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Why has Canada’s Inflation Target Been Set at 2 Per Cent?

The objective of Canadian monetary policy is to preserve confidence in the value (purchasing power) of money by keeping inflation low, stable and predictable. The Bank of Canada sets its policy interest rate so as to keep inflation at 2 per cent, on average, over the medium term.

Why 2 per cent inflation rather than zero, which would keep prices unchanged, on average, over time? For that matter, why not higher, say, 4 or 5 per cent?

A brief history of inflation targeting in Canada

In February 1991, the Government and the Bank of Canada agreed to adopt inflation targets. The initial objective was to gradually reduce inflation, as measured by the total consumer price index (CPI), from about 5 per cent in late 1990 to 2 per cent by the end of 1995, and then continue reducing it until price stability (which remained to be defined) was reached.

When the 2 per cent target was extended to 1998, it was judged important to see how the Canadian economy would perform through a full cycle, including a period of operating at or near capacity, before deciding on a long-run inflation target. Because the 2 per cent target was successful in delivering good overall economic performance, and because some questions remained about the net additional benefits from lowering it, the target was kept at 2 per cent through the 2001, 2006 and 2011 renewals of the inflation target agreement. However, the Bank has over the years examined carefully the case for both a lower and a higher inflation target.

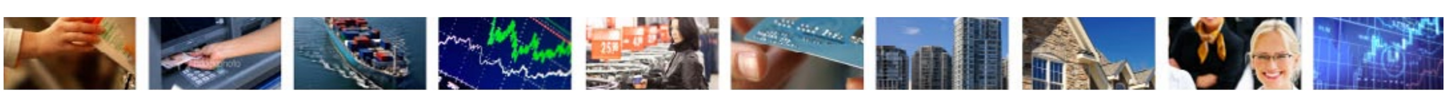
Why not zero inflation?

Why does the Bank aim for a moderate amount of inflation rather than no inflation? The reasons usually given for not targeting an inflation rate closer to zero focus on three issues: (i) problems caused by the constraint that interest rates cannot fall below zero; (ii) difficulties in measuring inflation accurately; and (iii) downward wage rigidities that could affect labour market adjustment.

Nominal interest rates cannot fall below zero (the zero lower bound on interest rates)

The main argument against a zero inflation target has to do with the inability of interest rates to fall below zero, known as the zero lower bound on interest rates (ZLB).

When interest rates are at or close to zero, the ability of the central bank to use its traditional tool, the policy interest rate, to stimulate the economy is limited since actual (nominal) interest rates charged by banks cannot be negative. However, *real* (inflation-adjusted) interest rates can still be negative, if the inflation rate is higher than the actual interest rate.



What is the significance of having negative interest rates at times of serious economic weakness? When real interest rates are negative, there is an increased incentive for people to spend and borrow rather than save. Here's why: if you deposit $100 in a savings account, it may earn you 2 per cent interest over one year; but if inflation is running at 4 per cent, your cash will be buying you less at the end of the year than it does now. The real rate of interest on your investment is a negative 2 per cent. So, in this case, you may choose to spend more now rather than save and have to fork out more money to buy later. Similarly, if you are a business owner looking to finance your purchases of machinery, and the real cost of borrowing today is negative, you may find it less costly to purchase the equipment now and pay later, than purchase when you have the money to pay for it. In times of severe economic weakness, this extra spending can prove helpful to the economy.

But with an inflation target of zero, the monetary authorities lose the option of stimulating the economy through negative real interest rates because, in this case, real interest rates too cannot fall below zero. Preserving the policy option of negative real interest rates is often cited as the main reason for having a positive inflation target.[1]

In addition to the risks associated with the ZLB, the following two arguments are frequently made for not targeting an inflation rate closer to zero.

Difficulties in measuring inflation accurately

Difficulties in measuring inflation accurately are one reason not to aim for zero inflation. As discussed in the measurement bias in the Canadian CPI, the measured rate of inflation tends to overstate the increase in the true cost of living by an estimated 0.5 per cent per year. This means that if the Bank targeted zero inflation (no change in the measured CPI), it would in reality be targeting a systematic, even if relatively small, year-after-year decrease in the true cost of living.[2]

Downward nominal wage rigidity

Some analysts believe that there is a psychological 'floor' to nominal (money) wages, such that wages are unlikely to decline even when there is considerable slack in the labour market. So they argue that a positive rate of inflation—preferably higher than 2 per cent—is needed to "grease the wheels" of the economy and encourage workers in struggling industries to accept a cut in "real" (inflation-adjusted) wages, rather than lose their jobs.[3]

While there is evidence of limited downward wage rigidity in Canada, this does not appear to have prevented labour market adjustment and to have raised the unemployment rate.

1 This does not mean that monetary policy has no other means of supporting the economy when the room for lowering interest rates has been exhausted. In such circumstances, monetary stimulus 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.

2 This does not necessarily mean that observed prices would be declining, but that they would be increasing less rapidly than the improvement in quality. So, this situation would not qualify as "deflation," which is a persistent decline in prices caused by a sharp contraction in spending.

3 This essentially says that workers can be fooled by higher inflation into accepting a cut in the purchasing power of their wages, but that they would resist a wage cut that results in a similar reduction of purchasing power under low inflation. Experience with the high inflation of the 1970s and 1980s shows, however, that Canadians soon figured out that accepting a wage increase of 2 per cent when inflation was 4 per cent really meant a cut of 2 per cent in their purchasing power. The question is why would they not be able to figure out just as easily that a wage cut of 2 per cent with zero inflation amounts to the same thing?

Overall, the measurement error in the CPI and downward wage rigidities would not, by themselves, provide a strong argument against an inflation target lower than 2 per cent, although they could have implications for how much lower the target could be.

On the other hand, the recent experience in many advanced countries, including Canada, has made it clear that the risks and costs associated with the ZLB must now be taken more seriously. ZLB considerations have shaped the Bank's perspective on the main issues studied for the 2011 renewal of the inflation-control target, including the potential net benefits to the economy from an inflation target lower than 2 per cent.

On this score, the Bank's latest findings suggest that such benefits may be greater than previously estimated, strengthening the case for a lower inflation target. However, research and the international experience have also highlighted the sizable risks associated with the ZLB. Accordingly, the Bank has concluded that before the benefits of a lower inflation target can be confidently pursued, ways must be found to limit the probability of hitting the ZLB and to deal with it more effectively when this happens.[4]

Concerns about the ZLB have also renewed calls from some analysts for a target higher than the 2 per cent the Bank of Canada and other major central banks are currently pursuing. However, there are important arguments against a higher inflation target.

Why not a higher inflation target of 4 or 5 per cent?

Many of the costs of inflation stem from its unpredictability. If inflation could be kept at 4 or 5 per cent, these costs might not be as great. But experience shows that the higher inflation is, the more uncertain and volatile it tends to be, and the less anchored are people's inflation expectations.

In this regard, one important question is: What would happen to the credibility that the central bank has worked hard to build by keeping inflation and inflation expectations around 2 per cent, if the target was raised to 4 or 5 per cent? Experience shows that moderate inflation can easily creep up to become high inflation if people are afraid that if the central bank can go from 2 to 4 per cent, why not from 4 to 6 per cent and so on.

Furthermore, if money loses 4 to 5 per cent (or more) of its purchasing power every year, it may become less effective as a unit of measurement for goods and services and as a store of value. Besides, history shows that higher inflation does not yield any lasting gains in terms of output and employment. So why not aim for a lower inflation rate that better preserves the value of money over time?

Finally, given the costs of inflation, it makes little sense to aim for a higher inflation rate year after year just so monetary policy has greater scope to use negative interest rates to prop the economy in case of a severe crisis, which is a rare event. This is a very costly proposition, especially since monetary policy can use other, non-traditional tools to provide stimulus in exceptional circumstances.

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4 See also Monetary Policy backgrounder and Bank of Canada. 2011. *Renewal of the Inflation-Control Target: Background Information.* (November).