Preserve the Value of Our Money

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In this column yesterday, I argued that the federal government should improve Canadian monetary policy in two ways. First, it should devote the resources needed to improve the Consumer Price Index (CPI) by eliminating the existing upward bias in its measurement of inflation. Second, it should reduce the Bank of Canada’s formal inflation target from 2% to 1%, thereby better preserving the value of Canadians’ money.

Today I discuss why the minister of finance and the government may see political reasons for avoiding these changes and instead maintaining the status quo. My purpose is not to be an advocate for the status quo; in fact, I think the economic benefits of making these changes outweigh the political obstacles. But I hope to identify the obstacles that do exist, and to emphasize that anyone seeking improvements in our inflation-targeting regime should recognize the need to pitch economic benefits against political costs.

In addition to giving us a better indication of the true path of the overall cost of living, a corrected measure of CPI inflation would put an end to the bias-induced loophole that “over indexes” the fiscal system – thereby reducing tax revenues and raising expenditures. For a government committed to balancing its budget by 2014-15, a few hundred million dollars per year of extra fiscal room should be viewed as a welcome policy change.

The changes on the tax side caused by correcting the CPI bias are unlikely to draw much attention, except perhaps for those few people who study their income-tax forms in excruciating detail. But the changes on the expenditure side create a significant political obstacle. If government outlays – on over-indexed items such as elderly and children’s benefits – have been
rising too quickly because inflation is mis-measured, then correcting the CPI bias would reduce these payouts relative to what would otherwise occur.

The government could sensibly claim that past payouts have been excessive and that the correction would merely put them back on their intended path. Whatever the government’s argument, however, the real growth rate of these payments would fall because of the CPI correction, and the government could hear complaints from groups whose payouts would be adjusted. Seniors and children make a potent political image when pitted against a government contemplating fiscal cutbacks.

Yet correcting the CPI raises issues beyond the fiscal ones. In a market-based economy, all economic values are measured in money -- prices, wages, rents, pensions, charitable donations, and much more. And with a systematic error in the measurement of CPI inflation, we are never really sure whether we are measuring these values correctly. Correcting our measurement of inflation is akin to tuning up a car to improve its performance. If the government determines that elderly and children’s benefits should not be adjusted, it can easily change those programs to maintain the payouts – but it should do so in a setting in which the actual payouts are not hidden behind the mis-measurement of inflation.

My recommendation to reduce the Bank of Canada’s formal inflation target to 1% is motivated by the desire to better preserve the value of Canadians’ money -- which has declined by 35% since the Bank started targeting inflation at 2%. Inflation that is both high and unstable creates many costs: these are now limited, I hope, to our past. But even low and stable inflation creates problems – especially for those millions of Canadians who have un-indexed incomes and see inflation as the never-ending erosion in their purchasing power.

The main political obstacle to reducing the Bank’s inflation target is a familiar political force: complacency. Nobody denies that the Bank of Canada has had great success in conducting its policy over the past 15 years. Inflation has been far lower and far more stable since 1995 than it was in the preceding twenty years, despite the existence of some major economic shocks. And in the past few years of financial crisis and recession, the Bank has proven itself to be both aggressive and creative in its responses to unfolding events.
In addition, the overall Canadian financial system – at the heart of which sits the Bank of Canada – is often held up as an example of moderation and sensible regulation for the rest of the world to follow. In this context, it is easy for a finance minister to see the value of maintaining the status quo, of “sticking to a winning model.” I suspect that such a decision would only be strengthened by the observation that no other developed nation has chosen to reduce its inflation target in the past year or two.

Canada is not like all other nations, however. It was early to move to fully flexible exchange rates, it was a pioneer in the adoption of inflation targeting, and it benefits today from both of these institutional arrangements. Our financial system’s strengths and our relatively stable public finances are assets that should be recognized.

But as good and solid as our economic fundamentals are today, we should not close our eyes to possible improvements. Reducing the Bank of Canada’s inflation target would generate a genuine improvement in the real lives of millions of Canadians, far into the future. To deny Canadians such benefits, the political obstacles should have to be very large and long-lasting. Are they?

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