Intelligence MEMOS

From: Steve Ambler, Jeremy M. Kronick, and William B.P. Robson

To: Bank of Canada Watchers

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Re: **Down to the Wire on the Monetary Policy Framework**

Inflation has risen to almost 5 percent and the federal government and the Bank of Canada are set to announce a new monetary policy framework in days. Should we be nervous?

Since 1991, the framework has been an inflation-control target, and since the end of 1995 that target has been 2 percent. It has been a striking success. The CPI's average increase over the 25 years from 1995 until the onset of the pandemic was 1.9 percent annually. Previous five-year renewals of the inflation-control agreement were quiet affairs with only minor tweaks.

Not so this time. COVID's hit to productive capacity has combined with massive monetary and fiscal stimulus to push inflation well above target.

Enthusiasm for loose fiscal and monetary policy is in the air, and there are calls for central banks to target other goals, ranging from jobs to income inequality to climate change.

Previous renewals were routinely enacted long before the deadline. It's natural to worry that talks are going down to the wire because of proposals to raise or otherwise compromise the 2-percent target.

That would be a mistake. Current high inflation is reminding us why inflation is bad. It erodes the value of the money we hold in cash and bank accounts. It complicates everyday life. Is the price increase for milk, gasoline or a refrigerator a signal to look for an alternative product or store? Or are prices higher for everything everywhere?

It poisons labour relations: strikes are more common when inflation is high. And it fosters scapegoating: blaming "gouging retailers" or traders or unions or whomever, when what really drives rising prices everywhere is the central bank letting things rip.

Advocates for compromising the 2-percent target do not necessarily propose higher inflation. One version on offer is lengthening the period over which the Bank measures inflation, from the 12-month comparison to, say, three years. This approach, often called "average inflation targeting" would mean that if inflation is below the 2-percent target for a time, as it was after COVID first hit, the Bank would allow it to run above target long enough to achieve an average of 2 percent over a three -year period.

One problem with this idea is that only obsessive monetary policy followers would understand it.

People would have to watch the annualized increase over the relevant period and relate that to the target, instead of watching their familiar year-over-year number.

A more overtly inflationary recommendation is to add something else – usually a labour-market indicator such as the unemployment rate – to the Bank's framework. Proponents often argue that inflation control hurts jobs and, more specifically, that central banks have been too quick to tighten before the economy reaches full employment. But unemployment in Canada has been lower and less volatile since the 2-percent target came into force (See Figure). And the blowout jobs report this month just underlines the problem of determining what full employment actually is, especially after a major disruption like the pandemic.

As for other goals, such as reducing inequality and or slowing global warming, we need to keep people's expectations about monetary policy in line with what it can actually do.

Monetary policy is about short-term interest rates, the growth of money and credit, the pace of spending, and the results of all this for inflation. While the Bank must assess how inequality and global warming impact its ability to hit the inflation target, asking it to target the price of assets held mainly by the wealthy or favour credit for some industries at the expense of others will lead to chronic confusion and disappointment.

The 2-percent inflation target has been a signal success in Canadian economic policy for a quarter century. We know it is achievable, and with inflation currently running close to 5 percent, we are getting a timely reminder that alternatives can easily be worse.

It is time to reassure Canadians that their government and central bank are committed to low and stable inflation.

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