# Still On Target

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By Finn Poschmann and Christopher Ragan

The expiry date has arrived for the Bank of Canada's five-year inflation-targeting agreement with the government of Canada, and the bank and Minister of Finance Jim Flaherty announced Tuesday its renewal, with no significant changes. The Bank of Canada's policy framework will remain tied to a consumer price index inflation target of 2%. This choice retains a coherent monetary-policy regime that has served Canadians well and, since 1995, the bank has kept the inflation rate close to 2% annually.

The renewed mandate brings an answer to the question that has long preoccupied monetary-policy experts: Should the bank do what it has been doing for another five years, or should its mandate be modified? Lowering the target rate of inflation, for example, would be a simple change to the existing system, and one that would slow the erosion in the value of Canadians' money.

Some observers have argued that the Bank of Canada should extend its mandate in less well-defined directions, such as to address economy-wide financial stability, or to target the growth rate of nominal gross domestic product (GDP), or to target full employment. A choice to target either of the latter two, which are to be the subject of House of Commons finance committee hearings next week, would have made Canadian monetary policy worse, not better.

Nominal GDP is the dollar value of the goods and services produced in the economy; its annual growth rate is by definition the growth rate of real GDP plus the rate of inflation. Many outcomes would be consistent with, say, a 5% growth target for nominal GDP — 1% real growth plus 4% inflation, 2% real plus 3% inflation, and so on. Such a target might appear to give the Bank of Canada more flexibility because it could place less emphasis on keeping inflation constant and more emphasis on short-run changes in real GDP.

The problem with a nominal GDP growth target is that if the Bank of Canada adopted it, the bank would become indifferent between any combination of real GDP growth and inflation that added up to the formal target, and inflation would be more variable than it is under the inflation-targeting system. More inflation variability means more uncertainty in a world in which there is more than enough: Firms and workers would find it harder to set sensible wages and prices, or to anchor their expectations for them.

It is also not clear that the bank has needed more flexibility. It has plenty in its conduct of monetary policy: Following an economic shock, the time it takes to return to 2% inflation is largely a policy choice; the bank says it strives to return to target within six to eight quarters. This same flexibility allows the bank to continue targeting inflation while paying close attention to threats to the stability of Canadian's financial system, a concern that in recent years has become more important.

An even worse idea would have been for the Bank of Canada to target "full employment." This slippery concept is not directly observable. Economists' theoretical models

rest on the idea that inflation will be stable only when land, labour and capital are fully employed, and GDP is then by definition at its full-employment level. But there is plenty of disagreement about our macroeconomic models, and perhaps even more about the precise level of full employment. This imprecision makes full employment a bad choice for a central-bank target. How could we ever judge the success of policy actions?

Further, the bank could never expect to succeed. After decades of economic shocks and policy mistakes, central bankers recognized two principles: First, high and volatile inflation is costly for economies, so aiming for low and stable inflation makes sense; second, inflation is the only macro variable that central bankers can influence in a systematic way. Given this reality, it makes sense for the Bank of Canada to target inflation, because it can control inflation over the long run — but not much sense for it to target things like real GDP or the unemployment rate, which it cannot control.

What other improvements to Canadian monetary policy might have made sense?

Economists have studied the benefits of switching from inflation targeting to price-level targeting. With a price level growth path target of 2%, the Bank of Canada would ensure that shocks pushing inflation above 2% would be followed by policy actions that held it below 2%. Canadians would be more confident in the long-run path of average prices in the economy, but would face confusion over the need for higher-than-average inflation to be followed by a period of lower-than-average inflation.

Another option would have been to keep targeting inflation but to lower the target — for example, to 1%. Inflation would be lower, and the costs that accompany inflation lessened. Some Canadians might not care much about such a reduction, given that inflation is already low, but the increasing number of Canadians who have un-indexed retirement incomes would benefit over their lifetimes.

Some economists argue that such a low inflation target would reduce the Bank of Canada's room to manoeuvre. With low inflation and low nominal interest rates, the bank would likely encounter a situation where its policy interest rate was very close to zero, making it difficult to reduce the rate if needed. But the last few years have shown that central banks still have ammunition even when their policy rate cannot be reduced further.

Whether at 2% or lower, inflation targeting is still the best option. And the government and the Bank of Canada have agreed on it, justified in part by the bank's solid track record with it. While a lower inflation target might have been a sensible modification to a well-understood system, and one that would slow the erosion in the value of Canadians' money, this is no time to make bigger changes to the Bank of Canada's mandate.

The government of Canada, and the bank, have done well.

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