



B A C K G R O U N D E R S

Inflation-Control Target

Inflation targeting has been the cornerstone of Canadian monetary policy since 1991.

The initial objective of the joint inflation-control agreement between the Government and the Bank of Canada was to reduce inflation, as measured by the total **consumer price index** (CPI), from a rate of about 5 per cent in late 1990 to 2 per cent by the end of 1995. Inflation reached the target well ahead of schedule; and so the focus in the 1995 agreement shifted towards keeping it low, stable and predictable over the medium term, at an annual rate of 2 per cent—the midpoint of a control range of 1 to 3 per cent.

The inflation-control target has been extended five times since 1991—in 1993 (for the period 1995-98), 1998, 2001, 2006, and 2011 to the end of 2016.

The inflation-targeting approach to monetary policy

The inflation-control target guides the Bank in determining the **monetary policy** actions that are required to maintain a stable price environment over the medium term.

To achieve the inflation target, the Bank of Canada adjusts (raises or lowers) its policy interest rate (the

Target for the Overnight Rate),¹ which in turn influences other market **interest rates** in the economy.

Monetary policy actions take time—usually between six and eight quarters—to work their way through the economy and to have their full effect on inflation. For this reason, monetary policy is always *forward looking* and the policy rate is set based on the Bank’s judgment of where inflation is likely to be in the future, not what it is today.

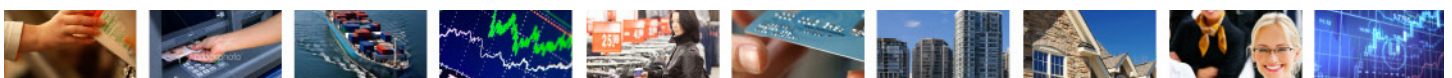
Inflation targeting is *symmetric*

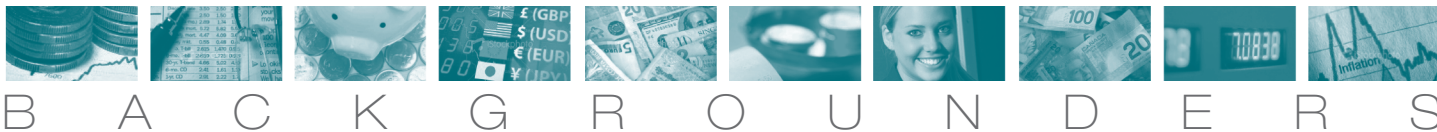
The Bank views the risks of inflation moving above or below target as equally serious and acts *symmetrically* to avoid both risks over the medium term. Such an approach guards against both high inflation and persistent **deflation**.

When demand is too strong, pushing the economy against its capacity limits, and there is a risk that *future* inflation will move appreciably above the 2 per cent target, the Bank raises its policy rate to cool down the economy and bring inflation back to target. When demand is weak, and *future* inflation pressures are likely to ease, the Bank lowers its policy rate to stimulate the economy, absorb spare production capacity, and return inflation to 2 per cent.

¹ When the policy rate is at its lowest possible level (the zero lower bound), as during the recent global financial and economic crisis, additional monetary stimulus to achieve the inflation target can be provided through a *conditional* statement about the future path of the policy rate and through two other non-traditional tools—credit easing and quantitative easing. The Annex in the April 2009 *Monetary Policy Report* describes these tools and the principles guiding their use.

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Inflation targeting is *flexible*

The Bank aims to keep inflation at 2 per cent over the medium term. This does not mean, however, that inflation can be at exactly 2 per cent all the time. Nor does it mean that the Bank is on automatic pilot, pursuing this objective mechanically, regardless of circumstances and economic costs. At times, shocks to the economy may push inflation above or below target in ways that cannot be offset in the short run (given the lags in monetary policy), without risking significant volatility in output and inflation.

Typically, the Bank will aim to return inflation to target within six to eight quarters. However, from time to time, the Canadian economy is buffeted by unusually large and persistent (mainly external) disturbances, such as a sharp lasting increase in oil prices or a major financial shock. In assessing the monetary policy actions required under these circumstances to achieve the inflation target, the Bank must also make a judgment about the most appropriate horizon for returning inflation to target, so as to manage the volatility that these actions may cause in the economy and financial markets. Such volatility can be harmful to the economic well-being of Canadians and is inconsistent with the ultimate objective of a low-inflation policy.

In this context, the Bank can make use of the *flexibility* inherent in the inflation targeting framework practiced in Canada (and elsewhere) to adjust somewhat the target horizon—lengthening or shortening it, as appropriate, depending on the nature and duration of the shock(s) hitting the economy. While this may mean sacrificing some inflation performance over the *usual* two-year horizon, it could lead to greater financial, economic and price stability over a somewhat longer horizon.²

² For a fuller discussion of the flexibility element of inflation targeting as it relates to the target horizon, and of the circumstances under which it might be desirable to return inflation to target over a somewhat longer-than-usual horizon, refer to the [monetary policy](#) background. See also, Bank of Canada. 2011. [Renewal of the Inflation-Control Target: Background Information](#). (November).

During the past 20 years of inflation targeting, there have been several instances when the Bank has exercised appropriate flexibility. Typically, the Bank has sought to return inflation to target within six to eight quarters. However, there has been significant variation in the horizon, from as short as two quarters to as long as 11 quarters. To date, the horizon has been extended beyond eight quarters on nine occasions.

The Bank's scope for exercising such flexibility is founded upon its demonstrated success and credibility in achieving the inflation target over time (since 1991, inflation has in fact averaged close to 2 per cent). This credibility is in turn best safeguarded by the Bank's commitment to, and success in, achieving the inflation target.

The advantages of inflation targeting

A credible monetary policy based on a symmetric, flexible inflation-targeting framework acts as an automatic stabilizer for economic activity. In this sense, inflation targeting has proven its worth in both tranquil and troubled times. As part of a broader sound policy and regulatory framework, inflation targeting has helped Canada to avoid the painful boom-and-bust cycles of the past and to weather the recent global financial and economic crisis better than most advanced economies.

Inflation targeting has also made the Bank's monetary policy actions better understood by financial markets and the public; and an explicit inflation target has provided a clear yardstick for evaluating the effectiveness of monetary policy.

Success in reducing inflation, coupled with a firm commitment to keep it low over time, has also helped to anchor inflation expectations around 2 per cent. Well-anchored inflation expectations foster lower interest rates and help businesses and households to take a longer view in their planning, which leads to a better allocation of economic and financial resources and a more stable economy.³

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³ See also the [Benefits of Low Inflation](#) background.

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