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Our Approach to Monetary Policy: Inflation Targeting

I am happy to have the opportunity to speak in Regina during Saskatchewan's centennial year. Throughout 2005, the people of Saskatchewan have been celebrating the many remarkable contributions that this province and its citizens have made to Canada. Gerald Bouey and Gordon Thiessen, two of my predecessors as Governor, are examples of individuals with deep Saskatchewan roots who have made great contributions to the Bank and to our country. As this province turns 100, you can be proud not only of your history, but also of your modern, increasingly diversified economy that positions Saskatchewan for success in the future.

This year also marks the 70th anniversary of the creation of the Bank of Canada, and we too have taken the time to celebrate our contributions to Canada. At such times, while it is appropriate to look back and celebrate history and accomplishments, it is also a good opportunity to look forward and think about where we are headed. In this spirit, I'd like to talk to you today about one of our main responsibilities; that is, the conduct of monetary policy. I want to recount a bit of the Bank's history and talk about how we developed our current framework for conducting monetary policy. At the Bank of Canada, we strongly believe that targeting inflation is the best way for us to fulfill our mandate to Canadians. I also want to look forward a bit, and talk about the future of inflation targeting, as we prepare to renew our inflation-targeting agreement with the federal government next year.

The Bank's Mandate

Let me begin with a brief discussion of the Bank's legislative mandate. The preamble to the Bank of Canada Act instructs us to "regulate credit and currency in the best interest of the nation." It goes on to say that the Bank should mitigate "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 . . . promote the economic and financial welfare of Canada."

So the question is, How can the Bank best provide the conditions for sustainable economic growth, bearing in mind the words in our mandate: "so far as may be possible within the scope of monetary action"? Over time, it has become clear that the best way for monetary policy to promote sustainable economic growth is to anchor expectations about the future purchasing power of money. In other words, it is important

for Canadians to have confidence that the value of their money will not be eroded over time. Focusing on domestic price stability is the best contribution that monetary policy can make to economic stability and sustainable long-term growth.

After the bitter inflationary experiences of the 1970s, it became clear that central banks needed to focus on achieving low inflation. But monetary authorities around the world were struggling to figure out how best to do this. At the Bank of Canada, we were trying to determine how to achieve price stability in a way that would allow us to accomplish three things: first, as I just said, we wanted to anchor Canadians' expectations about the future purchasing power of their money; second, we wanted an operational framework for the conduct of monetary policy; and third, we wanted an approach that would help markets, politicians, and the Canadian public to understand what we were doing, and what actions they could expect from us.

Throughout the 1980s, we at the Bank worked to come up with such an approach. By 1991, we had decided that targeting inflation was the best way to achieve high, sustainable growth in output and employment. And so the Bank and the Government of Canada agreed on a series of explicit targets for inflation. To be clear, however, inflation targeting is not an end in itself. Rather, as I said, it is the best means of fulfilling our commitment to promote the economic and financial welfare of Canadians.

The Canadian Version of Inflation Targeting

Once the Bank and the government agreed on the concept of inflation targeting, we needed to make some choices to put the concept into practice. Like many other central banks, we chose a target for the annual rate of inflation. Initially, our focus was on reducing the rate of inflation, which was running at more than 5 per cent annually in 1991. The target was set to bring inflation down gradually—first, to the 3 per cent midpoint of a 2 to 4 per cent target range by the end of 1992, and then to the 2 per cent midpoint of a 1 to 3 per cent range by the end of 1995. The target has remained there since then. Let me take you through some of the other key decisions that we made in 1991, and the rationale behind our choices, as we set out the details of our framework.

First of all, why did we choose the consumer price index (CPI) as our measure of inflation? The key reason is that the CPI is the measure of inflation most familiar and relevant to Canadians. Choosing a well-known indicator as a target makes it easier to explain our actions and to be accountable.

Second, why do we have a range? This is because there are some components of the CPI—such as some energy and food items—whose prices tend to move a lot, both up and down. These movements can cause large fluctuations in the index. If we tried to target inflation too precisely, we would then be adjusting our policy interest rate sharply and frequently, which would lead to greater instability in the economy. Having a range reflects the inherent volatility of the CPI. But to be clear, the range is *not* a zone of indifference—we *do* aim to achieve the 2 per cent target.

Another concern is that this volatility can obscure the underlying trend of inflation. So for operational purposes, we use a measure of core inflation. This measure strips out eight of the most volatile components of the CPI and the effect of changes in indirect taxes on the rest of the items. In this way, core inflation provides a better forward-looking indicator of the trend of inflation.

Finally, since today's monetary policy actions only affect future inflation, we needed to choose a time frame in which to achieve our target. From the beginning, we said that if inflation was pushed off target, we would conduct monetary policy so as to return inflation to target over a period of 18 to 24 months. This is because research has suggested that historically it takes 12 to 18 months for changes in interest rates to have most of their impact on output, and 18 to 24 months to have most of their impact on prices. Of course, there is always uncertainty about the lags involved, and I'll have more to say about this later on.

Before I move on, I want to emphasize three points about our inflation-targeting framework. The first is that we operate in a *symmetric* way, and we make it clear to everyone that we do so. By this, I mean that we worry just as much about inflation falling below target as we do about it rising above target. When the demand for goods and services pushes the Canadian economy against the limits of its capacity, and inflation is poised to rise above target, the Bank will raise interest rates to cool off the economy. And when the economy is operating below its production capacity, and inflation is poised to fall below target, the Bank will lower interest rates to stimulate growth. Paying close attention to signs that inflation is moving away from our target—in either direction—promotes timely action. This is how we keep the economy operating near its full capacity and thus keep inflation low, stable, and predictable.

The second point I want to stress is that having an inflation target as an anchor is very helpful in terms of the Bank's accountability. If inflation persistently deviates from the target, we are committed to explaining the reasons why, what we will do to return it to target, and how long we expect the process to take.

The third point is that any central bank that runs an independent monetary policy and targets inflation must allow its currency to float. It is simply not possible for a central bank to successfully control both the domestic and external values of its currency at the same time. We have only one instrument—our policy interest rate—so we can have only one target. Thus, with inflation as our target, we naturally operate with a floating currency.

Canada's Experience Under Inflation Targeting

Now, let me quickly review our record with inflation targeting. As we look at inflation and economic growth in Canada since 1991, it is quite clear that the benefits we had hoped would come from inflation targeting have, in fact, materialized. We expected inflation to become more stable—and it did so, sooner than we had anticipated. Since settling on the 2 per cent target for inflation at the end of 1995, actual

inflation has averaged very close to 2 per cent. And it has remained within the 1 to 3 per cent target range, with only rare exceptions. We expected our credibility to increase and inflation expectations to become well anchored—and this has also happened.

We also thought that inflation targeting would help the economy to avoid the exaggerated "boom-bust" cycles of previous decades—and it has. The business cycle is still with us, but economic volatility has diminished. By keeping inflation close to the target, monetary policy has helped to keep the economy operating near its potential.

Finally, and very importantly, our transparent framework has allowed markets and analysts to better predict how we will react to different economic outcomes. Within the Bank, too, focusing on inflation has brought increased discipline and clarity to our monetary policy decision process.

Canada was the second country after New Zealand to adopt explicit inflation targets. But over the past decade and a half, about 20 other central banks have also adopted this framework. Some, like the central banks of the United Kingdom and Sweden, are from advanced, industrialized economies. Others, such as the central banks of Chile and Brazil, are from emerging-market economies. In every case, inflation targeting has been a success: inflation rates have been reduced, and central banks have generally been able to hit their targets. Inflation has become less persistent where inflation targeting is practiced, and it is reasonable to assume that well-anchored inflation expectations are a good part of the reason why.

Given this success, it seems likely that other countries will join the ranks of inflation targeters in coming years—indeed, just last week the central bank of Turkey announced that it will move to formal inflation targeting next year. Inflation targeting is also being discussed in the United States where Ben Bernanke, Alan Greenspan's designated successor at the Federal Reserve, has been an enthusiastic proponent.

However, some have argued that inflation targeting is too limiting an approach, and that it can constrain a central bank's ability to act or to apply judgment in the case of extraordinary events. But this has not been our experience in Canada. For example, in the immediate aftermath of the 9/11 terrorist attacks, we lowered interest rates quickly and decisively to underpin confidence. When a major loss of confidence did not materialize, we were able to reverse course in fairly short order and withdraw some of that monetary stimulus. Our inflation-targeting framework did not restrict our ability to act. Indeed, because our framework is transparent, financial markets were able to appreciate why we made these rapid rate adjustments.

The Bank of Canada focuses on inflation at the *national* level. This can lead to suggestions that some of Canada's regions may not have the appropriate policy for their particular circumstances. We hear these comments more often during times such as these, when economic prospects and growth rates vary from sector to sector and—because of the geographic concentration of sectors in Canada—also from region to region. These comments reflect a fairly common misunderstanding about monetary

policy. Remember that in any market economy, adjustments are always taking place. Markets and prices send clear signals that indicate how economic resources should be allocated, shifting resources to rapidly growing sectors from slower-growing ones. Because our monetary policy targets inflation for the country as a whole, it does not try to mask these important price signals—nor should it. To do so would impede the adjustment process and, ultimately, lead to lower economic growth.

But this does not mean that we ignore what is happening on a regional basis—far from it. Indeed, the information we receive from our five regional offices, and from our *Business Outlook Survey*, is an important input to our monetary policy deliberations. Our job is to add up what is going on across the country and to conduct monetary policy so that we achieve our inflation target for the country as a whole.

The Future of Inflation Targeting

Despite our success to date with inflation targeting, I shouldn't leave you with the impression that this somehow represents the end of monetary policy history. Prudent policy-makers should always be striving to find better ways of getting things done. As I said at the beginning, our agreement with the federal government is up for renewal next year. So at the Bank, we have been busy thinking about those elements of our framework that we would not want to change, as well as others where changes might be considered.

From the Bank's point of view, the basic arrangement of aiming inflation at the 2 per cent midpoint of a 1 to 3 per cent target range has served Canadians well, along with the use of the total CPI as the target, and a measure of core inflation for operational purposes. The Bank will also continue to recognize the importance of communications and transparency. Inflation targeting does a good job of anchoring expectations, but it works better when a central bank communicates well. I expect that these basic elements of our framework will remain in place.

This is not to say that we haven't examined these elements. Indeed, we have asked ourselves if 2 per cent is the right target. When we last renewed the inflation-targeting agreement in 2001, we looked closely at this issue. At the time, our research could not convincingly demonstrate that the benefits of moving to a lower target would outweigh the costs. More recent research, while still inconclusive, provided a little more support for a lower target. Of course, we will continue to look at this question, but the evidence would have to be quite compelling before the target would be changed.

Another issue that we continue to examine is whether we should target the actual *level* of prices rather than the inflation *rate*. Let me explain what I mean. Had the annual rate of inflation been exactly 2 per cent since 1995, when we settled on that figure as our target, the consumer price index would have risen from a level of 102.8 in December 1994 to 127.6 in October of this year. The actual price level for October was 128.5—a minimal difference, as it turns out. But in the future, it is possible that we could get a series of shocks that moved inflation predominantly in one direction, either up or

down. And so, the price level could move significantly away from where it would have been if we had hit the 2 per cent target exactly over a period of years. Under price-level targeting, monetary policy would be set so as to offset those deviations from the desired price level. But under inflation targeting, those past price-level movements are essentially forgotten; they would not change the conduct of policy going forward. Economic theory tells us that, over the longer term, having certainty about the future price level would yield somewhat greater benefits than just having certainty about the future rate of inflation. But to date, it has not been possible to conclusively measure the costs and benefits of targeting the price level versus targeting the inflation rate. We are still working at building better analytical tools and methods to examine these questions, and we will continue to look at new evidence as it becomes available down the road.

Another issue that we are looking at is the appropriate time frame for returning inflation to target following various kinds of shocks. As I said before, we now conduct monetary policy with the goal of bringing inflation to target within an 18- to 24-month time frame. But there are questions as to whether this time frame is appropriate for every type of unexpected development that could affect inflation. There could be reasons to look at adjusting the time frame in response to inflationary pressures from major movements in asset prices—be they real estate, equity prices, or the exchange rate. Given the success we have had to date in dealing with various shocks within an 18- to 24-month horizon, we should not change that horizon lightly. But as inflation targeting and the global economy evolve, we will need to continue considering the appropriate time horizon and some of the other issues I discussed today. The Bank of Canada remains committed to conducting and encouraging research in these and other important areas.

Conclusion

I want to conclude by emphasizing a few key points. Despite the issues I've just raised, the economic record of the past 15 years shows that inflation targeting has served Canada well. The Bank's symmetric approach of keeping inflation low, stable, and predictable has laid the groundwork for solid, sustainable growth in output and employment. With inflation targeting, monetary policy is more focused, our communications are clearer, and inflation expectations are more solidly anchored. As we look forward, it is important that we maintain an anchor to keep monetary policy focused. From my perspective, inflation targeting is the best anchor we've seen.