Economic News
Desjardins Economic Studies
www.desjardins.com/economics
March 9, 2015

CANADA

The Bank of Canada considers raising its inflation target

A key component of Canadian monetary policy, the 2% inflation target, and its associated range of ±1%, is reassessed on a regular basis. In November 2011, that target was extended to the fall of 2016, but this does not prevent the Bank of Canada (BoC) from initiating deliberations about the matter now. In a speech given last November, the Deputy Governor, Agathe Côté, mentioned that the experience that has been acquired recently, and some research, suggest that consideration should be given to an inflation target that is above 2%.[1] Stephen Poloz reiterated that possibility at the end of February.[2] This is a 180-degree turnaround for the BoC, which had adopted the habit of entertaining the possibility of lowering the inflation target, or of adopting a price target regime.

It is generally accepted that low inflation is also more stable, which generates less uncertainty and lower costs for the economy, besides further limiting the erosion of purchasing power. But there are arguments against too low an inflation target, the main one being the zero lower bound of interest rates. A central bank cannot very well set its key interest rates below zero, and this can prevent it from giving sufficient stimulus to the economy. A higher inflation target would get around this problem by lowering the zero lower bound for real interest rates. Keep in mind here that real interest rates are defined as nominal interest rates less expected inflation. If the monetary policy is credible, expected inflation will be equal to the inflation target.

Using unconventional monetary tools, such as massive asset purchases, is another way to get around the problem of the zero lower bound. However, doubts remain about their effectiveness. While they can generate many benefits, significant costs are also associated with them.

Prior to the 2008–2009 financial crisis, the risk of reaching the zero lower bound was deemed to be very low. This is less true today, especially since the neutral interest rate seems to have dropped considerably. The neutral interest rate is the level that the main key interest rate should reach when the economy and inflation are at equilibrium. The decline in the potential for economic growth, the consolidation of public finances and some external factors account for the drop in the neutral interest rate. The BoC estimates that the real neutral interest rate now lies between 1% and 2%, whereas it was between 2.50% and 3.50% ten years ago. By raising the inflation target, the rise in expectations would take the nominal neutral interest rate close to past levels. This is a matter of a spread of around 1.50%, and the inflation target could be raised to 3.50%.

BoC officials insist that the bar is very high for changing the target. The advantages would have to clearly outweigh the costs, to avoid the risk of having to make readjustments later on. Under the circumstances, it would be surprising for the adjustment to be 1.50%, especially since the Canadian target would become the highest of all the advanced countries. Australia, Norway and Iceland are at the head of the pack with a target of 2.50% or a range around that level.

Implications: It is probably too early to believe on the inflation target being raised in Canada. However, the issue is likely to become more important between now and the end of 2016. The implications for the markets could be vast. In particular, short-term yields could fall in anticipation of less monetary tightening in the short term, but long-term yields would eventually move up to reflect expectations of higher inflation. The Canadian dollar could also be penalized, considering that its relative purchasing power would diminish if inflation were higher in Canada.

Hendrix Vachon
Senior Economist

[1] Speech given on November 18, 2014 by the BoC's Deputy Governor, Agathe Côté, before the CFA Society Calgary in Alberta, "Inflation Targeting in the Post-Crisis Era," www.bankofcanada.ca/2014/11/inflation-targeting-post-crisis-era/.

[2] Speech given on February 24, 2015 by the Governor of the BoC, Stephen S. Poloz, at the University of Western Ontario, "Lessons New and Old: Reinventing Central Banking," www.bankofcanada.ca/2015/02/lessons-new-old-reinventing-central-banking/.

François Dupuis
Vice-President and Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Mathieu D'Anjou Senior Economist
Benoit P. Durocher Senior Economist
Francis Généreux Senior Economist
Jimmy Jean Senior Economist
Hendrix Vachon Senior Economist