Controlling Inflation Is What the Job's All About

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The Montreal Gazette, January 10, 2008

Whatever daily challenges must be faced by central bankers, some of their brain power must be reserved for the big picture. In the late 1980s, John Crow decided that 6-percent inflation needed to be wrestled to the ground. Gordon Thiessen needed to make the new inflation-targeting system operational, which required advancing the Bank's transparency. David Dodge inherited a well-functioning policy regime, but had to keep inflation low and stable while responding to the 2000 stock-market crash, the 9-11 terrorist attacks, and the dramatic appreciation of the Canadian dollar.

Notice that in each case the big-picture challenge for the Bank's governor concerned inflation. This focus on inflation does not reflect their lack of imagination, but rather a solid understanding by central bankers of what they can actually do. It is now well accepted among economists of all stripes that monetary policy has its most systematic and sustained influence on one thing—inflation.

So what big-picture issue will face Mark Carney when he becomes the new governor on February 1st? Given the need to focus on inflation, there is really only one, and Carney may be just the right man for the job. (I assume, perhaps naively, that the heavy lifting required to smooth out the recent ABCP-related credit crunch will by then be completed.)

After sixteen years of keeping Canada's annual rate of inflation at or near 2 percent, it is time to seriously consider the possibility of reducing the inflation target, to 1 percent or maybe even to zero. For many Canadians who lived through the high inflation of the 1970s, today's low inflation may seem almost irrelevant. But there would be real benefits from even lower inflation.

If you are lucky enough to have a salary that increases more-or-less in line with the average price level, 2 percent inflation every year is no big deal. But there are many retired Canadians who live on incomes fixed in dollar terms. And with the aging of the baby-boom generation, these people are becoming a relatively more important part of the population. For anyone on such fixed incomes, even 2-percent inflation is a problem because it erodes the real value of their money. Since the start of the Bank's inflation-targeting regime in 1991, average prices in Canada have increased by 34 percent, thus reducing the value of a dollar by the same amount. If the inflation target were reduced to zero, the dollar's purchasing power would instantly be stabilized, and millions of Canadians would be better off.

So why isn't eliminating inflation a no-brainer for any central bank? The answer, familiar in economic debates, is that free lunches rarely exist. In other words, the benefits from reducing inflation may come only at some cost.

Some economists argue that reducing inflation further will create a recession. But if there is one thing the Bank of Canada has solidly established over the past 16 years, it is its credibility. If

Governor Carney announces at some point in the near future that the Bank will henceforth target a lower rate of inflation, nobody in their right mind would expect anything different. In this case, wage and price adjustments would take place quickly and the economy's transition to lower inflation would be virtually painless.

Other economists argue that a lower inflation target would weaken the Bank's ability to respond to large economic shocks through interest-rate reductions. This is a more serious concern, but it is worth noting that even if inflation (and thus interest rates) had been lower by 1 or 2 percentage points over the past 16 years, there would still have been plenty of room for the Bank to reduce its policy interest rate in the circumstances when it actually did so, during the Asian crisis and after the 2000-01 shocks. Unless we are expecting shocks far larger than these ones—and these were big shocks by any standards—a lower inflation target will not weaken the Bank's policy arsenal.

Economists at the Bank of Canada are now researching the pros and cons of reducing the inflation target. Mark Carney as the next Governor should make sure that this research is given the highest priority so that whatever decision he advocates in 2011 regarding the renewal of the inflation target is supported by the best possible evidence.

If the Bank's research clearly points toward reducing the inflation target, Carney is the right man to make the decision, despite whatever opposition might arise. Rumour has it that he was the brains behind the federal government's decision in 2006 to tax income trusts. As politically difficult as this decision was to make, it was surely good economics to eliminate an existing tax loophole that was of questionable overall value in the first place. The decision to reduce the inflation target would similarly be based on good economics, but would take plenty of guts. If Carney is prepared to use his, millions of Canadians will benefit.

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