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Canada's Experience with Inflation Targets and a Flexible Exchange Rate: Lessons Learned

The Canadian economy has undergone a dramatic transformation over the past decade. And it has emerged as a low-inflation economy, with declining levels of public and foreign debt and a private sector that is more cost-conscious, productive, and efficient, thanks to restructuring and investments in new technology.

There is little resemblance between this economy and the one many of us had to contend with in the 1970s and 1980s—one that was racked by high and variable inflation and by unsustainably large and rising public deficits and debt.

Since the 1990s, Canada's monetary policy framework, based on an explicit inflation-control target and a flexible exchange rate, has contributed importantly to putting the Canadian economy back on the right path to longer-term prosperity.

This is the main theme of my talk today. I will conclude with a few remarks on recent developments and the outlook for the Canadian economy.

The Mark of the 1970s and 1980s: High Inflation and Fiscal Excesses

To put Canada's inflation-targeting approach to monetary policy in context, a quick look into our economic history over the past three decades is in order.

Through the 1970s and 1980s, Canada, like many other countries, found that high inflation, large fiscal deficits, and rising public debt exacted a heavy toll on the economy.

Indeed, those of us who had to struggle with those unhappy times do not need to be reminded that high, variable, and unpredictable inflation increases uncertainty about the future. That it distorts the key signals and information individuals and businesses rely on to make important economic decisions. That it leads to exaggerated ups and downs in economic activity and employment. That it wastes valuable economic resources—resources that ought to be going into productive uses, but are instead diverted into hedging, as people seek protection from rising inflation.

To make matters worse, through much of the 1970s and 1980s, Canadian governments were running large budget deficits. Those deficits were absorbing a major part of our national savings. The resulting accumulation of public debt meant high risk premiums in our interest rates. And these, in turn, discouraged the investments in equipment and technology that were necessary to improve productivity.

To state the obvious, this was not a sustainable situation.

Speaking for monetary policy, I can tell you that it took us a long time and a lot of work with different policy frameworks before we arrived at our current approach.

By the late 1980s, it had become clear to the Bank that an explicit policy framework, which could be easily and clearly communicated to the public, was necessary to deal with the inflation problem. In January 1988, former Governor John Crow articulated a clear need to focus on achieving price stability. As the macroeconomic problems intensified through the late 1980s, it became evident that what we needed was an explicit commitment to a path for bringing inflation down.

The Canadian Experience: Agreeing on Targets for Inflation Control

February 1991 marked a turning point in this process. At that time, the Bank of Canada and the Government of Canada, acting on a growing *shared* appreciation of the economic damage caused by high inflation, agreed to adopt explicit targets for inflation reduction.

Subsequently, inflation came down quickly—indeed, faster than envisaged by the agreement. By January 1992, it had already fallen to close to 2 per cent.

Now, I do not want to leave you with the impression that this was a quick and painless process. Far from it. Indeed, because of the magnitude of our imbalances, we had to take strong medicine and live with high interest rates for some time. This caused a lot of economic dislocation and pain in the short run. And even as interest rates came down, there was still an appreciable risk premium built into those rates that reflected, at least partially, our fiscal problems. But once the fiscal adjustment got underway, financial markets quickly took note of it and the risk premiums were reduced significantly. Thus, we were able to reap one of the key payoffs of low inflation.

The original inflation-control agreement with the government has been renewed three times—most recently, in May 2001. The current agreement, which runs to the end of 2006, continues to aim at keeping inflation at the 2 per cent midpoint of a 1 to 3 per cent target range. The fact that we aim at the midpoint is of the essence, as I shall explain later.

Through the past decade, and with two different governments, there has been increased *shared* appreciation among Canadian authorities of the important contribution that inflation control can make to good economic performance.

I want to underscore that, in a democratic society, it is essential that the central bank and the government *share* the ultimate objective of a well-functioning economy. And that they both take action, and work co-operatively, to contribute to that common goal—hence my repeated emphasis today on words like "shared" and "agreement."

Based on the Canadian experience, I can tell you that the combination of a monetary policy aimed at low, stable, and predictable inflation and a fiscal policy aimed at bringing about a significant decline in the debt-to-GDP ratio works to reinforce the credibility of both policies.

Low and Predictable Inflation Provides a Credible Monetary Policy Anchor

When the Bank of Canada and the Government of Canada jointly announced explicit inflation targets in 1991, the purpose was to provide a clear path for inflation over the medium term to help Canadians make better economic decisions.

To make those better decisions, Canadians had to understand what their central bank was trying to do. At the Bank, we were expecting that the targets would help us communicate clearly the specific policy objectives down the road and, in that way, make our actions more understandable to everyone. The targets would also provide a better basis for judging the effectiveness of monetary policy.

The importance of communication in monetary policy is also something I would like to return to later.

Right now, let me tell you what we have learned from our experience with inflation targeting. One lesson we draw is that a credible monetary policy requires a credible anchor. Inflation targets fulfill that role successfully. They do so because they make inflation more predictable and firmly anchor inflation expectations well into the future.

With inflation expectations solidly anchored, investors can better assess the future value of their investments. Savers can be more confident that the purchasing power of their money will not be unexpectedly eroded by inflation. Wage bargaining can become less contentious and labour disruptions decrease. The duration of wage and financial contracts can lengthen considerably because people are confident that inflation will not greatly exceed 2 per cent over the medium term. Nor are they unduly concerned about the risk of deflation. Altogether, the real economy works better and is more stable.

Moreover, the significance of the increased credibility of the targets is that it changes the whole dynamic of the inflation process. For example, sudden temporary changes in energy prices, or movements in the exchange rate, do not feed into other prices in the economy and into wages the way they did in the 1970s and 1980s. Again, this is because inflation expectations are well anchored.

A main benefit of a credible monetary policy based on inflation targets is that it has helped the Canadian economy avoid the boom and bust cycles of the past. This is because the forward-looking framework of inflation targeting acts as an automatic stabilizer for the economy. Let me explain how that works.

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 target midpoint, the Bank will raise interest rates to cool off the economy. But this works also in the other direction. When demand is weak, and future inflationary pressures are likely to ease, as was the case in 2001, the Bank will lower interest rates to stimulate the economy, absorb economic slack, and return inflation to the target midpoint.

Let me stress here that the midpoint of our inflation target range is a *target*, not a cap. That is to say, we pay equal attention to any significant movement away from the 2 per cent midpoint—whether above or below.

By working in a symmetrical way in response to surprises in demand, our inflation-targeting system helps to smooth the peaks and valleys of the business cycle and to promote sound, and generally less variable, economic growth.

In this connection, let me emphasize that our mandate, as expressed in the preamble to the Bank of Canada Act, is not dissimilar from that of the U.S. Federal Reserve or from those of many other central banks. Our Act enjoins the Bank "to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada." The symmetry of monetary action that goes with our inflation-targeting framework is the best way to achieve inflation control and thus the objectives of the Act with respect to output and employment. In addition, a monetary policy that consistently delivers low, stable, and predictable inflation is likely to provide the greatest contribution to sustained growth in output and employment.

This brings me to a key point I noted earlier. It is vital that the central bank communicate with the public and with financial markets on the goals of monetary policy. Here too, inflation targeting can play an important role—both in making monetary policy actions more understandable and transparent, and in making it possible for an independent central bank to be held accountable by the public. It can also provide financial markets with a clearer view of how the central bank will operate over time.

Finally, let us not forget that monetary policy actions affect inflation with a lag of six to eight quarters. Because of that lag, in setting policy, one wants to emphasize those changes in prices that affect the underlying trend of inflation and downplay temporary fluctuations in very volatile components of the consumer price index. That is why, unlike some other central banks, we have explicitly chosen to focus on the underlying trend of inflation and use a core rate as our operating guide. The core rate excludes the eight most volatile components of the consumer price index as well as the effects of changes in indirect taxes. But I should add that the central bank can downplay those temporary price changes only if there is good reason to believe that they will not feed into other prices in the economy and affect inflation expectations. The reason we have been able to do that is because the inflation targets have helped to establish monetary credibility and to anchor inflation expectations.

Inflation Targeting and a Flexible Exchange Rate

My review of Canada's current monetary policy framework would not be complete without reference to its other key element—our flexible exchange rate.

Monetary policy can pursue only one objective—keeping inflation low as a means to promote the economic well-being of Canadians. In pursuing that goal, we have chosen an inflation target as our anchor. And that means that we have to have a floating exchange rate.

But I want to emphasize that Canada is a small and very open economy, with a structure of production and trade that differs significantly from that of the United States. A floating exchange rate is important because it facilitates the adjustment to economic disturbances, such as fluctuations in the world demand for, and prices of, our products. It also facilitates adjustment to changes in savings and investment flows.

Over the last few years, more countries around the world have moved to flexible exchange rate systems and have adopted inflation targets as their monetary policy anchor. Today, I have given you a flavour of the Canadian experience in this area, and I have talked about some of the lessons we have learned over the past decade. I hope that this has provided you with some useful insights.

Let me now turn to recent economic developments and the outlook for the Canadian economy.

Recent Economic Developments and Prospects in Canada

The immediate impact and the fallout from last September's tragic events here in New York, and elsewhere in the United States, led to a sharp increase in economic uncertainty around the world, exacerbating the effects of the global economic slowdown that had become more evident by last summer.

In those circumstances, the Bank of Canada moved quickly and aggressively to lower interest rates. The aim was to minimize the economic effects of the terrorist acts and to limit the loss of confidence at home. Since last September, we have cut our overnight rate target by 200 basis points, bringing the total reduction since the beginning of 2001 to 375 basis points.

The substantial monetary easing undertaken in 2001 will have its maximum impact as we move through this year and into 2003. In addition, tax cuts implemented at the beginning of last year continue to provide significant support to the Canadian economy. Further stimulus will also come from spending on enhanced national security. Thus, both monetary and fiscal policies are providing very significant support as we move forward.

Moreover, with the improvement since the fall in the geopolitical climate and in consumer confidence in North America and Europe, there are increasing signs that the global economy has turned the corner and will firm as the year progresses.

For these reasons, the Bank of Canada expects that the Canadian economy will gain momentum through 2002. After growing modestly in the first half—by 1 to 2 per cent, on an annualized basis—it should accelerate in the second half—to something like 3 to 4 per cent—and strengthen further in 2003.

Once our economy starts expanding at rates exceeding the growth of potential output later this year, the considerable amount of slack that has built up over the past several months will begin to be absorbed. Still, it could be late 2003 before the actual *level* of output in the Canadian economy will again reach its potential *level*.

This implies that core inflation will probably average just under 1 ½ per cent in the second half of 2002. Total CPI inflation is expected to stay below the core rate until late 2002, if energy prices remain near their current levels. Given the profile for output growth, the Bank expects inflation to move back up to 2 per cent in approximately two years.

Recent economic indicators for Canada support the view that a recovery is starting. Household spending, particularly on interest-sensitive purchases, has been stronger than expected. Exports have lately shown signs of revival. The inventory adjustment is progressing. And with early evidence of a firming U.S. economy, the world prices of non-energy commodities appear to have bottomed out.

Moreover, the national accounts data for Canada may well show slightly positive economic growth in both the last quarter of 2001 and the first quarter of this year. All available indicators suggest that final demand in the fourth quarter was stronger than anticipated. And the healthy employment data for January suggest that this strength is continuing. Also notable is the fact that production, especially in manufacturing, did not keep up with growth in final demand in the closing months of last year. So part of that demand was met by running down inventories. This bodes well for the coming months, because it means that production will likely begin to increase. This is another factor contributing to the momentum we expect to see in economic activity as the year unfolds.

This is not to say that there are no uncertainties or risks in the economic outlook, or that the Bank of Canada will not remain alert to unfolding developments. While we expect fixed investment to begin to increase in the second half of the year, we are very much aware that this is conditional upon a recovery in business confidence, especially for large multinational enterprises. How quickly and how strongly profits and the confidence of those enterprises bounce back will have an important bearing on the strength and sustainability of the overall economic recovery.

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To sum up, over the past decade, Canada has made major economic strides. We now have a solid anchor for monetary policy, and inflation expectations are well grounded. Fiscal health has been restored and, even in the short run, we will continue to make progress in bringing down our public debt-to-GDP ratio. And significant business restructuring has taken place, with more to come.

Thanks to these improvements, Canada fared better in 2001 than many other countries. And with encouraging signs of a turnaround in the global economy and strengthening final demand at home, prospects for the Canadian economy are favourable.

As we look past the current difficulties to the more positive longer-term trends and the potential of our economy, I expect that we will be moving forward with an enhanced sense of the importance and contribution of sound macroeconomic policies to good economic performance.

I have talked at length today of how Canada has gone about fostering a climate of low, stable, and predictable inflation by means of a monetary policy framework based on an inflation target and a flexible exchange rate. The inflation target and a floating exchange rate work well together—indeed they reinforce each other. This approach has worked extraordinarily well for us over the last decade. And we expect that it will continue to provide the foundation for a prosperous future.