For non-experts, who include even economists who don't specialize in monetary policy, the details are technical and arcane.

That means Mr. Martin and the bank's new governor, David Dodge, will be pretty much on their own as they make a decision that will affect every Canadian for years to come.