Economic Flash!

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Bank of Canada: Early Results on Prospective Changes to Inflation Targeting

A Bank of Canada conference today shed light on some of the early results from staff research on the merits of changing from its existing 2% CPI inflation target to a set of alternative approaches. This is part of the regular review that the Bank undertakes as part of a formal need to reset the target, which in this case comes up in 2021. Note that past reviews have explored several of the ideas been looked at here. In each case, the Bank concluded that it didn't see enough benefits to change from what it considers to have been the success it's achieved in terms of stabilizing inflation and the economy in using its existing methodology.

Could this time be different? Probably not, as we argue below.

But there are a couple of reasons for the BoC to consider at least some minor tweaks that were not as prevalent last time. We've spent more time at or near a 0.25% overnight rate, a symptom of a gradually declining neutral rate of interest. Unlike the last review a half decade ago under Governor Poloz, the Bank doesn't seem as willing to argue that negative policy rates would be an option. That's of importance because some of the shortcomings of the current policy regime lie in the limited room available to cut rates when recessions hit, and the difficulty in guiding expectations towards a low-for-long approach if investors believe that rates will rise when inflation returns to 2%, even if it's run below that level for an extended period.

The Bank is looking at several options to address those issues: inflation averaging (aiming at a 2% average inflation rate over, say, a couple of years), price level targeting (inflation averages 2% over its whole long term trend), targeting nominal GDP (either the trend level or the growth rate), or raising the inflation target to 4% for example, and therefore having a higher nominal neutral rate that leaves more room to cut rates in recessions. There are many prominent academic economists who favour a higher inflation target, but it seems very unlikely to be adopted in Canada unless other central banks pave the way, and is politically tricky because the general public thinks of higher inflation as simply a rise in their living costs, rather than a faster trend in both wages and prices.

The work presented today, while preliminary, appears to leave the current 2% inflation targeting regime (IT) (which doesn't explicitly pledge for inflation to run above target if it's had a period below 2%) and an inflation averaging (IA) approach (which makes up for such inflation divergencies, but not fully if they extend for a long period) as the options with the early lead in the Bank's staff research. But the gaps in performance are small in simulations using the Bank's forecasting model, and IA only has an edge over IT if the Bank believes that alternative tools like QE can't provide as much stimulus as they need when rates are already at 0.25%.

One twist is that, as we wrote in the Week Ahead, the Bank of Canada's behavior under what it calls "flexible inflation targeting" often ends up looking like it was already using a version of IA. That is, when there are large shocks that leave significant output gaps (and thus periods of below 2% inflation), the Bank is more willing to ignore overshoots of 2% inflation if they feel the output gap isn't tight enough to sustain them. As well, because the Bank looks through some temporary shocks to CPI inflation from volatile items like oil, we observe that undershoots of 2% inflation are indeed followed by overshoots.

More recently, the BoC's pledge that they won't raise rates until inflation is sustainably at 2% would imply that, given the lags in monetary policy, the subsequent rate hikes could come too late to prevent a temporary overshoot of 2%. In effect, perhaps this "conditional commitment", which is one of the other tools that can be deployed when rates are at their lower bound, can be used to temporarily impose IA when it really matters, after large economic shocks in which its better if markets can be convinced that short rates will stay low for long. A prominent academic economist speaking at today's conference (Pierre Fortin), explicitly argued for such temporary uses of AI, while retaining the current IT as the general policy rule outside these extreme times.

For investors, these discussions should have no bearing on inflation or interest rate projections for the next two years or so. If the Bank makes a change, its likely to only be meaningful further into the recovery, in 2023 and beyond. Our view is that the Bank's current messaging already includes room for inflation to overshoot a bit in 2023, so putting that explicitly into a different policy framework would be neither necessary, nor meaningful for our inflation or policy interest rate outlooks.