BANK OF CANADA
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CONTACT: Jeremy Harrison
613 782-8782

Bank of Canada Releases Background Information on Renewal of the Inflation-Control Target

Ottawa, Ontario – The Bank of Canada today released the document *Renewal of the Inflation-Control Target: Background Information*, which summarizes the key elements of Canada's inflation-targeting framework. The document describes Canada's 20-year experience with inflation targeting, provides a detailed explanation of the Bank's flexible approach to inflation targeting, and discusses the results of the Bank's research program since the previous renewal in 2006.

This release follows the 8 November announcement by the Government of Canada and the Bank of Canada that the inflation-control target agreement has been renewed for five years, to the end of 2016. Under the agreement, the Bank will continue to conduct monetary policy aimed at keeping inflation, as measured by the total consumer price index (CPI), at 2 per cent, with a control range of 1 to 3 per cent around this target.

Highlights of the *Background Information* document include:

Inflation targeting has served the Canadian economy well. Since Canada adopted an inflation target in 1991, inflation has averaged 2 per cent, and its variability has fallen by roughly two-thirds. Canadians have benefited from low, stable and predictable inflation in a number of important ways:

- consumers and businesses have enjoyed greater certainty about the future purchasing power of their savings and income;
- nominal and real interest rates have been lower; and
- Canada has experienced more stable economic growth and lower, less-variable unemployment.

Low inflation is not an end in itself, but rather the means to an end – a stable, well-functioning economy.

The inflation target is symmetric, which means that the Bank is equally concerned about inflation rising above or falling below the 2 per cent target. The Bank continues to use core inflation as an operational guide for its monetary policy because it is an effective indicator of the underlying trend in CPI inflation. Core inflation, along with other measures of inflationary pressures, is monitored to help achieve the target for total CPI inflation: it is not a replacement for the latter.

The inflation-targeting framework is flexible. Typically, the Bank seeks to return inflation to target over a horizon of six to eight quarters. However, over the past 20 years, there has been considerable variation in the horizon, in response to different circumstances and economic shocks. At times, the horizon over which inflation was projected to return to the 2 per cent target has been as short as two quarters and as long as 11 quarters. There have been nine occasions when the Bank has extended the target horizon beyond eight quarters.

Canada's monetary policy framework includes a flexible exchange rate. A floating Canadian dollar plays a key role in the transmission of monetary policy and allows the Bank to pursue an independent monetary policy focused on achieving the inflation target. It also helps to absorb shocks to the economy.

The relative stability of Canada's economy during the recent global economic and financial crisis has underscored the benefits of inflation targeting. The crisis of 2008-09 was larger than any shock the Canadian economy had previously experienced under inflation targeting and put the regime to an unprecedented test. It proved to be a solid framework within which the Bank provided an aggressive monetary stimulus response to the crisis that helped to mitigate its effects on the Canadian economy. This experience reinforced the value of flexibility in the inflation-targeting framework and provided notable lessons for the future.

The crisis experience has shaped the Bank's perspective on two questions it has been studying over the past five years, and added a third. The *Background Information* document highlights the results of those studies.

- **Targeting a lower rate of inflation:** While the prospective net benefits of a lower inflation target are believed to be greater than previously estimated, recent experience and ongoing research point to sizable risks associated with the zero lower bound (ZLB) on interest rates. Before the benefits of a lower target can be confidently pursued, central banks must find a way to limit the probability of hitting the ZLB, and to manage more effectively when they do.

- **Price-level targeting (PLT):** Recent research and theoretical modelling have shown that PLT could potentially deliver gains in terms of increasing both long-term certainty about the price level and short-term macroeconomic stability. However, given the current state of knowledge, the potential benefits of PLT over the inflation-targeting framework do not clearly outweigh the costs and risks of moving away from a policy framework that has resulted in well-anchored expectations and strong central bank credibility.

- **Monetary policy and financial stability:** The global financial crisis has reinforced the reality that economic stability and financial stability are inextricably linked. In some exceptional circumstances, monetary policy might itself be the appropriate tool to support financial stability. A framework anchored on a solid and credible inflation target provides the flexibility for monetary policy to play an occasional role in supporting financial stability.