

Tiff Macklem: Flexible inflation targeting in a shock-prone world

Remarks by Mr Tiff Macklem, Governor of the Bank of Canada, at the Bank of Mexico 100th Anniversary Conference, Mexico City, Mexico, 26 August 2025.

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It is wonderful to be here in Mexico City with you to celebrate Banco de México's 100th anniversary. This is a significant milestone in a storied history that has spanned the Great Depression and the surge in silver prices, post-World War II stabilization, central bank independence and, finally, flexible inflation targeting.

For many central banks, including Banco de México and the Bank of Canada, flexible inflation targeting¹ has become our guiding light, helping us to achieve our monetary policy mandates. So far, it has been more successful and more durable than anything that came before. But the evolution of monetary policy didn't end with the adoption of inflation targeting. And to continue to deliver for the people we serve, central banks need to periodically review our frameworks to ensure they are still fit for purpose.

In my remarks today, I'll begin by recalling some of the frameworks of the past, how the pitfalls of those frameworks led to inflation targeting and how inflation targeting has performed over the past few decades.

Then I'll consider some of the structural changes underway in economies across the globe. Big structural changes don't happen smoothly and there are often shocks along the way. So I'll discuss what monetary policy can and cannot do in a more shock-prone world. And I'll share the ways the Bank of Canada is adapting how we implement flexible inflation targeting to confront new realities, including more frequent supply disruptions and elevated uncertainty.

Finally, I'll come back to the idea of periodically reviewing the framework to ensure it is still the best way to meet our objectives. In Canada, we are reviewing our monetary policy framework now to prepare for its renewal next year. I'll outline the questions we are asking ourselves, particularly against the backdrop of this more shock-prone world. Perhaps I'll spoil it a bit by telling you that one thing we aren't revisiting this time around is the 2% inflation target itself.

Inflation targeting as a way to do better

To understand where we are, it's important to understand where we came from.

After World War II, central banks stopped pegging their currencies to the price of gold and, together with their national governments, tried different ways to stabilize the economy and inflation. For a while, inflation stayed low and relatively stable in most major economies. But by the late 1960s, global inflationary pressures began to build. And when major oil-producing countries sharply cut production in 1973, the shock to oil prices caused inflation to surge in much of the world.

In Canada, as in many other countries, the government resorted to wage and price controls. These controls generally worked to hold down inflation while they were in place. But they did little to address the underlying causes of inflation. So once the controls were removed, inflation jumped back up. And keeping prices artificially low led to shortages.

To try to address the root causes of inflation, many central banks turned to money growth targeting. Since "inflation is always and everywhere a monetary phenomenon,"² the favoured solution of the time was to suppress money growth. From 1975 to 1981, monetary policy in Canada was guided by a series of successively lower growth targets for M1—a narrow measure of money consisting mainly of physical currency and funds held in chequing accounts. Monetary policy successfully reduced M1 growth, achieving every target. But inflation continued to rise. The framework failed because the relationship between money, prices and income was not stable. As Bank of Canada Governor Gerald Bouey famously put it, "We didn't abandon M1, M1 abandoned us."³

Some countries adopted a fixed exchange rate framework—pegging their currency to that of a larger country to control inflation. Of course, this worked only if the larger country successfully controlled inflation. There was also the added problem of instability, particularly when policies in different countries were not aligned.

As you know well, Mexico fixed its exchange rate to the US dollar for many decades. But the collapse of oil prices in the early 1980s led to budget shortfalls, and the central bank expanded the supply of money to finance the deficit. That, combined with the devaluation of the currency, led to a surge in inflation. Structural reforms in the late 1980s helped, but price pressures stayed elevated.

Clearly, the monetary policy frameworks of the day were not delivering price stability. Central banks needed something different, and their wish list was clear: The framework had to be simple—targeting intermediate variables, such as money growth, had proven to be too complicated. It had to be flexible—central banks needed to be able to gear monetary policy to conditions in their own country. And it had to control inflation over time, while still allowing individual prices to adjust with shifts in demand and supply.

Inflation targeting combined with a floating exchange rate fit these criteria.⁴

In 1990, the Reserve Bank of New Zealand became the first central bank to adopt inflation targeting. Nine months later, in 1991, the Bank of Canada was the second. At that time, I was a newly minted PhD doing research and analysis at the Bank. I can tell you it was an exciting time as we figured out how to take inflation targeting from an unproven concept to a full-fledged monetary policy framework that worked both in theory and in practice. Along the way, many other central banks joined us, including Banco de México.

Since those early days, inflation targeting has proven to be a big success.

Take Canada and Mexico. In the 25 years leading up to the pandemic, inflation in Canada averaged very close to the 2% target and was inside the 1% to 3% band about 80% of the time. By comparison, in the 25 years before that, inflation averaged just

above 6% and was much more variable. Here in Mexico, inflation averaged 130% in 1987. The 3% target was adopted in 2002 with a band of 2% to 4%. From the early 2000s to the pandemic, inflation averaged about 4%. In both our countries, inflation targeting led to much lower and more stable inflation.

Inflation targeting has also made central banks' ability to deliver price stability more credible, making the framework resilient. Over time, inflation expectations have become better centred on the target and less sensitive to short-run fluctuations in inflation. This has been reinforced by a transformation in how central banks engage with the public. Inflation targeting is inherently transparent-the central bank sets a numerical target for inflation and publicly commits to achieving that target. The central bank also explains how its monetary policy actions will achieve the target. This creates accountability. When central banks are clear about their objective, explain how they will achieve that objective and then deliver on it, that builds credibility.

In Canada, the pandemic tested our framework like never before. We faced huge shocks to both demand and supply, a deep recession and then a rapid rebound. As the economy reopened, inflation rose sharply, hitting 8.1%-a 40-year high. To be clear, this was not a failure of the framework. Russia's unprovoked invasion of Ukraine was unforeseeable, and we misjudged the strength and persistence of inflation in 2021 and early 2022. But once it was clear that high inflation was not temporary, the framework guided our response, and we raised the policy interest rate forcefully to bring inflation down. It was a painful adjustment for many Canadians, but in the summer of 2024 inflation returned to 2%. And we got there without causing a recession or major job losses.

The credibility of our 2% target was the foundation for this success. While short-term inflation expectations in Canada rose temporarily when the inflation crisis hit, long-term inflation expectations remained anchored. After we started raising interest rates and inflation began to ease, short-term expectations normalized. We told Canadians our actions would reduce inflation and then they saw inflation start to come down. This reinforced the credibility of our target and made it easier to get inflation all the way back to 2%.

The experience here in Mexico was similar. Indeed, I want to salute Banco de México for raising interest rates ahead of the Bank of Canada and many other central banks. Your timely and decisive response made your economy resilient to the pressures of high inflation and helped ensure that long-term inflation expectations remained anchored. Your actions reinforced the credibility of your target.

My point here is that the measure of success is more than whether inflation stays at the target. It's also how the framework performs in the face of big shocks like a global pandemic.

More structural change and uncertainty

This brings me to where we are today. The world is changing.

The structural tailwinds of peace, globalization and favourable demographics are turning into headwinds, and the world looks increasingly prone to shocks. Elevated

sovereign debt, slower economic growth and lagging productivity also make our economies more vulnerable. These vulnerabilities are compounded by intensifying geopolitical risks and more frequent climate events. In addition, new technologies-including artificial intelligence-are set to disrupt existing industries and create new ones.

On top of these structural shifts, the rules of global trade are being overturned. Steep new US tariffs and the unpredictability of US policy have reduced economic efficiency and increased uncertainty. As the United States' biggest trading partners, Mexico and Canada are particularly affected. With businesses in both our countries looking for new suppliers and new markets, cross-border supply chains are shifting.

Headwinds that limit supply could mean more upward pressure on inflation going forward. And more frequent supply shocks could mean more variability in inflation.

Unfortunately, monetary policy cannot undo the economic impacts of the structural shifts ahead. Nor can it offset the hit to efficiency from higher tariffs and the reconfiguration of trade. And we can't reduce the uncertainty caused by the policies of other countries or by shocks that are outside our control.

But we can work to improve our understanding of these supply shocks and their impacts on our economies. We can also adapt our analysis, our decision-making and our communication to confront elevated uncertainty. What we can't do is let increased volatility and elevated economic uncertainty sow doubts about our commitment to price stability. Let me expand.

Improving information and models of the supply side

At the Bank of Canada, we've increased our use of non-traditional data and surveys to better understand how businesses and consumers are adapting to structural change and shifts in US policy. We have also stepped up our outreach across Canada. My colleagues on the Bank's Governing Council and I regularly travel to different regions of the country to meet with community and business leaders. We get to see first-hand how economic disruptions are affecting people and impacting business decisions. This, in turn, allows us to make more informed policy decisions.

We are also investing in new economic models that capture what is happening in specific sectors of the economy and the interconnectivity between sectors. We're developing these new models because our existing models were ill-equipped for the COVID-19 shock. Those models focused on the overall economy, which was in excess supply during that period, so they missed the inflationary consequences of bottlenecks and shortages in certain sectors.

Recent events-from geopolitical tensions to US tariffs-have only reinforced the need for models that can help us evaluate how sectoral disruptions affect the broader economy and what that could mean for monetary policy.

Managing uncertainty in an unpredictable world

Better information and analysis can reduce uncertainty, but they won't offset the fundamental unpredictability of a more shock-prone world. If we can't avoid uncertainty, we need to accept it and manage it as best we can.

When faced with elevated uncertainty, point forecasts for where the economy and inflation are headed become less useful as a guide. This means two things. First, when the future is more clouded, we naturally put more weight than usual on recent data until we have a better sense of how the economy is responding to new shocks. And second, we put less weight on the base-case projection and more weight on the risks. Here, scenarios can help. Scenarios allow us to examine how our economy could evolve depending on different assumptions about key unknowns. Different assumptions can point to different economic effects, allowing us to consider how monetary policy could respond in each case. This helps us understand how our policy decisions will hold up across a range of outcomes.

Let me give you an example. At our last few interest rate decisions at the Bank of Canada, we used scenarios rather than conventional forecasts because US trade policy was simply too unpredictable. In April, we considered two scenarios—one with high US tariffs and retaliatory tariffs around the world, and one with modest tariffs and little retaliation. In July, we considered three scenarios—one based on tariffs that were in place or had been agreed as of late July, a second with much higher tariffs and a third with lower tariffs.⁵ By using scenarios, we were able to take a monetary policy decision that would fit a range of economic outcomes. The scenarios also highlighted just how important the Canada–United States–Mexico trade relationship is for the Canadian economy.

Enhancing our decision-making and communication

We have also adapted our governance and communication. In a world with more supply shocks, we face more hard choices—we can't stabilize inflation and output at the same time. And when we are faced with more uncertainty, the likelihood of our getting things wrong is higher. Hard choices and uncertainty increase the risk of public disappointment, frustration and criticism. That's why it's important for central banks to remain independent from the political process. But we can't hide behind our independence. We need to draw on a diversity of views, and we need to be transparent and accountable in everything we do.

At the Bank of Canada, we've added two external Deputy Governors to our Governing Council. And we've improved transparency by holding a press conference after every interest rate decision, releasing a summary of our policy deliberations and expanding our media presence.

High inflation in 2022 was a reminder that even though inflation was low and stable for years before the pandemic, central banks cannot take public trust for granted. We need to constantly earn that trust—by being clear about our objectives, accountable for our actions and humble in the face of uncertainty.

A framework fit for purpose

We've been targeting inflation for almost 35 years in Canada. Every five years we review and renew our monetary policy framework with the federal government. These reviews are a strength of our system. They give us the opportunity to assess performance and consider whether our current framework remains the best one for the future.

Our last renewal was in 2021, so the next one is coming in 2026. Ahead of this review, we took a close look at our policy response to the pandemic emergency, particularly our use of exceptional policies.⁶ It's important we take on board the lessons of the pandemic so that we're ready for future crises. For our framework review, we are asking three sets of questions.

First, in a world more prone to supply shocks, what are the implications for inflation and the economy? How should monetary policy respond? When should we look through supply shocks and when should we lean against them or even into them? Should our response depend on the size and persistence of the shock, or on the state of the economy? In short, how can we best use the flexibility in the framework in the face of supply shocks?

Second, with more supply shocks and greater volatility in inflation, what is the best way to measure core inflation? At the Bank of Canada, we've used various measures of core inflation over the past few decades. And in practice we often use an even broader range of indicators to assess underlying inflation. Going forward, what's the best approach-narrow or broad-and what are the best indicators?

The third set of questions relates to the interaction between monetary policy, housing affordability and inflation. Many Canadians are struggling to find affordable housing, a common issue across many countries, including Mexico. Monetary policy cannot directly increase the supply of housing-that's an issue for elected governments. But, through interest rates, monetary policy does have a direct effect on the demand for housing. And housing is a big part of the consumer price index in Canada, so the cost of housing affects inflation. Therefore, it's worth examining how monetary policy affects housing sector dynamics, and how best to factor housing affordability into our focus on overall price stability.

As I said at the start of my remarks, there's one key question we won't be asking this time around. In our reviews since 1995, we've repeatedly asked whether 2% is the right target. We've considered whether the target should be lower or higher. We've also weighed alternatives to inflation targeting, including price-level targeting and nominal GDP targeting. Each time, we've concluded that targeting 2% inflation is the right framework for us.

The experience since the last renewal in 2021 has only reinforced this conclusion. The 2022 spike in inflation was a painful reminder of just how much Canadians don't like high inflation. We also know that Canadians generally understand and support the 2% target. That familiarity has helped anchor inflation expectations through thick and thin, including through the pandemic crisis.

In short, the 2% target has proven its worth in achieving price stability over time. We are already facing a more uncertain and unpredictable world. Now is not the time to question the target.

Conclusion

It's time for me to wrap up.

Inflation targeting has worked well for central banks over the past few decades. It was tested by the global financial crisis, the pandemic and the post-pandemic surge in inflation. Unlike the monetary policy frameworks that came before, inflation targeting has proven durable—a framework for all seasons. As Banco de México embarks on its next century, that is something to celebrate.

Central banks are at their best when they learn from the past and prepare for the future. To prepare for more structural change and greater volatility, central bankers need to reduce uncertainty where we can and manage it where we can't. This means better information and richer models. It means putting more weight on the risks and considering monetary policy that is robust to more than one outcome. It means being open, accountable and free of political influence. This is how we build and maintain the trust of the people we serve. We need to earn that trust every day.

The Bank of Canada and Banco de México have a long history of working together, and your expertise has been an invaluable resource to us on many occasions. So I am honoured that you invited me here today to celebrate this historic occasion with you. Your centennial is a testament to the rich history of central banking around the world. If I can leave you with one message today, it is that in a more uncertain world, the value of public confidence in central banks and our ability to deliver price stability is greater than ever. Thank you.

I would like to thank Jing Yang, Oleksiy Kryvtsov, Louis Poirier and Kun Mo for their help in preparing this speech.

¹ Flexible inflation targeting is a monetary policy framework used by central banks to manage inflation while also allowing them to consider other economic goals such as stabilizing output. The framework is centred on a target for inflation. But its flexibility means monetary policy can respond to temporary economic shocks and work to smooth fluctuations to help stabilize the broader economy.

² M. Friedman, *Inflation: Causes and Consequences* (New York: Asia Publishing House, 1963).

³ See House of Commons of Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs* (32nd Parliament, 1st Session, volume 1, 1983).

⁴ A floating currency allows a central bank to focus on controlling inflation rather than on maintaining a pegged exchange rate. In many circumstances, it also helps the economy absorb and adjust to shocks.

⁵ See Bank of Canada, [*Monetary Policy Report-April 2025*](#) and Bank of Canada, [*Monetary Policy Report-July 2025*](#).

⁶ See Bank of Canada, [*Review of the Bank of Canada's Exceptional Policy Actions During the Pandemic*](#) (January 2025).