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Inflation targeting in Canada: Experience and lessons

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Abstract

In 1991, the Canadian government and the Bank of Canada agreed on targets for inflation reduction. The major lesson that we at the Bank of Canada draw from our experience with inflation control since then is related to the advantages of establishing a credible anchor for monetary policy by focusing on the predictability of inflation. Overall, it became increasingly evident through the last decade that the inflation target deals with expectational problems. It promotes a much greater degree of confidence and understanding than monetary targets or a vaguely expressed desire for price stability ever did.
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1. Introduction

In the 1970s and 1980s Canada found—in common with many other countries—that high and variable rates of inflation created a lot of economic damage. And it took a long time and a lot of work with various monetary policy frameworks before we got back on track (Fig. 1). I would point to two particular sets of arrangements for policy during that time that were both designed to lead to low inflation rates.

The first was monetary targeting—specifically, targeting the narrow monetary aggregate M1, beginning in 1975. A close relationship between M1 growth and inflation held only over very long periods of time. Moreover, this relationship was subject to sizable downward shifts in the demand for money. Such shifts did indeed occur. Thus, after a period of disinflation between 1975 and 1978, inflation picked up again in 1979–1982 despite the achievement of the

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Fig. 1. Consumer price index.

M1 target (Fig. 2).[1] Because of the lack of success in bringing down inflation, this approach to monetary policy was unable to build confidence and understanding on the part of the public.

The second policy approach took place from 1982 to 1990, a period in which there was no clear monetary policy target. Rather, there was only a desire to bring inflation down and (particularly after 1987–1988) to approach "price stability." After the disinflation of 1982–1984, there was no further progress in reducing inflation. And with no explicit target, there was still little understanding of monetary policy and no focus for inflation expectations.[2]

The economic boom at the end of the 1980s, together with an oil-price shock and the introduction of the goods and services tax, led to fears that inflation would again escalate and stay high. It was against this background that, in 1991, the Canadian government and the Bank of Canada agreed on targets for inflation reduction. Canada was the second country, after New Zealand, to set out formal, medium-term inflation targets.

2. The Canadian experience: agreeing on a target

I would now like to turn to the question of how we adopted inflation targets in the first place. The Bank of Canada operates under the Bank of Canada Act. The preamble to the act notes that the central bank is established "to control and protect the external value of the national

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