Bank of Canada’s Experience with Inflation Targeting: Partnering with the Government

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Introduction of inflation targeting in Canada

- Government’s proposal
- Bank of Canada’s response
- G-10 Governors’ reaction
- Initial inflation-reduction framework (1991):
  - Target of 3 per cent for 1992
  - Declining to 2 per cent by 1995
  - 1 per cent bands on either side of target mid-point
- Post-1995 agreement to be guided by 1991-1995 experience

Key aspects of the inflation targeting agreement

- Joint public announcement by the Government and the Bank
- Simple press release without any supporting legislation
- Government-Bank of Canada partnership, with one more equal than the other
- Goal vs operational independence and the directive power
- Early ambitions regarding the ultimate price stability goal
- Origins of the renewal process

Aiming for price stability vs. low inflation

- Excerpts from the 1991 press release

  - "The specific targets for the year-over-year rate of increase in the consumer price index (CPI) are as follows:

    … 2 per cent by the end of 1995"
  - "Thereafter the objective would be further reduction in inflation until price stability is achieved."
  - "A good deal of work has already been done for Canada. This works suggests a rate of increase that is clearly below

    2 per cent."

Performance under inflation targeting

- Target renewed in 1993 (instead of 1995) and again in 1998, 2001, 2006, 2011, and 2016
- 2 per cent maintained as the target mid-point
- Objective recast as "low, stable and predictable inflation" as opposed to "price stability"
- Performance over the last 27 years better than expected:

  - Lower average inflation and interest rates (and growth)

  - Lower volatility of inflation, interest rates and growth
- Suspicions the Bank has been price-level targeting covertly

Chart 1: Inflation performance has been better than expected

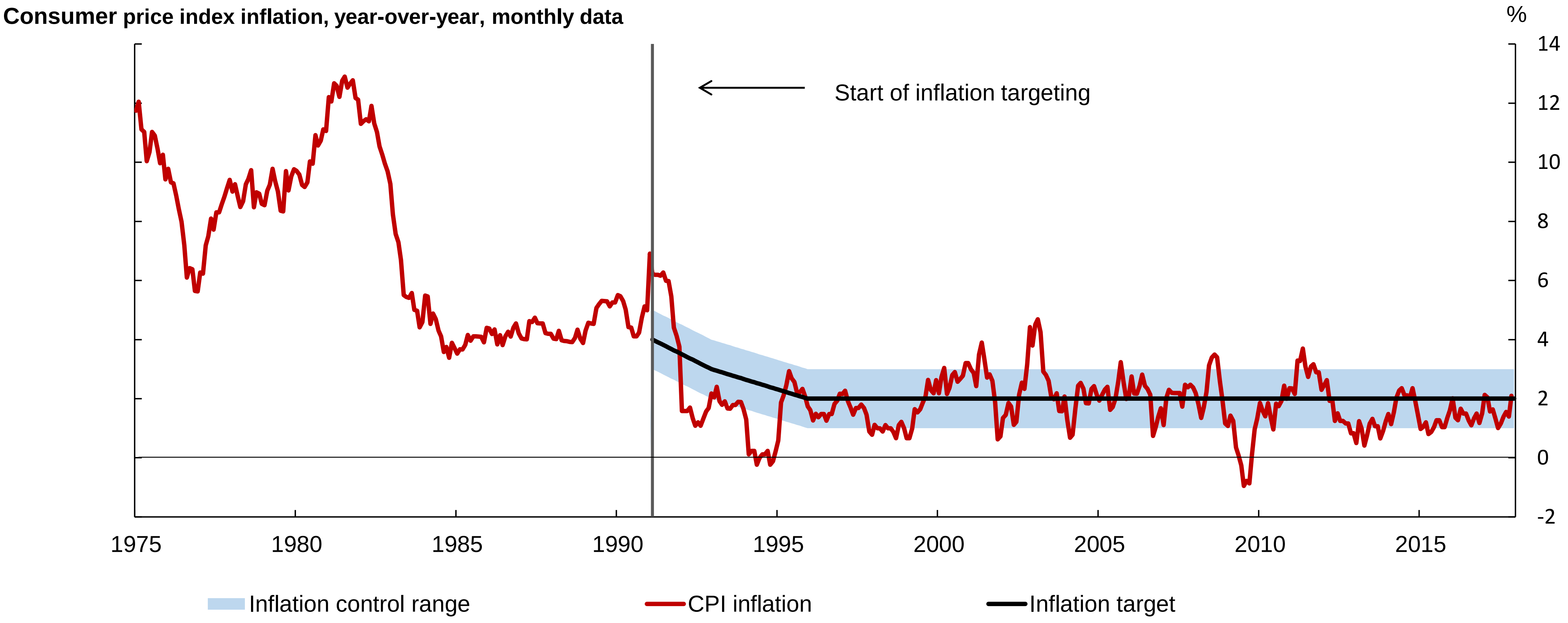
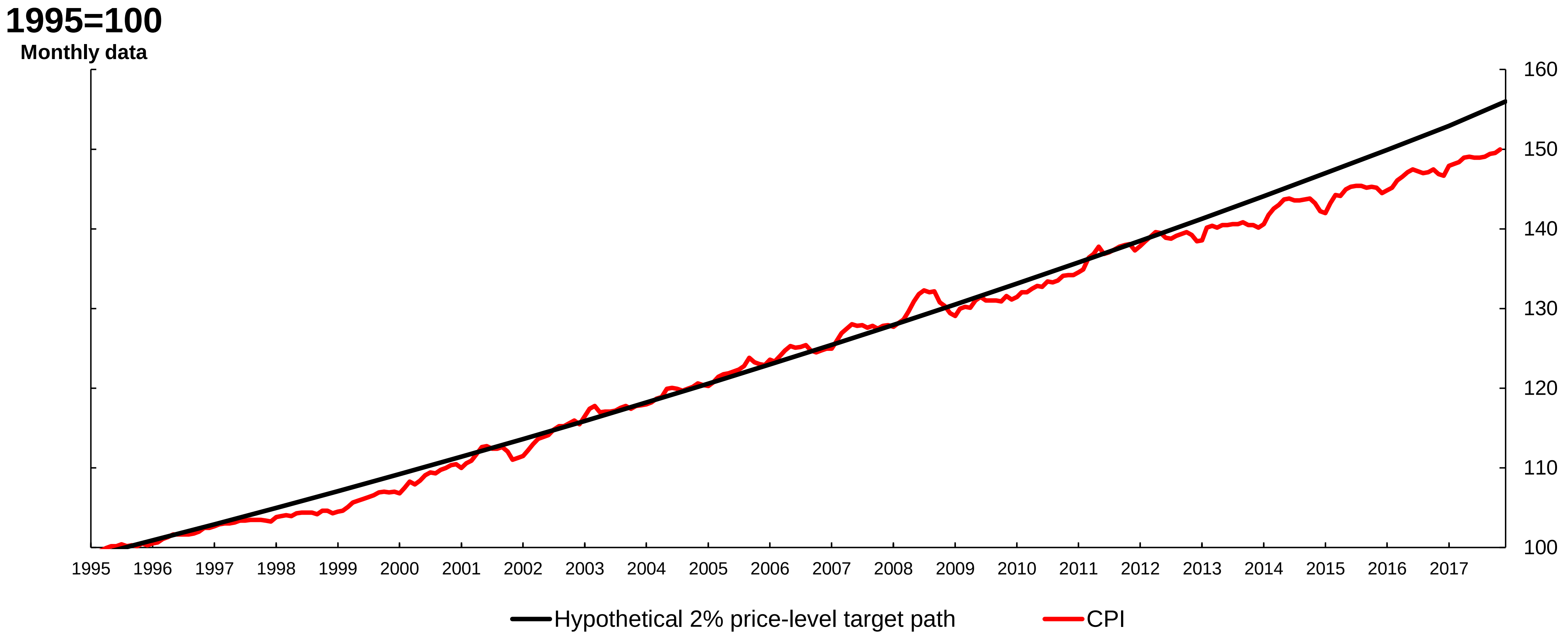


Chart 2: Suspicions that the Bank of Canada has been price-level targeting



Source: Statistics Canada and Bank of Canada

Last Observation: November 2017

Advantages of the regular renewal process

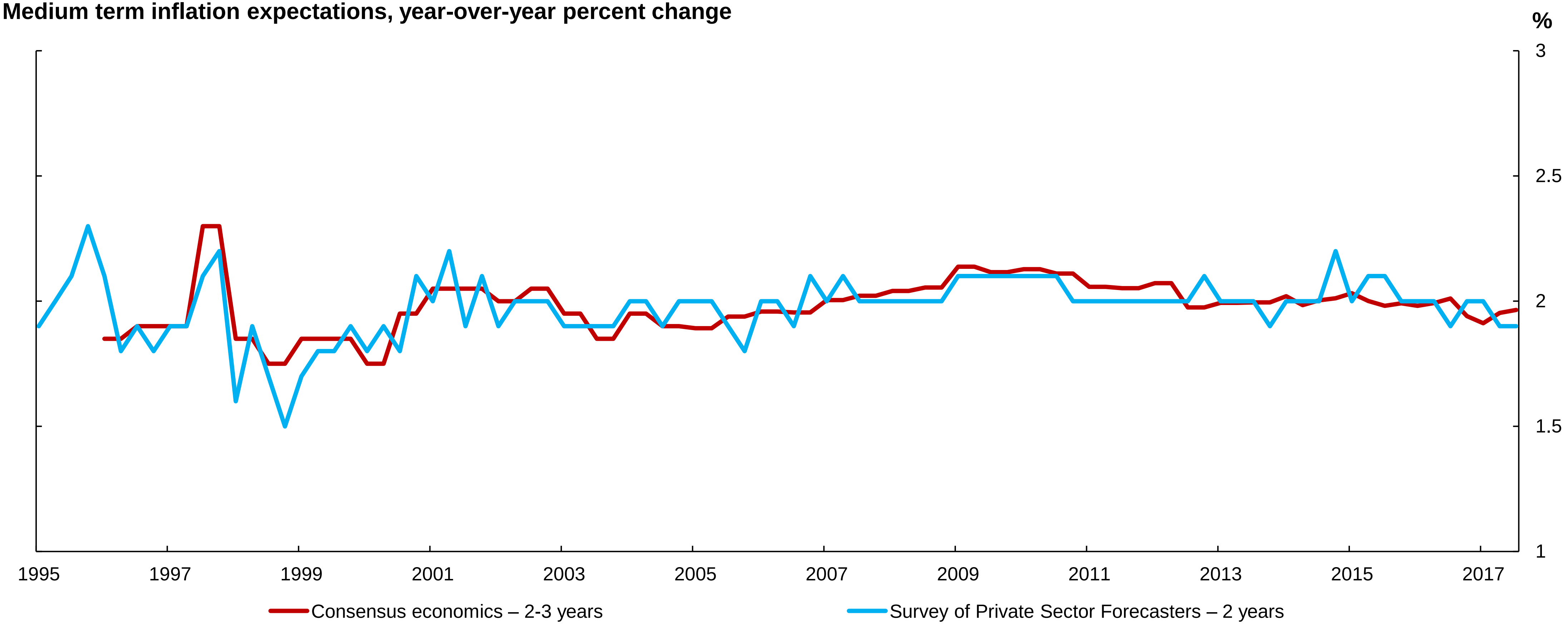
- Critical part of the Bank's accountability and fiduciary duties
- Way of diffusing potential problems – "just business as usual"
- Deliberate and transparent mechanism to engage stakeholders and get feedback
- Means of promoting public awareness and understanding
- Driver for more focused research effort within the Bank
- Something new has been learned on each occasion

Possible disadvantages of the renewal process

- Disadvantages:
  - Expectations less well-anchored, greater inflation uncertainty
  - Increased scope for unhelpful outside interference
  - Waste of time and energy
  - Trying the public's patience (announcement fatigue)
- Counter-arguments
  - No evidence of fragile or unanchored inflation expectations
  - Mechanism for enhancing central bank independence
  - Important confirmation (or not) of the framework's soundness

Chart 3: Inflation expectations have become well anchored

Medium term inflation expectations, year-over-year percent change



Issues the Bank of Canada has examined

- Two types of issues examined as part of the renewal process
- Fundamental:
  - Should the inflation target be lowered (raised)?
  - Would a price-level target be better?
  - How much recognition should be given to financial stability?
- Operational/housekeeping:
  - Is the CPI the best target price index?
  - What is the best measure of core inflation?
  - How important is measurement bias?

Looking ahead

- Next renewal is set for 2021
- BoC already mapping out a research program for the next five years
- Final questions not yet determined but intend to take a broader sweep
- Three main categories: objectives, tools, and communication
- Some old issues will likely be revisited, other new issues will be added

Main Takeaway – The Bank of Canada values the renewal process and believes it provides significant net benefits