The Bank of Canada's Inflation Target Task

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Money is one of man's most amazing inventions. Imagine the difficulty of daily life without those metal coins or coloured pieces of paper. To make any transaction, you would have to find someone who has what you want, and who wants what you have, and then the two of you would barter. In a world with thousands of products, you would spend most of your time looking for trading partners and very little time actually earning your income. Or, to avoid having to find trading partners, you could do a little of everything yourself. But with money on the scene, every transaction is simple and each of us can specialize; doing what we do best and then trading with other specialists. Each of us can therefore be much more productive, and thus richer. It is easy to lose sight of the basic point that we owe a large part of our high living standards to the existence of money.

There is a catch in all of this, however. Money works best when its value is stable over time; in other words, when there is no inflation eating away at the value of money. No economist I know argues that the current inflation rate of 2 percent will force us back to bartering, but there are many people who would nonetheless prefer lower inflation. Millions of Canadian pensioners have part of their annual income fixed in dollar terms. And with each passing year of inflation, the purchasing power of that income declines. Over one or two years, not much is noticeable. But with the average 2-percent inflation since 1991, the purchasing power of a dollar has fallen by about 34 percent. We should all wonder why Canada's policy makers seem to be so content with their national currency steadily losing its value.

Last month, the Bank of Canada and the Department of Finance agreed to extend the 2-percent inflation target until the end of 2011. Given the Bank's considerable success in meeting its target since 1991, there is no reason to expect any other average inflation rate for the next five years. So we can expect another 10.4 percent reduction in the value of our money by 2011. That's the bad news.

The good news is that the Bank recently released a background paper laying out its near-term research agenda, and apparently it will continue exploring the costs and benefits of reducing the inflation target. Depending on the outcome of the research, the Bank may choose to reduce the inflation target beginning in 2011—maybe to 1 percent, maybe to zero.

You might wonder what needs to be researched. Isn't it obvious that lowering the inflation rate is a good thing? Actually, no. Lower inflation might present some problems for the economy. If you don't know why, you're not alone. Most people happily avoid discussions about the deep mysteries of how monetary policy works.

If the Bank targets zero inflation, all interest rates will eventually fall by roughly 2 percentage points from their current levels. For most rates, this is no big deal, as the *real* borrowing or lending rates will be unchanged. But a standard lesson in Economics 101 is that the Bank conducts its monetary policy through changes in its target for the overnight interest rate. If the Bank needs to speed up GDP growth to achieve its inflation target, it reduces its policy interest rate; if it needs to slow down GDP growth, it raises its policy interest rate. But the Bank's policy interest rate, like any interest rate, can never be negative—this is what economists call the "zero lower bound". So if an economic shock occurs requiring the Bank to reduce its interest rate, and that rate is already close to zero, the Bank will be unable to significantly stimulate the economy. In short, there may be some situations in a world of low inflation where monetary policy is impotent—never a nice thing for central bankers.

This possibility is well worth thinking about, but there are some nagging questions. One is whether it is likely that the Bank would ever actually need to reduce its policy rate so much that the zero lower bound would get in the way. If you look at the past decade, when there were some major shocks that required the Bank to reduce its policy rate, there is little evidence that there would have been any problems had we been targeting zero inflation rather than inflation of 2 percent. Another question is, in the unlikely event the zero bound was hit, whether the Bank might still have another trick up its sleeve. For example, the Bank could directly enter the financial markets and purchase securities from commercial banks, thus injecting liquidity into the financial system and stimulating the economy in this (slightly) different manner.

Debates remain among economists (when don't they?) and there are some unanswered questions. So the Bank is right to continue this research. In order for the Bank to reduce the inflation target in 2011, it will have to convince itself and the Department of Finance that the benefits of such a policy change outweigh the costs. The benefits are largely related to preventing the continual erosion in the value of money, and in making price movements more reflective of changes in scarcity rather than average inflation. The costs are mostly about whether low inflation will weaken the Bank's ability to influence GDP growth in the short run and thereby achieve its inflation target in the long run.

Both the benefits and the costs are easy to think about in general terms, but much harder to quantify with any precision. So the Bank will have to do its research carefully, and be pretty confident about its conclusions before making a change in policy. But it shouldn't wait too long. With each passing year, our money continues to lose its value. The Bank should either put an end to Canada's inflation or convince us that life would we worse without it.

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