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MONETARY POLICY

Room for Manoeuvre – Monetary Policy Over the Next Eighteen Months, and the Allure of Price-Level Targeting

By
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- Moving to price-level targeting from inflation-rate targeting could be an interesting option for the Bank of Canada after 2011, when its current agreement with the Minister of Finance is up for renewal.
- The viability of that option rests on whether the Bank can maintain its credibility in monetary matters over the coming months, as it handles a pressing task – striking a balance between providing support to the still fragile economic recovery, and avoiding a resurgence of inflation above its 2 percent inflation target.
- Further complicating the situation, speculative exchange rate appreciation that depressed output and prevented inflation from moving back to its 2 percent target could create pressure to replace the current regime with one focused on the exchange rate. Easier monetary policies aimed at avoiding such an appreciation, however, could provoke above-target inflation – and damage the Bank's credibility.
- Intriguingly, there would be more room for manoeuvre over the next 18 months if the Bank was already targeting the price level rather than the inflation rate.

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Among the more interesting proposals for Canadian monetary policy after 2011, when the Bank of Canada's current inflation-control agreement with the Minister of Finance expires, is a target for the time path of the price level itself, rather than the inflation rate.[1] More urgently however, the Bank must achieve a delicate balance as it tries to spur a still tentative recovery while avoiding excessive inflation next year. These two seemingly unrelated issues, one strategic and the other tactical, are linked. The chances of getting a satisfactory regime in place post-2011 will be enhanced by maintaining the right monetary policy balance over the next 18 months. Intriguingly, this would be much easier were price-level targeting already in place.

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1 An inflation targeting regime treats past deviations from the target as bygones; a price-level targeting regime takes them into account. For examples of price-level targeting regime proposals, see: Robson, William B.P. *To the Next Level: From Gold Standard to Inflation Targets – to Price Stability?* C.D. Howe Institute, Commentary No. 285, March 2009 and Parkin, Michael, *What is the Ideal Monetary Policy Regime? Improving the Bank of Canada's Inflation-targeting Program.* C.D. Howe Institute, Commentary No. 279, January 2009. The Bank of Canada has hinted that it is at least considering the adoption of a price-level targeting regime. For example, in a speech at a symposium sponsored by the Federal Reserve Bank of Kansas City, the governor of the Bank stated that, coupled with a financial stability objective, "[t]he discipline of a transparent and accountable price stability objective via the price-level target could maintain central bank credibility." (See Carney, Mark "Some Considerations on Using Monetary Policy to Stabilize Economic Activity." Remarks to a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 22 August 2009.)

Negotiating the 2011 Monetary Policy Agreement

Bank of Canada policies are not completely independent of politics, not least because its Governor is required by law to consult about its policies with the Minister of Finance. Since 1991, however, a series of inflation reduction and control agreements have defined the policy goals that frame such consultations, and have perhaps made it easier for successive Governors to resist short-term pressures arising from everyday politics as the Bank makes its interest rate decisions.

The current agreement, however, expires in 2011, and a new one must be negotiated, so the degree to which it protects the Bank's tactical independence is diminishing. To ensure that price-level behaviour remains at the heart of the Bank's assigned goals after 2011, the Bank must be particularly careful to avoid outcomes in the next 18 months that would discredit its strategy. A "double dip" recession, or even just a serious slowdown, later this year brought on by a run-up of the exchange rate ahead of fundamentals could cause the public to lose confidence in this overall approach to monetary policy, as could a surge of inflation in 2011 noticeably above the current 2 percent target. The margin between these two outcomes is disturbingly narrow.

A serious policy slip-up in 2010 could shift the 2011 debate away from a straightforward choice between inflation and price-level targets, towards the merits of adding exchange rate, employment and/or financial stability goals to the Bank of Canada's agenda. Even a political decision to do without a formal agreement after the current one expires is not beyond the bounds of possibility.

The Exchange Rate in the Current Policy Nexus

In the context of the current monetary policy agreement, and under normal circumstances, the Bank of Canada focuses on controlling domestic inflation and lets the exchange rate look after itself. However, circumstances in the foreign exchange market are becoming increasingly abnormal, and there is a real danger that major countries are now beginning to "compete to weaken their currencies," as the *Economist* recently put it.[2]

The US dollar, the yen and sterling all have their own well-known problems, and the Chinese authorities continue to resist an appreciation of the yuan. Until recently, it seemed that the euro would absorb much of the strain, but this suddenly seems less likely. The emerging fiscal problems of Greece, Spain, Portugal, Italy and Ireland, and the resulting political tensions within the euro-zone as a whole are unlikely to be resolved quickly, even if the euro-system does turn out to be resilient enough to cope with them in the long run.

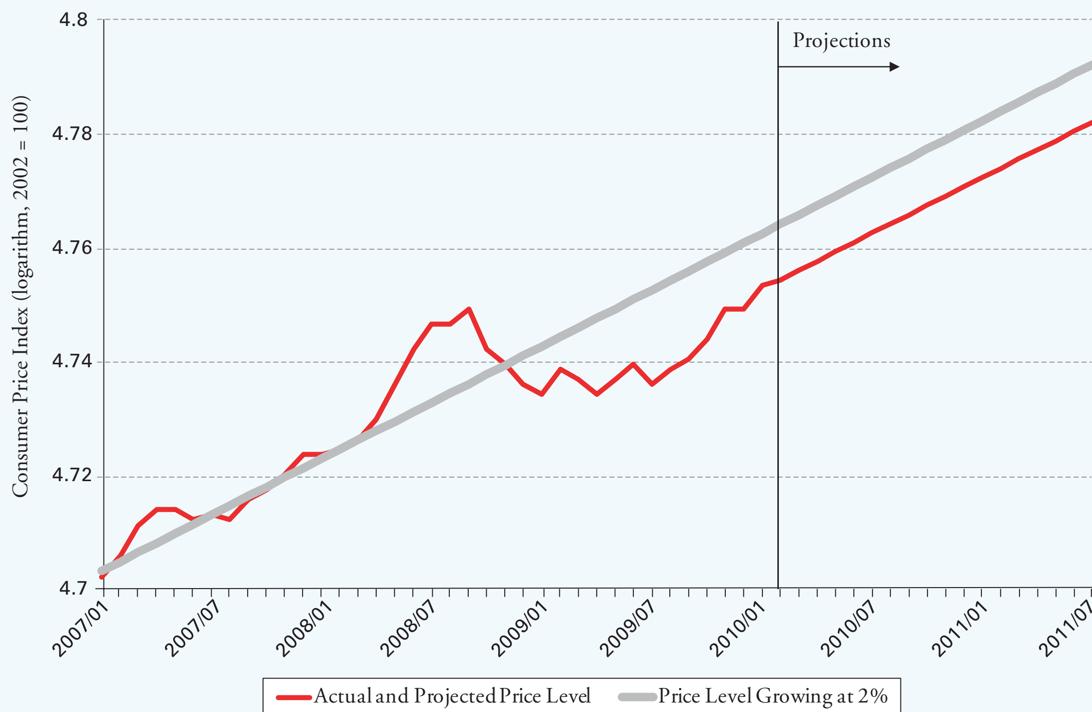
These developments, coupled with supportive influences from commodity prices, not to mention Canada's own relatively healthy fiscal outlook, all strengthen the fundamentals underpinning the Canadian dollar, and account for its recent appreciation. But exchange rates notoriously move ahead of fundamentals and can attract speculation, so the Bank of Canada must take particular care to avoid measures that inadvertently provoke a surge that takes the dollar to a range that brings the current recovery to a halt. Economically undesirable in itself, such an outcome would also delay the return of the inflation rate to its 2 percent target, weaken the current regime's credibility and create scope for a resurgence of those political pressures that are always present in Canada to replace domestic price level goals with a US dollar exchange rate target of some sort.[3]

With the future stability of the US fiscal balance, and therefore of its monetary system, now in more serious question than it has been since the 1970s, this would be a particularly unwise policy choice for Canada to make right now, but it could nevertheless become an attractive option for politicians who must always be concerned with their own immediate electability. Here, moreover, it is worth recalling that the *Bank of Canada Act* designates the Bank as the Minister of Finance's agent in the foreign exchange market, not as an independent decision maker, and that the Bank's current ability to leave the exchange rate to its own devices stems in good measure from the very inflation-control agreement that will expire next year, and which would also stand discredited in the wake of an appreciation induced downturn.

2 See "Race to the Bottom." *Economist*, March 4, 2010.

3 For a recent proposal along these lines, see Konrad Yakabuski "Putting to rest a too vigorous bird." *Globe and Mai*l, October 23rd, 2009.

Figure 1: Actual and Projected Price Level Compared to Price Level Growing at 2 Percent (Seasonally adjusted in logarithms)



Note: The projections are a simple linear interpolation between the latest CPI data and the Bank of Canada current forecast of CPI returning to 2 percent in the third quarter of 2011. The price levels are presented on a log scale to ensure that constant percentage changes appear as a straight line.

Source: Statistics Canada.

But if the Bank must steer clear of such an outcome, it must also take care not to generate a surge of inflation as it does so, something made more difficult by the desirability of following through on the conditional commitment made in April 2009 to keep interest rates down until the second half of 2010. It is beginning to look like the forecasts for growth, employment and inflation that were in place when this commitment was made were on the low side, but not by enough for the Bank to be able to change course without damage to its credibility. When the Bank's undertaking expires in mid-2010, therefore, domestic considerations considered in isolation will likely be calling for a fairly sharp increase in interest rates to avoid an upsurge of inflation in 2011.[4] There is a real possibility, however, that this move would spark the above-mentioned speculative run-up in the exchange rate.

The Time-path of the Price Level as a Policy Target

Specific advice to Governor Carney and his Governing Council as they navigate between these contradictory forces for the balance of 2010 will depend in large part on economic indicators not yet seen. However, it is worth pointing out that their problems would be a great deal less acute had a price-level targeting regime been put in place in late 2006, at the time of the last agreement.

Figure 1 tells the story. It is constructed on the counterfactual assumption that after 2006 the Bank of Canada was expected to aim for a time path for the price level that saw it growing at 2 percent per annum from its average value

4 Michael Parkin gives a forceful statement of this viewpoint in a recent C. D. Howe Institute e-brief. See Parkin, Michael. "How Soon? How Fast? Interest Rates and other Monetary Policy Decisions in 2010." February 23, 2010.

for 2006.[5] It shows that, with the onset of recession in 2008, the CPI fell below this growth path, and that on current forecasts (which admittedly look likely to be revised upwards) it will cease falling further below this growth path only at the end of the second quarter of 2011, when the Bank expects the inflation rate to return to 2 percent.[6]

At present, of course, the Bank is required to target a 2 percent inflation rate, not the price level, so it cannot be expected deliberately to aim to bring prices back up to the trend path used in Figure 1. Were it now targeting that time path, however, in order to maintain its credibility, the Bank would have to aim for a short-term rate of inflation close to 2.5 per cent for two full years – closer to 3 per cent to get back on track in a single year – and in doing so it would also reduce those down-side risks to the economy presented by the foreign exchange market.

Furthermore, such policies would produce outcomes for private-sector decisions made before the recent recession that would be consistent with inflationary expectations at that time – hardly an undesirable result. The costs of the upside inflation risks that inform current policy discussion are thus largely associated with the Bank of Canada's need to maintain its own credibility in the context of the actual inflation targeting regime to which it committed itself in 2006, and to this extent are artifacts of that regime.

Concluding Comment

The considerations discussed above cannot, considered in isolation, make the case for price-level targeting as a regime superior to inflation targeting. Distributional and financial-market stability issues must be considered in any choice here, as must questions about situations where the price level was initially pushed significantly above rather than below its designated path. Even so, they strengthen its claims to be taken seriously as an option for policy post-2011, always provided that monetary policy in the meanwhile preserves an environment in which such a choice remains politically possible.

5 We have also considered the consequences of starting a 2 percent time path at the beginning of 2007, and using the 2005-2006 average value of the CPI starting at the beginning of 2006. Our conclusions are not very sensitive to these variations. Note, however, that as the starting point for this counterfactual experiment is pushed further back in time, the more sensitive does its outcome become to the particular date chosen – hardly surprising given that the actual data were generated under an inflation targeting regime that treats shocks to the price level itself as bygones.

6 Bank of Canada, "Monetary Policy Report," January 2010.

This *e-brief* is a publication of the C.D. Howe Institute.
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