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Rethink

inflation

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Whether you know it or not, one of the most important numbers in your life is two, as in two per cent.

Two per cent is the rate of annual inflation that one of the country's most powerful institutions, the **Bank of Canada**, uses to guide its decisions. As far as the central bank is concerned, the economy works best when the cost of the food you eat, the clothes you wear and the rent you pay increase at a pace of about two per cent every year.

The cost of your commute, the booze you drink, the pot you smoke: yes, two per cent. Maybe the price of gasoline spikes five per cent, while potatoes are up by only 1.5 per cent. But the **Bank of Canada** will tolerate those sorts of product-specific rises and falls, as long as **Statistics Canada's** Consumer Price Index, which combines the cost of about 700 goods and services, settles at an increase of two per cent compared with a year earlier.

If it doesn't, the **Bank of Canada** will raise or lower interest rates to whatever level it deems necessary to hit the bull's-eye. Tiff Macklem, in his first speech as central bank governor, said low, stable and predictable inflation "is the best contribution we can make to **Canada's** economic welfare."

See TWO PER CENT on FP2 This is inflation targeting, the guiding light of central banking for the past three decades. And the **Bank of Canada's** benchmark inflation-altering interest rate eventually finds its way to you through the rates commercial banks offer businesses and consumers. The current setting is 0.25 per cent, matching the lowest rate ever, reflecting the **Bank of Canada's** worry that the COVID-19-caused recession could send prices and wages into a tailspin.

Most experts think two per cent has worked out pretty well for **Canada**. Businesses and employees have a ballpark idea of where wages should be, consumers aren't gobsmacked by price increases and investors can be confident their money won't become worth a fraction of what it was overnight. The **Canadian** economy has also grown at a steady clip, albeit maybe an unimpressive one.

"The fact that we have a clear and simple framework is golden," Carolyn Wilkins, the **Bank of Canada's** senior deputy governor, said at a conference on Wednesday.

Yet it took a lot of trial and error - as well as annual inflation that spiked more than 12 per cent in 1981 - before the **Bank of Canada** began targeting inflation in 1991. In doing so, the bank, which opened its doors during the Great Depression, became one of the first central banks to make inflation targeting a pillar of its monetary policy.

Now, every five years, the **Bank of Canada's** governor and the federal finance minister agree on a mandate, and then the government essentially leaves the central bank alone to complete its mission. Essentially, officials have since 1991 believed that aiming for two-percent inflation, the middle-ground of a target range between one per cent and three per cent, was the way to go. Agreements struck between the central bank and the government in 1993, 1998, 2001, 2006, 2011 and 2016 basically came to the same conclusion: two per cent.

But **Canada's** central bank is currently in the middle of its next mandate review, and for the first time since the two-per-cent target was adopted, there are obvious cracks in the consensus.

In May 2018, 61 **Canadian** economists signed a letter to former finance minister **Bill Morneau** requesting the **Bank of Canada** consider not just inflation, but also full employment - the point at which anyone who wants a job can find one - in making interest-rate decisions.

Such pressure hasn't gone away. In March, Quebec Senator **Diane Bellemare** sought to have the **Senate's** banking committee study adding the pursuit of full employment to the central bank's mandate of price stability, which would make that mandate a dual one.

"The challenges that the **Bank of Canada** is facing today are very different from those of the last century," Bellemare said.

It's true that inflation has been pretty stable, and interest rates have also been stuck at unusually low levels for more than a decade, stoking asset-price bubbles in stocks and real estate that have caused concern and helped widen the gap between the richest and everyone else.

"By having well-anchored inflation, we've had a massive decline in nominal rates," said Charles St-Arnaud, chief economist at Alberta Central, the province's central-banking facility and trade association for the credit unions. "And in some ways, that has been fuelling the debt bubble we've been seeing over the past 20 years."

Central bankers counter that things would be much worse if they hadn't slashed interest rates, but increased fragility is a side-effect of their efforts.

In addition, the coronavirus pandemic struck at a time of already-low borrowing costs, forcing the **Bank of Canada** and others to engage in massive bond-buying to help governments, companies and the financial system stay afloat.

With another agreement on the **Canadian** central bank's approach to monetary policy needing to be struck by next year, the question of whether we should try something different looms larger and larger.

"I think the debate that we should be having in the next, let's say, year, is ... what should the bank be targeting?" said Chris Ragan, an economist and director of the Max Bell School of Public Policy at Montreal's Mc-Gill University. "Should it be targeting high or low inflation? Should it have a dual mandate? What should it be doing? And I think we need a better debate on these options."

The **Bank of Canada** is trying to stir some debate with public consultations and by running a "horse race" that looks at alternatives to its current approach to monetary policy, including the dual mandate demanded by some of its critics.

Some of the other alternatives include trying to achieve an average inflation rate over several years, setting the current target higher, and attempting to achieve a specific increase in nominal gross domestic product - the value of all the goods and services produced in **Canada** at current prices.

"We saw that none of the frameworks that we looked at dominate across all the criteria that we brought to bear," Wilkins said on Wednesday.

"However, some do much better than inflation targeting in some circumstances."

Even so, it already looks like it is going to take a pretty convincing case to get the **Bank of Canada** and the federal government to budge on two per cent.

Following the 2016 review, the bank found that a higher target "may yield modest and largely episodic improvements in macroeconomic performance," but that moving to a new target could risk "the hard-won credibility that has underpinned the success" of **Canadian** inflation targeting.

Both the previous governor and the current one were also responsible for some of the seminal research that led to the inflation target when they were researchers at the **Bank of Canada** in the 1980s, suggesting some institutional attachment to it.

"There are many prominent academic economists who favour a higher inflation target," Avery Shenfeld, chief economist at CIBC Capital Markets, said in a note, "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 current framework has been delivering stability as well. From the start of 2010 to the end of 2019, the 12-month growth rate for the total consumer price index never went above 3.7 per cent or below 0.4 per cent in any given month. That has made double-digit interest rates to contain hyper-inflation a thing of the past. Moreover, the **Canadian** economy is still in one piece, even after a global financial crisis and in the midst of a pandemic.

"The bar for changing the mandate has to be pretty high because I think it's been pretty successful over the last 30 years," Jeremy Kronick, associate director of research at the C.D.

Howe Institute, said. "And I'm not sure that this COVID crisis changes that."

Canada could still find inspiration abroad. On Thursday, the U.S. Federal Reserve, which caught up with most other major central banks in 2012 by adopting an annual two-per-cent inflation target, announced it will now aim to achieve inflation that averages two per cent "over time."

New Zealand, the first country to formally embrace inflation targeting, could bolster the case for another route as well. The country in 2019 added "supporting maximum sustainable employment" to the Reserve Bank of New Zealand's chief economic objectives, joining the Fed as one of the few central banks that takes responsibility for more than price stability.

Considering Prime Minister **Justin Trudeau** and New Zealand Prime Minister Jacinda Ardern have favoured similar policies in the past, a **Bank of Canada** dual employment-inflation mandate might not be a stretch. The **Bank of Canada** does the research on the best way to conduct monetary policy, but the government has the final say.

Yet there are early indications from the bank itself that the two-per-cent target remains the gold standard, although, perhaps, there may be some room for improvement.

"I don't think we should expect meaningful change," said Alberta Central's St-Arnaud, a former **Bank of Canada** economist. "At this point, it's more, can we improve on what we have to make it even better, and maybe also address some of the unintended consequences so that we don't get there again."

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