

Intelligence MEMOS



From: Steve Ambler
To: Governor Stephen Poloz
Date: July 20, 2016
Re: **DON'T SQUANDER THE BANK'S CREDIBILITY BY INCREASING THE INFLATION TARGET.**

Negotiations with the Government of Canada over this year's renewal of the inflation control agreement are likely at an advanced stage. However, I would like to add a few thoughts on one of the primary questions being considered, specifically whether the Bank should consider raising the inflation target above 2 percent. I believe increasing the target would be a serious mistake.

Some prominent economists have argued in favour of increased inflation targets because of sluggish economic growth and lower world real interest rates since the Great Recession. As a result, the "neutral rate" for the Bank's overnight rate target (when output is at full capacity and inflation is stable and equal to target) is also lower than a decade ago. A lower neutral rate raises the likelihood that the Bank's overnight rate target will be driven to its effective lower bound, forcing the Bank to resort to unconventional monetary policies to provide future stimulus to the economy. Raising the inflation target would give the Bank more "room to cut", but the costs could be severe.

First, increasing the target would cause an unexpected transfer of wealth from savers to borrowers as the real value of debts fixed in nominal terms would depreciate more quickly. Savers could view this as the Bank reneging on a promise to deliver low and predictable inflation.

Second, the Bank would stand to lose much of the hard-won credibility it has achieved since it introduced the inflation targeting regime and since inflation stabilized at around 2 percent in the late 1990s. If the Bank unexpectedly raises the target once, individuals may come to fear that it could do so again. Inflation expectations could become less firmly anchored, reducing the effectiveness of the Bank's monetary policy and defeating the purpose of creating more room to cut.

Third, the costs of low to moderate inflation could be considerably higher than conventional economic analysis has led us to believe. Advocates of higher inflation targets believe in an economic paradigm in which inflation is costly because it induces distortions in relative prices, but these distortions are not very important until annual inflation is well above 10 percent. Extending the standard paradigm to account for the complex input-output structure of modern economies shows that increasing the target to 4 percent could impose economic costs equivalent to almost 7 percent of one year of aggregate consumption.

If the Bank is concerned about its target overnight rate being driven to its effective lower bound, there are better alternatives available. The Bank could take a new look at research (some of it at the Bank itself) on the advantages of alternative monetary policy frameworks such as price-level path targeting. A price-level path target would greatly reduce the probability of the target rate hitting its lower bound. It would also eliminate one of the potential drawbacks of an inflation-targeting regime (even with a higher target rate) when low interest rates prevent the Bank from responding strongly to changes in inflation and lead to instability.

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