**Don’t Inflate Inflation**

**New deal with Bank of Canada should lower target to 1%**

by Christopher Ragan

The Canadian government will soon unveil two crucial economic documents – the annual budget and a renewal of the inflation-targeting agreement with the Bank of Canada. The budget will appear in March and, if past history is a guide, it will likely contain the government's intentions for the new inflation-targeting agreement. We should not miss this opportunity to adopt two policy reforms, tightening the target and improving its measures, to tune monetary policy so that it better preserves the value of our money.

The rate of consumer price inflation is something Canadians see as reflecting the increase in the overall cost of living – but if it is measured incorrectly we are unsure what is really happening. Current research shows that inflation, as measured by Statistics Canada’s Consumer Price Index, the CPI, is biased upward by about 0.6%, so when the inflation rate is measured to be 2%, the "true" rate of inflation is only 1.4%.

This is a problem for any firms or individuals with payments or receipts contractually tied to growth in the CPI – from nominal wages and rental rates to pension payouts and children's benefits. And it is a big problem for the Bank of Canada if the bias changes over time, because then measured inflation does not accurately reflect the excess demand or supply pressures in the economy.

The bias in the measured CPI also creates a sizable loophole in the government's fiscal system. Personal income taxes are indexed to measured inflation, so the basic personal amount, for example, rises along with the measured CPI, as do the income levels that define the various tax brackets. If true inflation is regularly less than measured inflation, tax revenues will be lower than otherwise. The problem also exists on the spending side, because many benefits are indexed to measured inflation. Here, the bias in the CPI results in the government spending more than it needs to. I estimate that the overall effect on the budget from this “over-indexation” of the fiscal system is likely to be several hundred millions of dollars per year.

In the March budget, Ottawa should therefore devote the necessary resources to improve measurement of the (CPI), arguably the most important piece of data for monetary policy.

The second improvement for monetary policy should be to reduce the Bank of Canada's inflation target – to 1% from the existing 2%. For over 15 years, the Bank has been very successful in keeping inflation close to its 2% target, and it should be applauded for this achievement.

Yet there is a dark side to the Bank's success: since 1995, the value of Canadian money has fallen by over 35%. For those of us whose nominal incomes tend to rise with the price level, this erosion in money's value is no great issue. But inflation has significantly reduced the purchasing power of the millions of Canadians who have un-indexed incomes. And with the ongoing aging of Canada's baby boomers, the fraction of the population in this category will continue rising.

What is more, if the government chose to correct the bias in the CPI, measured inflation would fall from 2.0% to 1.4% – but the true rate of inflation would be unchanged at 1.4%. Indeed, if the Bank of Canada continued to target inflation of 2.0% after the bias had been corrected, the true rate of inflation would actually increase from 1.4% to 2.0% – and this would occur without any formal announcement. So to avoid such a stealth increase in inflation, the decision to correct the bias in the CPI should be accompanied by a reduction in the Bank of Canada's formal inflation target.

How far should it be reduced? An inflation target of 0% would immediately put a halt to the erosion in the value of money. However, many economists argue that a zero rate of inflation, which would reduce all nominal interest rates in turn, might introduce new problems – in particular, by restricting the Bank of Canada's expansionary monetary policy in situations where nominal interest rates are effectively at their lower bound.

An inflation target of 1% is an obvious compromise solution. Since the true rate of inflation (on average) is currently 1.4%, a reduction in the formal target to 1% would be a relatively small change in true inflation. The reduction would be large enough to generate real

gains for the millions of Canadians who rely on their money retaining its value over time, but not so large that the Bank's monetary policy would be unduly restricted.

This two-step policy package – correcting the CPI bias and reducing the inflation target to 1% -- would generate genuine economic benefits for millions of Canadians and result in better monetary policy. It would also create some much-needed fiscal room for a government committed to balancing its budget by 2014-15.

As I will argue in my next column, however, the minister of finance may see a compelling "political" logic against making these policy changes, especially at a time when Canada's financial system is so well regarded internationally.

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