# David Dodge: Inflation targeting - a Canadian perspective

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the National Association for Business Economics, Washington DC, 21 March 2005.

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Good afternoon. Three years ago, when I last addressed this group, I spoke about the conduct of monetary policy in the presence of economic shocks. In those remarks, I made passing reference to the Bank of Canada's inflation-targeting framework. Today, I am happy to accept your invitation to return and talk in more depth about how we use inflation targeting as our monetary policy anchor.

The invitation is timely, given that the Bank of Canada's inflation-targeting agreement with the Canadian government is up for renewal next year. At the Bank, we are always reflecting on our framework, deciding what works well and what we can improve. Against that backdrop, we have watched with interest the debate taking place here in the United States - inside and outside the Federal Reserve - about whether that institution should join the ranks of inflation-targeting central banks.

As part of that debate, the minutes of the February FOMC meeting show that my colleagues at the Fed had a discussion about the merits of inflation targeting last month. According to the minutes, arguments were made both for and against the adoption of an explicit inflation target. Those in favour spoke of how such a target can anchor inflation expectations, add clarity to monetary policy decision making, and help with communications. Those opposed said that the benefits of adopting a target were unlikely to be large, that adopting a target might bias or constrain policy, and that it might *appear* - and I stress the word "appear" - to be inconsistent with the Fed's dual mandate to promote price stability and maximum employment.

Before I proceed with my remarks today, I want to make it absolutely clear that my purpose here is not to weigh in on the debate within the Federal Reserve. I would not presume to tell the Fed what it should or should not do. Rather, I want to talk about the Canadian experience with inflation targets. However, in doing so, I will address some of the arguments raised at the FOMC meeting that I just mentioned.

I will begin by discussing the Bank of Canada's legislated mandate, and how inflation targeting helps us to meet the objectives of that mandate. I will then talk about some of the choices that we have made to establish and refine our particular framework. I'll discuss some of the benefits that we can attribute - at least in part - to inflation targeting. And I will conclude by touching on some of the issues still facing us as we look to the future.

## Our Mandate and Objectives

Let me start with the Bank of Canada's legislated mandate. It is interesting to compare our mandate with the one spelled out in the Federal Reserve Act, given that the nature of the Fed's mandate is often cited as one reason why it should not adopt an explicit inflation target.

The pieces of legislation that govern the Bank and the Fed do contain some clear differences. But in terms of the conduct of monetary policy, it is the similarities that are more striking. Our mandate is broadly set out in the preamble to the Bank of Canada Act. The preamble was drafted in 1934 and, of note, has not been substantively amended over the past 70 years. The preamble calls on us to "regulate credit and currency in the best interest of the nation." It goes on to say that the Bank should mitigate "fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada." By comparison, the most recent revision of the Federal Reserve Act calls on the Fed to maintain growth of credit and the money supply "commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The Fed's mandate is a bit more specific than ours in that it states directly that monetary policy should aim at having the U.S. economy operate at full capacity. But the main point is that both central banks have references in their mandates to production, prices, and employment. Indeed, a key goal for all central banks is to conduct monetary policy so as to provide favourable conditions for maximum, sustainable long-run growth, while recognizing that monetary policy alone is not sufficient to bring about that growth.

So the question is, What is the best way to operate monetary policy in order to provide the conditions for sustainable growth, bearing in mind the words in our mandate: "so far as may be possible within the scope of monetary action"? Over the years, central banks have tried various frameworks in attempting to answer this question. First, central banks tried fixing exchange rates to gold; most later tried fixing their exchange rates to those of other countries. Some central banks tried to target credit or the growth of monetary aggregates, while many relied solely on their own judgment. All of these frameworks have had their problems, which I won't go into today.

But over time, what has become clear is that the best way for monetary policy to promote sustainable economic growth is to anchor expectations about the future purchasing power of money. What we have learned from the bitter experience of many countries - including Canada and the United States - is that when monetary policy chases short-term goals, mistakes are made, uncertainty is increased, and fluctuations in economic activity are aggravated. Focusing on domestic price stability - however that term is defined - is the best contribution monetary policy can make to economic stabilization and sustainable long-term growth. Indeed, as my predecessor Gordon Thiessen put it, "Focusing on price stability helps us to guard against the sort of systematic [policy] errors that often occurred when we tried to aim directly at output and employment."[1]

At the end of the 1980s, the Bank of Canada faced the question of how to pursue price stability in a way that would allow it to accomplish three things: first, help to anchor expectations about the future purchasing power of money; second, give the Bank a guide for the conduct of policy; and third, help us to explain to markets, politicians, and the Canadian public what we are doing and what actions they could expect from their central bank.

By 1991, the Bank and the Government of Canada had agreed that inflation targeting was the right framework for pursuing this objective. We considered targeting inflation as the best way to achieve high, sustainable growth of output and employment. To be clear, inflation targeting is not an end in itself. Rather, it is the best means of fulfilling our commitment to promote the economic and financial welfare of Canada.

## The Canadian Version of Inflation Targeting

Let me now say a few words about some of the particular choices we have made over the years to shape our inflation-targeting framework. A central bank that wants to target inflation and run an independent monetary policy must allow its currency to float. As you know, a monetary authority cannot control both the domestic and external values of its currency. We have one instrument, so we can have only one target. Thus, with inflation as our target, we naturally operate with a floating currency.

Once the Bank and the government agreed on the concept of inflation targeting, we needed to make some choices to put the concept into practice. Our goal of price stability came to be defined as low and stable inflation. Like many other central banks, we chose a target for the annual increase in the consumer price index (CPI). Initially, our focus was on inflation reduction. So it was announced that the target would decline gradually - from the 3 per cent midpoint of a 2 to 4 per cent target range at the end of 1992 to the 2 per cent midpoint of a 1 to 3 per cent range by the end of 1995. The target has remained there since. Let me take you through some of the key decisions that we made in 1991, and the rationale behind our choices, as we set out the details of our framework.

First of all, why did we choose the CPI as our target? The key reasons were that it is widely understood and is the measure of inflation most familiar to Canadians. Choosing a well-known indicator as a target makes it easier to explain our actions and to be accountable to Canadians. However, movements in the prices of particularly volatile components of the CPI can cause the index to fluctuate sharply. So we use a measure of core inflation as an operational guide. This measure strips out the most volatile components and the effect of changes in indirect taxes on the rest of the index, giving us a better understanding of the trend of inflation.

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[1] G. Thiessen, "Can a Bank Change? The Evolution of Monetary Policy at the Bank of Canada 1935-2000," The Thiessen Lectures, (Ottawa: Bank of Canada, 2001), p. 79.

Second, why have a range? While we emphasize the 2 per cent target, we have a range - as many central banks do - because monetary policy operates with long and variable lags. If we tried to target inflation too precisely we could have "instrument instability;" in other words, we would be adjusting our policy interest rate sharply and frequently, which would lead to greater instability in the economy. Further, measured inflation itself can be volatile as specific prices adjust. But to be clear, the range does *not* represent a zone of indifference - we *do* aim to achieve the 2 per cent target.

Third, given that we must always be forward looking as we conduct policy, what time frame would we choose to achieve our target? From the beginning, we said that if a demand shock pushed inflation away from the target, we would conduct policy so as to return inflation to target over a period of 18 to 24 months. This is because our research suggests that it takes 12 to 18 months for changes in interest rates to have most of their impact on output, and 18 to 24 months to have most of their impact on prices. Of course, there is always uncertainty about the lags involved, and I'll have more to say about this later on.

To be sure, there will always be times when there are large swings in relative prices in the economy - energy prices being a good example. Under inflation targeting, the objective is not to try to offset or stifle these relative price movements. Our experience has been that with a clear inflation target and with well-anchored expectations, these types of relative price shocks have only a one-off effect on the price level, and do not feed into ongoing inflation.

Before I leave this section, I want to emphasize two points about our inflation-targeting framework. The first is that we operate in a symmetric way, and we make it clear to everyone that we do so. By this, I mean that we worry just as much about inflation falling below target as we do about it rising above target. This is a tremendously important point. When the demand for goods and services pushes the Canadian economy against the limits of its capacity, and inflation is poised to rise above target, the Bank will raise interest rates to cool off the economy. Just as importantly, when the economy is operating below its production capacity, and inflation is poised to fall below target, the Bank will lower interest rates to stimulate growth. Whatever the direction of the demand shock, the Bank of Canada will respond appropriately.

This symmetry is our answer to the charge that central banks target inflation at the expense of growth. On the contrary, paying close attention to signs of deviation from our target promotes timely action in response to both positive and negative demand shocks. This is how we can keep the economy operating near its full capacity and thus keep inflation low, stable, and predictable.

The second point I want to stress is that having an inflation target as an anchor is very helpful in terms of the Bank's accountability. If inflation persistently deviates from the target, we are committed to explaining the reasons why this is so, what we will do to return it to target, and how long we expect the process to take.

### Our Experience with Inflation Targeting

Now let me turn to our experience with inflation targeting. Just as Canada was a pioneer at having a floating exchange rate, we were also among the very first to adopt inflation targeting. And as in other countries that have done so, the result has been unambiguously positive. Indeed, as Claudio Borio put it, "no country embracing inflation targeting has regretted doing so."[2]

Back in 1991, Canada had several compelling reasons for moving to inflation targeting. Compared with today, inflation was still relatively high. Further, the Bank of Canada and the federal government wanted to minimize the possibility of a wage-price spiral developing in the wake of the introduction of the Goods and Services Tax. We recognized the importance of having both the general public and financial markets understand our actions. And as inflationary pressures built towards the end of the 1980s, we saw that the lack of a monetary anchor was leading to rising inflation expectations.

As we look at Canada's record since 1991, in terms of inflation and economic growth, I can tell you that all of the benefits we had hoped would come from inflation targeting have, in fact, materialized. We expected that inflation would become more stable under a targeting framework - and it did so, sooner than we had anticipated. We expected that our credibility would increase and that inflation

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2 C. Borio, "Wrap-up Discussion." The Future of Inflation Targeting, (Sydney: Reserve Bank of Australia, 2004): p. 278.

expectations would become well anchored under targeting - and this also happened. Indeed, short-term expectations quickly became anchored to our target, although longer-term expectations took a bit more time to fall in line. Together with marked improvements in Canada's fiscal position in the mid-1990s, our excellent track record on inflation added to our credibility. Private sector forecasts for inflation in Canada now average close to the 2 per cent target far into the future.

We expected that setting out a clear paradigm for operating under inflation targeting would bring benefits - and it did. Internally, focusing on inflation brought increased discipline and clarity to our monetary policy deliberations. But more importantly, being transparent about our operational paradigm has allowed markets and analysts to better predict how we will react to different economic outcomes. Financial markets and analysts now pay more attention to their own evaluations of the prospects for the economy and inflation in assessing the future path of our policy interest rate. Appropriately, they do not have to rely on the wording of our communications for guidance.

Empirical evidence shows that inflation targeting has been an unqualified success for Canada. Inflation has averaged very close to 2 per cent and has remained within the target range since we adopted our targets, with rare exceptions that were due mainly to large swings in the prices of oil or other commodities. Further, there is evidence that inflation targeting has been successful as a macroeconomic stabilizer, helping to smooth the peaks and valleys of the business cycle.

Our symmetric approach to inflation targeting is crucial in this regard. Because we guard against both inflationary and deflationary pressures, businesses and individuals can make long-range economic plans with increased confidence. Scarce economic resources are no longer wasted trying to hedge against the threat of runaway inflation. And because our paradigm makes it clear that we guard against deflationary pressures, Canada has avoided any serious threat of deflation. Throughout all the shocks we have experienced, Canadian inflation expectations have remained remarkably well anchored on the 2 per cent target.

At the time that we were considering the adoption of inflation targeting, we heard many of the same arguments against such a framework that we hear today in the United States. Some argued that inflation targeting could constrain our ability to act, or would take away our ability to apply our own judgment in the conduct of policy. Our experience has shown these concerns to be groundless.

Let me illustrate with a couple of recent examples. In the immediate aftermath of the 9/11 terrorist attacks, we lowered interest rates quickly and decisively to underpin confidence, which could have been profoundly shaken by the attacks. When a major loss of confidence did not materialize over the next few months, we were able to reverse course and withdraw some of that monetary stimulus. Our inflation-targeting framework did not restrict our ability to act. Indeed, because our paradigm is clear, financial markets were able to understand why we made these rapid rate adjustments.

Another example is our reaction to the continuing realignment of world currencies over the past two years. The Canadian economy has had to adjust to sharp movements, not just in the external value of our dollar, but also in the foreign demand for many of our goods and services. Inflation targeting gives the Bank an important guideline for dealing with the currency appreciation, allowing us to maintain our focus on macroeconomic stabilization at a time when various sectors of the economy are dealing with the exchange rate shock. Our paradigm has given us the flexibility to apply judgment in the face of considerable uncertainty over this period.

### The Future of Inflation Targeting

Before I close, let me say a few words about the future of inflation targeting in Canada. As I noted at the beginning, our current agreement with the federal government is up for renewal in 2006. So it is useful to think about those elements of our framework that we would not want to change, and other areas where changes might be considered.

From the central bank's point of view, the basic arrangement of aiming inflation at the 2 per cent midpoint of a 1 to 3 per cent target range has served us well, along with the use of the CPI as our target. The CPI may not be a perfect indicator of inflation, but it is the most readily recognized and understood measure, and so likely represents our best option for targeting. However, given the volatility inherent in the index, the Bank has emphasized a core inflation measure for operational purposes. I would expect that these elements of our framework will remain in place. But good public policy demands that we continue to do the necessary research to confirm that these remain the best options.

Also, the Bank of Canada will continue to recognize the importance of communications and transparency to the conduct of monetary policy. Inflation targeting is a helpful tool for anchoring expectations, but its effectiveness is greatly enhanced when a central bank communicates well. And a symmetric approach to inflation targeting allows the bank to make a convincing case for its policy actions, even during difficult economic conditions.

But I don't want to suggest that there aren't questions to be answered as we go forward. One question facing us now is whether 18 to 24 months is the appropriate time horizon for monetary policy to bring inflation back to target after various types of shocks. One type of shock that we have to consider is a major movement in asset prices. Do these types of movements in asset prices contain any information about future inflation beyond our typical policy horizon? And if so, what should we do about it? This is not to suggest in any way that we should try to target asset prices. Rather, the question is whether it would ever be appropriate to lengthen the time horizon for returning inflation to target.

A similar question applies to exchange rate shocks. Globalization appears to have altered the way in which economies adjust to movements in exchange rates. This applies both to the adjustment of real economic activity to the shock, as well as the direct pass-through of exchange rate movements to prices. This raises the question of whether 18 to 24 months is too short a time horizon for monetary policy to deal with exchange rate shocks. On the other hand, the reduction in the persistence of inflation that we have seen under inflation targeting would suggest that it may instead be more appropriate to shorten the policy horizon.

Given the success to date of handling shocks within an 18 to 24-month horizon, we should not change our framework lightly. But we need to think hard about the appropriate time horizon in dealing with various shocks as inflation targeting evolves in the future.

## Conclusion

Let me close by emphasizing a few key points. There is no doubt in my mind that inflation targeting is the right monetary policy framework for Canada. Through our symmetric approach of keeping inflation low, stable, and predictable, we have laid the groundwork for solid, sustainable growth in output and employment. In doing so, we fulfill our commitment to "promote the economic and financial welfare of Canada," as spelled out in the Bank of Canada Act. With inflation targeting, our policy is more focused, our communications are clearer, and Canada's inflation expectations are more solidly anchored.

During a period when consumer price inflation is low and appears to be stable, it may be tempting to some to conclude that an inflation anchor is unnecessary. In my opinion, to reach this conclusion would be a huge mistake. On the contrary, it is particularly important at this time, in the face of large terms-of-trade movements and other shocks, that central banks have an anchor to keep monetary policy focused. From my perspective, inflation targeting is the best anchor we've seen.

Of course, I'm not saying that inflation targeting is the end of monetary policy history. And, I love a good debate. So I hope that my remarks today may have helped to add some context to the ongoing discussions here in the United States. And I can tell you that we in Canada will continue to watch, with great interest, as the debate unfolds.