TECHNICAL BACKGROUND DOCUMENT 2: LOWER RATES OF INFLATION AND IMPROVED ECONOMIC OUTCOMES

In recent years, the Bank and its researchers have reviewed and summarized the literature on the benefits of a lower inflation target (Coletti and O'Reilly 1998; O'Reilly 1998; O'Reilly and Levac 2000). The conclusions that the Bank has reached regarding these benefits are summarized briefly in this document.

The ongoing benefit of a lower inflation target arises from reducing the distortions created by a rising price level when most of our institutions and habits (including our legal, contractual, fiscal, and accounting frameworks) are predicated on the assumption of a stable unit of account. These distortions come primarily from:

- the computational inconvenience of using real (i.e., inflation-adjusted) rather than nominal values
- the costs of changing prices
- the confusion between real and nominal interest rates
- the widespread use of nominal accounting practices to report financial results
- the non-indexation of an important part of the income tax system (particularly investment income, depreciation, and inventory profits)

Although the benefits of reducing these distortions are neither as large, nor as obvious, as those of reducing the volatility and unpredictability of inflation, they are nonetheless real. These benefits include, but are not limited to:

- longer contract and planning horizons
- fewer financial transactions inappropriately undertaken because of a confusion between real and nominal interest rates
- less variability of relative prices and less asymmetry of price changes arising from "menu costs" (the costs of changing prices)
- more transactions based on relative prices that are closer to fundamentals
- more appropriate business decisions about investment in fixed capital
- fewer resources spent on taking inflation into account and guarding against it
- overall, a better economic allocation of resources and thus a higher level of economic well-being

Each of these benefits is unambiguously positive but has proven difficult, thus far, to quantify or to demonstrate empirically. This difficulty has been highlighted by Ragan (1998). Thus, given current evidence, it is hard to make a convincing case that the benefits of a lower target inflation rate are large enough to justify the change to a lower target.

REFERENCES

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