Intelligence MEMOS

From: Paul Jenkins

To: Canada's Monetary Policy Community

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Re: **Time Inconsistency and Inflation Expectations**

Many analysts and pundits have been pointing to well-anchored inflation expectations as an important reason why inflation risks remain low in Canada and elsewhere, notwithstanding the very accommodative stance of monetary policies, strongly expansionary fiscal policies, and the rollout of COVID-19 vaccinations in helping to reinvigorate economies.

They are right to point to the importance of expectations in the conduct of monetary policy. But we should not assume that expectations are fixed.

Put simply, inflation expectations are a main driver of inflation because expected inflation influences price setting, wage negotiations, and financial contracts – in normal times and in response to unanticipated shocks to the economy (such as the global financial crisis and COVID-19). Because of this link, monetary policy can influence current and future inflation by anchoring economic agents' expectations of long-term inflation.

Canada has had a robust history of well-anchored expectations ever since the introduction of an explicit inflation target in 1991. On virtually any measure, expectations have remained consistent with Canada's inflation target.

A quick look back: In 1990, CPI inflation in Canada peaked at around 6 percent, after having averaged close to 7.5 percent in the 70s and 80s. In his 1988 Hanson Lecture, Bank of Canada Governor John Crow presented the case for price stability as the appropriate goal for monetary policy. In February 1991, the Governor and the Minister of Finance jointly set out explicit targets for reducing inflation and reaching price stability.

By 1992, after two decades of high and variable inflation, CPI inflation was on a path converging to a rate of 2 percent (which after several years of experience with inflation targeting became the explicit inflation target for the Bank and the government). To be sure, the 1990 recession was an important reason why inflation fell rapidly. But **research** at the time, and the successes since, point to the credibility of the inflation targets in anchoring people's expectations in a relatively rapid, and durable, manner.

So can we count on inflation expectations remaining well anchored as we exit the pandemic?

Or is there a risk that expectations may become unanchored? After all, if expectations fell rapidly in 1991, could they not also be prone to adjust rapidly upwards under certain circumstances.

Given the massive stimulus injections and clear signs of strong pent-up demand, there has been a recent chorus of analysts and academics who have expressed serious concern about a building of inflationary pressures. The counter argument is that considerable slack remains, especially in labour markets, and that well-anchored inflation expectations continue to point to strong central bank credibility.

A critical element in understanding central bank credibility is the notion of **'time inconsistency'** first developed by Kydland and Prescott. Time inconsistency arises in the conduct of monetary policy when the public perceives that the central bank is unlikely to achieve its announced inflation objective because the objective is seen to be incompatible with central bank actions over shorter horizons. The dynamic at play is that the monetary authorities, in believing that inflation expectations are well anchored, yield to the temptation to boost the economy more than the public expects, leading to expectations being adjusted higher than consistent with the announced long-run policy.

A solution to the problem of time inconsistency is an explicit agreement between the government and the monetary authority on the goal of policy. Such an agreement, if easily understood and transparent, holding the central bank accountable for it, builds and sustains policy credibility – as we have in Canada.

However, there is a risk that the public will view the amount of stimulus currently in the works, and planned, as being incompatible – time inconsistent – with the long-run objective of 2-percent inflation, leading them to reassess their expectations. This risk would seem to be multiplied by the possible spillover effects from the recently passed record stimulus bill in the US Congress.

Such a risk should not be ignored.

As it conducts policy through this challenging and unprecedented period, the Bank must continue to reinforce through its words and actions its commitment to its inflation target in order to benefit from inflation expectations remaining well anchored. More so, in this time of **heightened (radical) uncertainty**. This, too, must be kept front of mind as we approach this year's inflation renewal agreement.

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