Recent Research on Inflation Targeting

John Murray, Guest Editor

The inflation targeting framework that Canada introduced in 1991 has played a significant role in the exceptional economic performance that the country has experienced in recent years. Understanding the factors that have contributed to the success of the current inflation-targeting framework, and investigating the various ways in which it might be improved in the future, are an important part of the Bank of Canada's medium-term research program. This special issue reports on some of the results of this research program, and examines inflation targeting from several different angles. We plan to provide similar updates on a regular basis in the run-up to the 2011 renewal of the inflation-targeting agreement.

In “The Costs of Inflation in New Keynesian Models,” Steve Ambler describes three new channels in New Keynesian models through which inflation affects economic welfare. These channels were absent from traditional analyses, and may have caused researchers to underestimate the costs associated with variable inflation, even at relatively low levels of inflation. The article concludes with a preliminary assessment of the quantitative importance of the new channels and their significance for monetary policy.

The article by Marc-André Gosselin, “Central Bank Performance under Inflation Targeting,” looks at the various factors that contribute to successful inflation targeting. Using a panel of 21 inflation-targeting countries over the period 1990Q1–2007Q2, he finds that the ability of central banks to hit their targets varies considerably. Some of these differences can be explained by exchange rate fluctuations, fiscal deficits, and differences in financial development. Others are explained by differences in the targeting framework itself and the manner in which it is implemented.

Stephen Murchison and Claude Lavoie look at one of the most important factors that must be considered if countries are thinking about lowering the target level of inflation much below 2 per cent—the zero interest bound. Targeting inflation rates that are too low, the authors note, may restrict the ability of monetary policy to respond to economic shocks by limiting the amount by which interest rates can be eased. The size of the shocks hitting an economy, the formation of inflation expectations, and the conduct of monetary policy are also seen to exert an important influence on the risks of hitting the zero interest bound. The evidence that the authors review suggests that the probability of encountering the zero bound when average inflation is at least 2 per cent is relatively small.

The special issue finishes with a comparison of inflation targeting and price-level targeting, in the context of a small open economy subject to sizable terms-of-trade shocks. The article by Donald Coletti and René Lalonde, “Inflation Targeting, Price-Level Targeting, and Fluctuations in Canada’s Terms of Trade,” summarizes recent research that compares the ability of price-level targeting and inflation targeting to stabilize the macro economy when confronted with shocks similar to those experienced by Canada in recent years. The authors’ preliminary results suggest that price-level targeting may represent a feasible alternative to traditional inflation targeting. Their article also provides insight into the direction of current research in this area at the Bank.