BANK OF CANADA
BANQUE DU CANADA

Stephen S. Poloz
Governor – Gouverneur

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The Honourable William Francis Morneau
Minister of Finance
90 Elgin Street
Ottawa, Ontario K1A 0G5

Dear Minister Morneau,

In preparation for our meeting on 28 September, I am pleased to bring to your attention the Bank of Canada's recommendation for the renewal of our inflation-control framework. As you know, the framework sets the objective for monetary policy, which, since 1991, has been a specified inflation target and is defined by a joint agreement between the Government of Canada and the Bank of Canada. This agreement is reviewed and renewed every five years.

The agreement is of great importance to the Bank's mandate to promote the economic and financial welfare of Canada: it makes the conduct of monetary policy more effective and efficient because it enhances the credibility of the target and of the Bank's inflation mandate.

The Bank recommends maintaining the framework that was agreed to in 2011 for a further five-year period, ending 31 December 2021. With the agreement of the Government of Canada, 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. This recommendation is the result of research and analysis, as well as careful study of the experience of Canada and other countries with an inflation-targeting framework. Officials at the Department of Finance were regularly consulted during the renewal process.

Since 1991, our current flexible inflation-targeting framework has served Canadians well, in calm and turbulent times. It has contributed importantly to macroeconomic and financial stability and thus to sustainable economic growth and higher living standards. Therefore, the bar for change is high, and, based on the evidence, we see no strong justification to alter the framework at this time.

Each time the inflation-control agreement is renewed, the Bank carefully reassesses important aspects of the targeting framework, with new research building on analysis done in the past. In preparation for this year's renewal of the agreement, the Bank focused on three issues:

- the level of the inflation target,
- financial stability considerations in the formulation of monetary policy, and
- the measurement and use of core inflation.

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These issues were introduced as the focus of Bank of Canada research and analysis in a speech given by former Deputy Governor Agathe Côté in November 2014, which Finance officials reviewed in advance.

Our recommendation for the inflation-target renewal draws on research by Bank staff and other researchers, as well as consultations with other central bank officials and academics. Our views take into account input from a Bank-hosted conference, workshop presentations to several groups of economists and discussions with other private sector stakeholders. As well, to deepen the dialogue with Finance officials, we launched quarterly bilateral meetings with the Department in the spring of 2015. These interactions provided important peer reviews of Bank research and opportunities to keep key stakeholders informed of the evolution of our thinking.

To communicate our research and analysis more broadly, these three issues have been discussed in speeches, and a Bank website is dedicated to information on renewing Canada's inflation-control agreement.

Level of the inflation target

Our research for this renewal examined the benefits and costs of raising the level of the target. Please note that research leading to the renewal of the framework in 2011 focused on the benefits and costs of lowering the inflation target and concluded that the benefits of a lower target are insufficient to offset the constraints on monetary policy to stimulate the economy when nominal interest rates are at or near the effective lower bound (ELB).

In our more recent research, we found that pursuing a higher target could yield modest and largely temporary improvements in macroeconomic performance by alleviating the effects of the constraints imposed by the ELB on the policy rate. However, estimates of these gains are uncertain and shrink when the potential use of unconventional policy is taken into account.

It is notable that in 2009–10, when the Bank's policy rate reached what was then considered the ELB, monetary policy was not materially constrained. By April 2009, the Bank had lowered the policy rate to 25 basis points, a rate that, at the time, was assessed to be the ELB. The Bank also made effective use of forward guidance during this episode. However, it did not need to employ any other unconventional measures, and the duration of the ELB episode was limited to about a year.

Further, a higher inflation target would exacerbate the costly distortions caused by inflation on an ongoing basis. Let me outline a few:

- In the presence of price and wage rigidity, inflation can lead to arbitrary differences in relative prices and a less efficient allocation of resources.
- The interaction of inflation with the tax system can lead to important distortions, although changes to the tax system since the 1990s have reduced these costs.
- The burden of higher rates of inflation is more likely to be borne by households that are generally less able to hedge against inflation risk, such as low-income and/or older or retired households.
- Inflation can cause changes in wage- and price-setting behaviour. For example, were indexation of wage contracts to become more widespread, inflation persistence could increase.

Finally, a target of 2 per cent remains in line with that adopted in most advanced economies. Setting a new target would be a departure from the norm and could put at risk the hard-won credibility that underpins the success of Canada's inflation-control framework.

In summary, based on its analysis of the arguments and evidence, the Bank finds the case very compelling for remaining with the 2 per cent target at this time.

Financial stability considerations and the formulation of monetary policy

Our analysis suggests that the post-crisis financial sector reforms and the effective use of macroprudential measures reduce the incidence of significant tension between monetary policy's objective of low and stable inflation and potential risks to financial stability. Moreover, such episodes are likely to be limited to situations where policy interest rates are held very low for an extended period.

We conclude that monetary policy should be adjusted to address financial vulnerabilities only in exceptional circumstances. However, the Bank of Canada will continue to contribute importantly to the promotion of financial stability through its roles as liquidity provider of last resort and overseer of payment and clearing systems, its system-wide assessment of vulnerabilities and risks in the *Financial System Review*, and its other public communications. These assessments raise awareness and thereby promote responsible behaviour by borrowers and lenders and help inform regulatory and supervisory policy-making.

The existing macroprudential framework in Canada has functioned reasonably well. Nevertheless, the Bank supports efforts to enhance the framework that are in line with the best-practice recommendations of the International Monetary Fund. When it comes to the use of macroprudential policy, the Bank is very well placed to help ensure that macroprudential and monetary policy are effectively working together to promote both macroeconomic and financial stability at the same time. The Bank looks forward to exploring ways to strengthen the existing macroprudential framework.

The measurement and use of core inflation

This issue is outside the scope of the agreement between the Government of Canada and the Bank. However, it is significant for our communication of the factors motivating our monetary policy decisions.

The inflation target in Canada is expressed in terms of total CPI inflation, which is a broad measure of inflation and is familiar to Canadians. However, total CPI inflation is subject to considerable volatility and is not always the best indicator of underlying inflationary pressures. For this reason, the Bank looks to core inflation as an operational guide. After evaluating different measures of core inflation and reviewing the practices of other central banks, the Bank has decided to replace our current measure of core inflation with three new measures. As has been the case with our current measure of core inflation, the three new measures are to be constructed and published by Statistics Canada, together with the CPI data releases.

Related issues

In addition to the three focal issues, Bank staff and other analysts have continued to examine other aspects of the monetary policy framework. Let me take this opportunity to touch on some that have recently received media attention.

Nominal GDP (NGDP) growth targeting has been proposed as an alternative to our current inflation-targeting framework. It sets an objective for the sum of the growth rate of the real economy and inflation. Like inflation targeting, the focus is on getting one variable—NGDP growth—back to target without regard for past outcomes. It does not matter if the target is achieved through relatively strong economic growth and weak inflation or vice versa.

Some of the gains ascribed to NGDP growth targeting are currently being achieved by Canada's flexible inflation-targeting regime. The Bank already sets a policy path to return inflation to target in a manner that minimizes excessive fluctuations in economic activity and employment. In the case of supply shocks, the flexibility in Canada's current regime provides a mechanism to nuance responses to achieve favourable results for Canadians. Further, the Bank of Canada looks through relative price changes that have temporary effects on inflation when setting monetary policy. Finally, it is important to note that: (i) unlike inflation targeting, NGDP growth targeting does not provide a fixed anchor for inflation expectations; (ii) claims that NGDP growth targeting alleviates challenges associated with the ELB are usually accompanied by an implicit increase in the average inflation rate; and (iii) NGDP growth incorporates a measure of inflation that is less relevant to consumers than CPI inflation.

Arguments have also recently been made that the Bank should shift from inflation targeting to price-level targeting (PLT). With PLT, following periods of below-target average inflation, monetary policy would seek a period of above-target inflation to ensure the targeted rate of change in the price level over time. Theoretical modelling indicates that PLT could potentially deliver some gains in macroeconomic stability as long as people understand the framework and fully incorporate the reverting nature of the price level in their forecasts of inflation. Experimental results, however, suggest that this would not be the case.

The Bank conducted extensive research on PLT in advance of the 2011 renewal. After much consideration, the Bank concluded that the potential benefits of PLT did not clearly outweigh the costs and the risks of moving away from a policy framework that had resulted in well-anchored expectations and strong central bank credibility. New analysis since then hasn't changed the Bank's view on this issue.

Finally, both NGDP growth and PLT would be much more of a departure from the status quo and from the frameworks used by other major central banks.

Future Research

The beauty of the five-year renewal cycle is that it is not forever. Research on all of these fronts continues and we have the ability to adapt and introduce new topics as conditions change. Among the issues we have begun investigating are the impact of macroprudential regulation and financial vulnerabilities on the transmission of monetary policy; the optimal mix of monetary, fiscal and financial policies to maximize Canadians' standard of living; and the use of central bank communications as both a monetary policy tool and a mechanism to enhance transparency and credibility.

A proposed draft of the joint statement of the Government of Canada and the Bank of Canada on the renewal of the inflation-control target is attached.

Also attached is a Bank of Canada background document that spells out in detail the results of our research and analysis. The Bank's work has benefited from discussions with and comments from our colleagues in the Department of Finance. I thank you for that input.

We will release this document publicly at the time of, or shortly after, the announcement of the joint agreement between the Government of Canada and the Bank of Canada.

I thank you for your review and consideration of the Bank of Canada's recommendation for the renewal of the inflation-control agreement. I look forward to our discussion on 28 September.

Attachments