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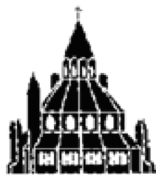

IN BRIEF

Parliamentary Information and Research Service
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26 March 2007

A Primer on Inflation Targeting

Inflation targeting refers to a system in which monetary policy decisions are made, implemented and communicated according to a clearly stated inflation target or target range. Debates on the merits of such a monetary policy framework have recently resurfaced, especially in North America. The new chair of the Federal Reserve Board in the United States, Ben Bernanke, has said that he would like to see the Federal Reserve adopt such an inflation target. Furthermore, the Bank of Canada's agreement with the federal government on inflation targeting has been renewed.

This paper describes how the Bank of Canada implements its monetary policy. It also explains how inflation affects the economy, and some of the pros and cons of inflation targeting.

CENTRAL BANKING IN CANADA

One of the main functions of the Bank of Canada concerns interest rates.(1) The *Bank of Canada Act*, enacted in 1934, stipulates in its preamble that the Bank of Canada shall mitigate "fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action." The Bank of Canada carries out its monetary policy by setting the target for the overnight rate, i.e. the rate at which major financial institutions borrow and lend one-day funds among themselves. When the Bank of Canada alters the level of this very short-term interest rate, other interest rates – such as the chartered banks' prime lending rates – essentially move in tandem with it.

The central bank can prevent the inflation rate from moving outside the target range by changing the target for the overnight rate; this, in turn, would alter borrowing costs for individuals and businesses, thereby affecting consumption and investment. Increases in economic activity put upward pressure on inflation rates. Combating inflation would indicate the need for a higher target for the overnight rate, which would raise borrowing costs and reduce consumption, all other things being equal.

A change in the target for the overnight rate also has an impact on the value of the Canadian dollar. An increase in the overnight rate would, all else being equal, make investments in Canada more attractive because of higher expected rates of returns. This rise in foreign investments would increase demand for the Canadian dollar and put upward pressure on its relative value. Furthermore, an appreciation in the relative value of the Canadian dollar makes foreign goods less expensive and may, therefore, reduce inflationary pressures domestically. The opposite effects would be expected in the case of a decrease in the target for the overnight rate.

Since 1991, the Bank of Canada has adopted an inflation-targeting framework with the goal of low and stable inflation as measured by the Consumer Price Index (CPI). The Bank currently aims to keep the yearly rate of change in the CPI at 2%, within a target range of 1% to 3%.(2) In late 2000, the Bank of Canada also adopted a system of eight pre-announced dates per year on which it can adjust its target for the overnight rate, a system that is intended to make the Bank's decisions more predictable and transparent.

WHY INFLATION MATTERS

Inflation can be defined as an increase in the overall level of prices over an extended period of time. Broadly speaking, inflation may result from "too

much money chasing too few goods," or from increases in the costs of production (cost-push inflation).

A rise in the price of a good normally means that demand for that good exceeds its supply. However, in an economy experiencing high inflation it is difficult to distinguish between excess demand and price increases due to inflation, which may result in a less efficient allocation of resources. Furthermore, volatile inflation makes investment decisions more difficult because the future cash flow associated with an investment is also more uncertain.

Inflation also negatively affects what economists refer to as the "time value of money." It reduces the purchasing power of those who hold cash and those with fixed incomes.

Although inflation may have negative effects, a general decrease in prices – deflation – may also be damaging, mainly because it encourages individuals and businesses to delay spending as their purchasing power increases over time.

A rate of inflation should be stable and low but high enough to prevent deflation.(3)

PROS AND CONS OF INFLATION TARGETING

A. Pros

One of the main arguments in favour of inflation targeting is that it increases public confidence about the stability of future prices. When a central bank adopts an inflation-targeting framework, it sends a clear signal that inflation control is a priority. When this inflation-targeting framework is credible and well communicated, people will expect prices to be relatively stable around the stated inflation target.

Adopting an inflation target does not mean, however, that the goal of economic growth is abandoned. In fact, some believe that price stability is the best contribution that monetary policy can make to economic growth. According to David Dodge, the current Governor of the Bank of Canada, the adoption of inflation targets allows "businesses and individuals [to] make long-range economic plans with increased confidence. Scarce economic resources are no longer wasted trying to hedge against the threat of runaway inflation."(4)

Furthermore, once people expect prices to remain stable, central banks can respond better to macroeconomic shocks. For example, because the recent rise in oil prices did not result in higher inflation, the Bank of Canada was able to keep interest rates relatively low.

As well, inflation targeting may increase the transparency and consistency of monetary policy. In the view of Governor Dodge, the adoption of inflation targets may have "brought increased discipline and clarity to … monetary policy deliberations."(5)

B. Cons

Some who do not support inflation targeting note its lack of flexibility, since it focuses on inflation rates at the expense of other monetary policy objectives such as full employment. For example, inflation targeting may limit the ability to respond effectively to economic crises, since its focus is too narrow. Furthermore, if an economic downturn and high inflation are concurrent (such as previous oil shocks), a narrow inflation-targeting framework would result in a rise in interest rates, hampering further an already weak economy.

On the whole, arguments against inflation targeting may rely on a very narrow definition of "inflation targeting." In practice, central banks do not target inflation to the exclusion of all other considerations. According to Chairman Bernanke of the U.S. Federal Reserve Board, inflation targeting is, in practice, more a "constrained discretion" than a strict mathematical formula imposed at the expense of the judgment of monetary authorities. The historical reluctance of the U.S. Federal Reserve Board to adopt inflation targeting may also result, in part, from its mandate, which explicitly mentions "maximum employment" in addition to price stability and moderate long-term interest rates.

CONCLUSION

Inflation targeting is increasingly popular among central banks. The recent appointment in the U.S. of Chairman Bernanke – who has in the past said that he believes in the merits of inflation targeting – provides an example of this popularity. The Bank of Canada has been a pioneer in adopting explicit inflation targets and has a record of success in limiting inflation in this country. However, inflation targeting is not

free of criticism, and critics highlight the need for ongoing review of central banks and the means by which they attain their monetary policy objectives.

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(1) The other functions of the Bank of Canada, which are less relevant for the purpose of this paper, are to: supply bank notes; purchase federal government debt; advise the federal government on debt management; act as the lender of last resort; and act as a clearing house for banks and other members of the payments system.

(2) Although the inflation-control target is expressed in terms of the year-over-year rate of increase in the total Consumer Price Index (CPI), the Bank of Canada uses core CPI (i.e., total CPI excluding the eight most volatile components as well as the effect of changes in indirect taxes on the remaining components) as its operational target.

(3) Low inflation rates are usually preferred to low deflation rates, since people are reluctant to see their wages reduced in nominal terms.

(4) David Dodge, "Inflation Targeting: A Canadian Perspective." Presentation to the National Association of Business Economics, Washington, D.C., 21 March 2005.

(5) Ibid.