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COMMENTARY

MONETARY POLICY

Precision Targeting:

The Economics – and Politics – of Improving Canada's Inflation-Targeting Framework

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In this issue...

The lasting economic benefits from a coherent package of policy changes would overcome the obstacles posed by short-term political considerations.

The Study in Brief

The Author of This Issue

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The Bank of Canada's inflation-targeting framework, since its inception in 1991, has proven itself a success. Yet further improvements in the system should be considered seriously for inclusion in a renewed monetary policy agreement, between the Bank of Canada and the federal government, and renewal is due in 2011.

Some improvements would deliver genuine economic benefits to millions of Canadians over the years ahead. Lowering the target rate for consumer price inflation in particular would help secure the domestic purchasing power of our financial assets. Such a change, however, should be part of a coherent framework, which addresses financial stability goals and political imperatives.

This *Commentary* proposes the following five-part policy package:

- The federal government should devote the necessary financial resources to Statistics Canada so that it can eliminate the most significant biases in the CPI over the course of the next few years.
- The Bank of Canada's formal inflation target should be reduced to 1 percent, perhaps gradually over the course of the new agreement.
- The federal government should announce its intention to indemnify the Bank of Canada against possible financial losses brought about through changes in the value of government bonds purchased during (possible future) episodes of quantitative easing.
- The new inflation-targeting agreement should mention explicitly the importance of financial stability, and that the Bank henceforth will take financial stability into consideration when conducting its monetary policy decisions.
- The federal government should direct the Ministry of Finance, the Bank of Canada, the Office of the Superintendent of Financial Institutions, and other relevant parties to ensure that, among them, they have the appropriate regulatory and oversight mechanisms in place, and responsibilities for actions clearly assigned, so that policy henceforth might be properly informed by concerns of financial stability.

Political arguments, or inertia, might stand in the way of adopting these policy changes, but their potential economic gains are significant enough for the country as a whole that they should be pursued. The economic benefits would extend far into the future, and would apply to current as well as future generations; in contrast, the political obstacles are one-time difficulties that would be forgotten soon after they were surmounted.

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The existing inflation-targeting agreement between the Bank of Canada and the government of Canada will expire this year, and a new agreement for 2012 and beyond will soon be needed. Both parties must think carefully about this renewal, and fully explore the costs and benefits of modifying the agreement. Solid economic arguments exist for making changes that could generate modest benefits to millions of Canadians over the coming years. But equally solid "political economy" arguments exist for maintaining the status quo, not the least being that the current system has been very successful for almost 20 years.

This *Commentary* has two purposes. The first is to outline four ways that Canadian monetary policy could be improved. These include switching from inflation targeting to price-level targeting; reducing the Bank of Canada's current inflation target; correcting the existing bias in measured inflation; and placing greater emphasis on financial stability. The second purpose is to outline reasons the federal government, as represented by the minister of finance, might see a strong case for renewing the inflation-targeting agreement in its current form. The point is not to advocate the status quo; rather, it is to understand the nature of such arguments and to recognize the obstacles for those who advocate changing the existing regime.

I thus confront traditional economic arguments with broader but more nebulous ones based on political economy. Those who would modify the current regime on the grounds that economic improvements are possible need to think carefully about how to communicate these economic benefits to a minister and government likely to see the advantages of maintaining a system that is in no obvious need of repair. In politics as in physics, inertia is a powerful force.

The *Commentary* is organized as follows. It begins by briefly describing Canada's 20-year experience with inflation targeting, with a slight emphasis on the past few years of financial crisis and recession. Then it describes possible improvements for Canadian monetary policy, and explains the nature of the benefits and the conditions under which they are likely to exist. In the the following section, the discussion turn away from economics and focuses more on political economy, and examines the obstacles likely to exist for each of the proposed improvements.

Finally, the paper recommends a coherent package of policy changes predicated on the belief that the economic benefits from these changes would be sufficient to justify overcoming the obstacles posed by political economy. If the Bank of Canada decides to recommend these or other policy changes, it will need to convince the minister and the government that the expected economic gains are indeed large enough to warrant the change in policy. This might prove to be a difficult task.

Canadian Inflation Targeting since 1991

Others have provided excellent reviews of monetary policy in Canada (see, for example, Laidler and Robson 1994, 2004; Crow 2009b; and Robson 2009), so a detailed treatment here is unnecessary. But it is clear that the adoption of inflation targeting in 1991 has been a significant policy success. The early years witnessed a notable evolution of policy, with focus on both implementation and communication. Perhaps the most visible changes that took place during this period were the Bank of Canada's emphasis on the target for the overnight interest rate as its primary

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instrument, its establishing of eight fixed announcement dates (FADs) per year regarding interest rates policy decisions, the regular publication of the *Monetary Policy Report*, and the increase in the number of speeches by the Bank's governor and deputy governors. As the years passed and the policy regime matured, it also became increasingly clear that *expectations* of inflation play a crucial role, and that a large part of the success of monetary policy relates to how well expectations can be influenced, not only by what the Bank says but, more important, by how the Bank acts. As for performance, the Bank certainly delivered on its commitments. Between 1991 and 2007, the average rate of inflation was remarkably close to 2 percent, though there were brief periods when inflation strayed noticeably from the Bank's formal 2 percent target (Melino 2011).

If the experience of the 1991-2007 period suggests a fully mature and well-functioning policy regime, events since then reveal that regime's resilience. When the global financial system began to show its strains in summer 2007 and these strains eventually revealed deep and systemic problems, the Bank of Canada was able to respond effectively by increasing the liquidity available to financial institutions, reducing the fears of counterparty risk, and maintaining the flow of credit.

By fall 2008, global financial markets were in full crisis. Even though the epicentre of the crisis was not in Canada, the globalization of financial markets assured that Canada would experience significant tremors. Well-anchored inflation expectations, together with the Bank of Canada's long-established credibility in returning inflation to target, permitted the Bank to respond aggressively by sharply cutting its target for the overnight interest rate. By spring 2009, with its policy rate at its effective lower bound, the Bank was on the verge of implementing quantitative easing and perhaps even credit easing. The US Federal Reserve and the Bank of England had already taken these steps, but the economic situation in Canada was then less dire. Though the Bank explained the potential need for these policies in its April 2009 *Monetary Policy Report*, they were never implemented. Instead, the Bank tried something less dramatic but no less innovative: it issued a commitment to hold its policy rate at its effective lower bound until summer 2010, conditional on the outlook for inflation. The payoff appeared almost immediately in the form of a reduction in long-term interest rates (He 2010).

The economic events of the past few years have brought to the fore the issue of "financial stability." The nature of the financial crisis – including low capital levels, highly leveraged financial institutions, the questionable transparency of some financial transactions and instruments, the collapse of storied institutions, and huge government clean-up policies – has led to the widespread recognition of the need for better "macro-prudential" behaviour by financial institutions. The conventional view holds that existing "micro-prudential" regulations are mostly acceptable. In contrast, an important lesson from the financial crisis is that we need to place much more emphasis on the interconnected nature of financial institutions within an overall financial system. The goal is to design regulations that encourage behaviour less likely to lead to the collapse of individual institutions, and especially less likely to lead to systemic problems in the face of the occasional individual collapses that are inevitable in a dynamic market economy.

Within the G20 countries, there is much debate about the nature of macro-prudential regulation, including which regulations should be changed and how. The Basel Committee on Banking Supervision is hard at this task, and recently came out with some recommendations on capital adequacy and liquidity standards (TD Economics 2010). The G20 countries endorsed these recommendations at the Seoul Summit, and will implement agreed-upon changes gradually over the coming decade. Beyond the specific regulatory changes, there is also a legitimate debate about which governmental institutions are best positioned to provide the necessary oversight of the financial system (Masson and Pattison 2009). The precise role that central banks will or should play in providing this greater oversight is not yet clear. I return to this important issue later in the *Commentary*.

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Looking back on the period since 1991, and especially the past few years, it is difficult not to be impressed with Canadian monetary policy and the people charged with making it work. For almost 20 years, in the face of shocks from various sources, the Bank of Canada has upheld its commitment to keep inflation low and stable. Even the dramatic events of the past few years have not revealed the Bank to be lacking in any substantive way, either with an insufficient ability to analyze and respond to unfolding events or with insufficient command over institutional arrangements to make its policy actions effective. Some important issues regarding macro-prudential regulation are yet to be settled, but this in no way lessens the Bank's tremendous policy success since 1991.

Improving Canada's Inflation-Targeting Regime

Despite this success, we should not be blind to the possibility of further improvement; but we also need to admit that policy changes should not be undertaken lightly. As Bank of Canada Deputy Governor John Murray has written, the present system "has shown its worth in both turbulent and tranquil times. This represents a relatively high bar against which any future changes must be judged" (2010).

In what follows, it is useful to distinguish between "objective" changes and "implementation" changes. The former involves changes to the Bank's formal, written objective – specifically, to its *precise policy target*; the latter involves changes in the way the Bank behaves in order to achieve its policy target. I focus here only on potential changes to the Bank's objective, as I assume that the details of implementation would be left to the Bank to determine.

Consider four potential improvements to Canadian monetary policy. First, the policy target might be adjusted in a way that better preserves the long-run value of money – which means reducing the long-run increase in the price level. This goal could be pursued by adopting price-level targeting or by reducing the inflation target. Either option could achieve the goal as long as the target path for the price level was chosen to rise more slowly than the current rate of 2 percent. The important differences between these two options relate to stabilization and communication, which I examine below.

A second general improvement to monetary policy would be to enhance its output-stabilizing properties. Given the existing literature (thoroughly reviewed by Ambler 2009), this goal might be achieved by the adoption of price-level targeting – "might" because the benefits of greater stabilization rely on the satisfying of some important conditions.

Monetary policy could also be improved by removing the existing bias in the construction of the consumer price index (CPI). While such a correction would not imply much of a change for the basic implementation of monetary policy, the result would be a greater alignment between the Bank's formal target and the growth path of the genuine cost of living. However, correcting the bias in the CPI would have important implications for the agreed-upon inflation target.

Finally, monetary policy could be improved by ensuring that the Bank increases its focus on financial stability. There are three general options. First, the Bank could establish formal targets for selected financial variables, such as asset prices or stocks of money or flows of credit. Second, the Bank's formal role in the regulation and oversight of financial institutions could be increased. Third, the Bank could become more aggressive in adjusting its key policy instrument to offset evolving financial excesses. This last issue, which White (2009) describes as the choice between "leaning" and "cleaning," is of tremendous importance – but it is really more about the implementation of monetary policy than about the Bank's formal objective.

Given these four general improvements in monetary policy, and the various specific policy adjustments that could deliver them, my comments in this section are divided into four areas: adopting price-level targeting, reducing the inflation target, removing the bias in the CPI, and enhancing financial stability.

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Adopting Price-Level Targeting

An undisputed benefit of price-level targeting (as compared to inflation targeting) is that it reduces uncertainty about the long-run price level and thus reduces uncertainty about the long-run value of money. The key distinguishing feature of price-level targeting is that shocks pushing the price level off its intended growth path must be recouped, meaning that a temporary rise in inflation above 2 percent must at some point be offset by future inflation of less than 2 percent.[1] In contrast, with inflation targeting, the same positive inflation shock is subsequently reversed, but not recouped: for the price level, bygones are bygones. As a result, the long-run variability of the price level is higher in a world of inflation targeting than in a world of price-level targeting.

This greater long-run certainty in the price level would be of no great benefit for those lucky people whose incomes are completely indexed to inflation. But most of us live in a world with incomplete indexation and with institutional arrangements where changes in nominal values have real effects. And with the aging of the baby-boom generation, the fraction of the population living with incomplete indexation is likely to rise. The long-run preservation of the value of money thus will become increasingly important to Canadians over the next few decades.

A consensus is also emerging that price-level targeting might be superior to inflation targeting for the stabilization of output. The traditional view of price-level targeting was that the need to recoup inflation shocks by sharply pulling the price level back to its target path inevitably would lead to greater volatility in real output. A more modern view – starting with Svensson (1999) and Dittmar and Gavin (2000) – emphasizes the importance of forward-looking expectations and how these imply that price-level targeting actually can enhance output stability. The intuition is straightforward. Following a positive demand shock that pushes inflation above 2 percent, agents know that the central bank will be obliged to reduce inflation to below 2 percent at some point in the near future. As a result, inflation expectations will actually *fall* in the face of the positive inflation shock. For any given nominal interest rate, the reduction in inflation expectations raises the real interest rate and thus enhances the tightening by the central bank. Real gross domestic output is thus more stable than in the world of inflation targeting.

This striking result relies on two key assumptions. First, consumers, workers, and firms need to understand the difference between the *price level* and the *rate of inflation*. Yet any truly economically literate person who reads the press or listens to the nightly news knows that these two concepts are often confused, and far too often by people who really should know the difference. The second key assumption is that inflation expectations are forward looking. In general terms this seems quite tenable, but in this particular case it means that people need to understand fully the "recouping" aspect of price-level targeting – that inflation above 2 percent today must imply inflation below 2 percent at some future point. This might seem a little bizarre to people who have become comfortable with the idea that the Bank of Canada always tries to return the rate of inflation to its unchanging 2 percent target. The challenge of explaining a regime of price-level targeting should not be overlooked.

If price-level targeting is not fully understood by the private sector, the short-run gains of greater stabilization are likely to disappear. Recent research by Kryvstov, Shukayev, and Ueberfeldt (2008) suggests that, if private expectations do not match reality when the central bank switches from inflation targeting to price-level targeting, the stability-enhancing properties of the regime are reduced and some transitional costs are created. The same research suggests that these transitional costs might never be offset fully by the long-run benefits (Parkin 2009).

1 This recouping of shocks would be symmetric, so that a temporary fall in inflation to below 2 percent would need to be followed in the near future with inflation above 2 percent.

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Reducing the Inflation Target

The principal benefit of reducing the inflation target is the better long-run preservation of the value of money.[2] This policy option has two compelling advantages over trying to achieve the same objective by adopting price-level targeting. First, it represents a simple adjustment to a well-understood policy regime, and given the Bank of Canada's long-established credibility for doing what it claims it will do, it is likely that inflation expectations would adjust quickly.

The second advantage relates this credibility to the sacrifice ratio: the cumulative loss in output (relative to potential) per point of policy-induced disinflation. Conventional thinking is that the lower the central bank's credibility, the more slowly expectations adjust to the new policy and thus the larger is the sacrifice ratio (Ball 1994). But after almost 20 years of successful inflation targeting, credibility is one thing the Bank surely has in spades. If inflation expectations do adjust quickly to an announced reduction in inflation, there is good reason to expect the transitional costs in terms of output and employment to be very small.[3]

That a reduction in the inflation target might dominate the adoption of price-level targeting (for the equivalent growth path of the price level) does not necessarily mean that a reduction in the inflation target dominates the status quo. Traditionally, there have been two concerns about very low rates of inflation, and a formal inflation target below 2 percent is very low by all practical standards, across time or across countries (Roger 2009). First – as argued many years ago by Tobin (1972) and more recently by Akerlof, Dickens, and Perry (1996) and Fortin (1996) – the presence of downward nominal-wage rigidity might imply that a very low rate of inflation increases unemployment permanently because some necessary sectoral adjustments in real wages become infeasible. Second, as is now commonly discussed, very low inflation might significantly constrain the conduct of monetary policy because of the zero lower bound for nominal interest rates.

Both concerns have diminished in recent years. There is some evidence that nominal wages are not as rigid as was once thought and also that the employment implications are not as significant as once believed (see Crawford and Hogan 1998; Farès and Hogan 2000). Perhaps this is due to our increased experience in a low-inflation environment and thus greater willingness on the part of workers to accept cuts in nominal wages in the face of large negative shocks. The modest decline in union membership evident since the 1980s also might play a role. In addition, the existence of labour-market turnover permits new employees to be hired at lower wages than existing employees, meaning that aggregate nominal wages might be more flexible than any individual worker's wage. Regarding employment, perhaps the real wage plays a less allocative role than we are used to thinking and, therefore, whatever nominal-wage rigidity does exist has few implications for employment and unemployment.

As for the zero lower bound on nominal interest rates, the past few years have been extremely informative. For those economists previously unable to imagine how a central bank could take expansionary actions once its policy rate was at (or near) zero, it is now clear from the US and UK experiences that quantitative easing is a viable tool for injecting reserves into the financial system and possibly for reducing long-term interest rates. And from the Canadian experience, we know that a conditional commitment to keep policy rates low is a tool that can be added to the central bank's arsenal (He 2010). It must be admitted, though, that we do not yet know enough about the full success of these policies. In the case of quantitative

2 The possible growth benefits associated with further reductions in the inflation rate are ignored here. I have argued elsewhere (Ragan 1998) that there is no compelling reason for believing that reducing the annual inflation rate from 2 percent to 1 percent would have any effect on the growth rate, though it may generate other hard-to-measure benefits.

3 Given the prevalence of long-term bonds (both private and public), a relatively quick one percentage point reduction in the rate of inflation would generate windfall redistributions between debtors and creditors. If avoiding such windfall gains and losses was viewed as important, the transition could be made much more gradually (Parkin 2009).

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easing, it is possible that aggregate demand will not respond as intended to the increase in reserves; we may also end up learning a great deal about the nature of the monetary transmission mechanism, especially if inflationary pressures start to build well before the relevant output gaps are closed. Nonetheless, there is now growing evidence that central banks with policy rates at the zero lower bound are far from helpless.

The argument that monetary policy is not helpless when policy rates are near zero is not the same as arguing that we should feel comfortable about intentionally putting the Bank of Canada in a situation where it must use "unconventional" policy, especially quantitative easing. When I was at Finance Canada in 2009-10, I noted that many officials were quite content that the Bank never found it necessary to go this far. It still puzzles me that many people seem to think quantitative easing is entirely new, and do not seem to remember that, behind the scenes of the Bank's "conventional" interest-rate decisions, money and bonds are changing hands (with a lag) in a way that we now describe as "unconventional." Be that as it may, the thought of the Bank's engaging in quantitative easing (and especially credit easing) made some people very uncomfortable.

Some legitimate concerns exist with quantitative easing. First, it is difficult to know how many bonds to purchase in order to generate the intended effects on longer-term interest rates. This fundamental ignorance about the position and interest elasticity of money demand is, of course, one of the main reasons central banks eventually came to adopt the targeting of short-term interest rates rather than monetary quantities. Though this is an important operational detail, it is not a fundamental reason quantitative easing should not be pursued when expansionary policy is needed. Second, there is a concern that the central bank might not get the timing right on the exit – although this exit challenge is similar to any exit for monetary policy, balancing the need to support a growing economy with the need to avoid inflationary pressures.

Finally, quantitative easing raises an interesting question of accounting. When the Bank of Canada purchases government bonds in the ordinary course of providing cash to a growing financial system, these bonds are assumed to be held to maturity and are valued at their historical cost. But any bonds purchased with the intent of reselling them in the near future – as would be the case for quantitative easing over a period of a few years – are valued at their current market value. As a result, as economic recovery takes hold and interest rates eventually rise, these newly purchased bonds would decline in value and the Bank would experience a capital loss. If the volume of these newly purchased bonds and the decline in their value were large, the Bank could report an overall financial loss. In an extreme case, the losses could cause the Bank to become technically insolvent. To avoid this possibility, the government could indemnify the Bank of all losses. Of course, since the government of Canada has a consolidated balance sheet, which includes all of the Crown corporations, including the Bank of Canada, this indemnification would amount in financial reality to no more than shifting accounting entries from one place to another on the same balance sheet.[4] But there is an important issue of financial *perception:* how would the government or the minister of finance like the possibility of the Bank's either losing money or becoming insolvent and needing a government "bail out"?

Removing the Existing Bias in the CPI

Recent evidence suggests that Canada's rate of CPI inflation is biased upward by about 0.6 percent (Rossiter 2005), so when inflation is measured to be 2.0 percent, true inflation is only 1.4 percent. The two primary causes of this bias are the failure to account quickly for the creation of new products and the disappearance of old ones, and

4 An insolvent Bank of Canada could still conduct monetary policy, as long as it still possessed the ability to create money and it still owned assets (government bonds) that it could sell into the open market in order to reduce the money supply.

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the failure to account for consumers' substitution away from products with faster-rising prices and toward products with slower-rising or even falling prices (Smith 2009). Two motivations for correcting this bias are mundane but nonetheless fundamental in a modern economy; the third is of direct interest to fiscal policy.

First, the corrected CPI inflation rate would provide a better indicator of changes in the true cost of living, and thus monetary policy would be targeting a variable more meaningful to Canadian firms and households. Second, to the extent that the existing bias has a cyclical component, the more accurate measure of true inflation would better reflect demand or supply pressures that lead to changes in inflation, and thus would be a better guide for monetary policy decisions. More generally, for the many nominal values in the economy that are geared to movements in the CPI, from wages and rents to child-support payments and pensions, correcting the measurement of the CPI would be akin to recalibrating an engine to improve performance.

The fiscal implications of correcting the CPI bias are likely to catch the attention of the minister of finance. The income-tax system is indexed to measured inflation; similarly, many government expenditures, such as elderly benefits, children's benefits, and interest payments on real-return bonds, are indexed to measured inflation. If measured inflation is above true inflation, expenditures are higher and tax revenues are lower than would be the case with more accurate measurement. It follows that correcting the CPI bias would unambiguously improve the federal government's fiscal position, although a precise estimate of the size of the improvement would require detailed tax and expenditure information only the federal government possesses. Simple back-of-the-envelope calculations, however, suggest that the fiscal gains would be hundreds of millions of dollars per year.[5] In contrast, the cost of making the CPI corrections likely would be only a small fraction of this amount.

If the government devoted the necessary resources to eliminating the CPI bias, there would be important implications for monetary policy. Correcting the bias would close the gap between true and measured inflation, but it would matter *how* this gap was closed: through a reduction in the measured value or through an increase in the true value. Consider three policy options.

In *Option 1*, the bias would be corrected but the formal inflation target would be left unchanged. As the bias was removed and the Bank of Canada kept measured inflation at its target value, the true inflation rate would rise from 1.4 percent to 2.0 percent. In the absence of a clear announcement, such an increase in inflation by *stealth* surely should be avoided. Note also that the government would receive no fiscal benefits in this case because there would be no change in measured inflation. Since this option would generate few benefits and introduce new costs through higher inflation, there are solid reasons to avoid it. Yet, I have been told by some in Ottawa that this scenario is too extreme, and that the change in true inflation would not occur suddenly. The process of correcting the bias in the CPI apparently would take several years to accomplish, so instead of an immediate upward jump in the true inflation rate, there would be a gradual upward creep in true inflation as the existing CPI bias was gradually reduced. Even if true, as seems likely, this claim does not solve the underlying problem that this policy option, by increasing inflation, would impose costs on millions of Canadians over many years. That it would occur gradually by stealth, and thus without public discussion or acknowledgement, is hardly an argument in its favour.

5 Consider the payment of Old Age Security, an expenditure of roughly $35 billion annually. This sum is increasing at an annual rate of approximately 4 percent, half due to the growing number of recipients and half due to the indexation of the payments. If measured inflation fell by 0.6 percent, the growth of these payments would fall commensurately, by roughly $210 million annually. The total annual fiscal impact of correcting the CPI bias, including the effect on other indexed expenditures and tax revenues, therefore, would be considerably larger than this amount.

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Option 2 would be to correct the CPI bias and to reduce the inflation target to 1.4 percent. In this case, true inflation would remain unchanged at 1.4 percent, but measured inflation would fall from 2.0 percent to 1.4 percent. Here, there would be no costs associated with the possibility that inflation was now too low, since the true rate of inflation would be unchanged. We would get all the benefits associated with measured inflation's now being a better indication of cyclical pressures and of changes in the real cost of living. In addition, the government would receive the full fiscal benefits of eliminating the overindexation of taxation and expenditures. The only downside with this option is that the formal inflation target would become an unusual number: 1.4 percent.

The emphasis on eliminating a bias of 0.6 percent and thus a reduction of the inflation target by this same amount suggests, however, a level of precision greater than we actually possess. After all, the estimated bias of 0.6 percent is just that – an estimate – and as such it should be viewed with some caution. In addition, it is an estimate based on an average across time (Rossiter 2005). At any moment, it is likely that the bias is either higher or lower than this average amount. Furthermore, the process of correcting the CPI bias would unlikely eliminate *fully* the existing bias for the simple reason that it would be prohibitively expensive to do so; instead, realistic and cost-effective corrections to the data-collection process would eliminate only the most important sources of the bias. The upshot is that we should not be too literal in presenting this second policy option as reducing the inflation target to *exactly* 1.4 percent – a numerical target that would indeed be odd. But even if we recognized that the CPI correction would be only *approximately* 0.6 percent and thus modified this option so that the inflation target was reduced to 1.5 percent, we would still be left with a formal inflation target that probably would fail a sensible "focal point" test. For the purposes of communicating with the public and focusing inflation expectations, there is genuine value in using round numbers for the inflation target.

Option 3 would be to correct the CPI bias and reduce the inflation target to 1.0 percent. In this case, true inflation would fall modestly, from 1.4 percent to 1.0 percent, even though measured inflation would fall by one full percentage point. A compelling case can be made for this option, for several reasons. First, the reduction in true inflation would generate long-run benefits to Canadians through the better preservation of the value of money. Second, measured inflation now would reflect more accurately cyclical pressures and genuine changes in the cost of living. Third, the communication of the new inflation target would be simple; a 1 percent target clearly would be as easy to explain and to communicate, and would represent as good a "focal point" as the current 2 percent target. Fourth, the government would receive the full fiscal benefits from removing the overindexation of the tax and expenditure system. The only potential downside of this policy option is that true inflation then might be "too low." However, given the weak evidence of problems associated with nominal wage rigidity, recent US and UK experience with quantitative easing, and the fact that true inflation would fall by less than one percentage point, any problems on this front likely would be quite small. The correction of the CPI bias together with a reduction in the inflation target to 1 percent would constitute a coherent and desirable policy package.

Enhancing Financial Stability

Discussing financial stability is difficult for many traditional macroeconomists (like me) whose formative training typically assumed away most of what we now know to be the interesting features of financial markets. Laidler (2010) and Laidler and Banerjee (2008) have explained the extent to which we collectively missed the boat and also some of what we will need to do to get back on board. A better understanding of financial markets, and a better integration of these markets into aggregate macro models, must be on the research agenda for the profession.

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Yet one can better understand financial markets and still have difficulty knowing what is meant by financial *stability*. The term is used in different ways by different people, making it difficult to have a constructive conversation about the issues. For some people, financial stability means that firms and households are less prone to developing financial excesses. For others, the emphasis is on asset-price “bubbles” – the tendency to have long bull markets followed by sudden crashes. Some emphasize the need to prevent the collapse of individual financial institutions of any size, while others think that individual collapses are inevitable but that the key issue is about ensuring systemic stability in the face of such collapses (Freedman and Goodlet 2007). Finally, many are concerned about the “too big to fail” problem, and how the embedded moral hazard leads inevitably to further financial excesses (Goodlet 2010).

My understanding of the 2007-08 financial crisis and the subsequent recession is that many complex and interrelated factors came together to produce the problems that emerged (Ragan 2010). But if pushed to identify the fundamental problem, I would single out inappropriate regulation of many kinds. It follows that the fundamental fix is one of designing better regulations and better mechanisms for regulatory oversight. Various regulations need to be reviewed, including those related to bank leverage and capital, in terms of both the appropriate level and cyclicality. The valuation of assets and liabilities is also an issue, as is the appropriate provisioning for losses. The transparency of specific financial instruments and the markets in which they are transacted also deserve attention. And regulations dealing with the form of mortgages, mortgage-lending practices, and mortgage insurance also need to be reviewed (Masson and Pattison 2009).

These kinds of regulatory changes are currently being examined by the Basel Committee on Banking Supervision, and when implemented they will have two general implications for monetary policy. First, by making the behaviour of financial institutions more “macro-prudential,” the overall financial system presumably will become more resilient to various kinds of financial-market shocks, including the collapse of individual institutions. If so, there will be less need for central banks to intervene in those markets with extraordinary measures such as those taken in 2007 and 2008. Second, changes in specific regulations, especially those dealing with the level and cyclicality of bank capital, are likely to alter the nature of the monetary policy transmission mechanism – perhaps in unexpected ways. Central banks thus need to do more research, especially on how the precise regulatory arrangements will affect institutional behaviour over the business cycle and thus how central banks will need to alter their decision rules.

Both sets of changes are of obvious importance to central banks, so one should never argue that regulatory solutions designed to enhance financial stability are unrelated to monetary policy. However, neither change has an obvious implication for whether or how a central bank's inflation objective should be altered. Perhaps greater future knowledge of financial stability and how it would be affected by regulatory changes will suggest that clear improvements are available if central banks shifted to price-level targeting or altered their inflation objective in other specific ways. But our current state of knowledge does not permit such a clear policy recommendation. In arguing that the prevention of future financial crises is mostly about having better regulation and oversight, I agree with Bank of Canada Governor Mark Carney, who has stated that,

> “Experience has shown that monetary and financial stability are more tightly bound than had been appreciated. Price stability is a necessary, but not sufficient, condition for the stabilization of economic activity, and it must be supplemented by a robust macro-prudential regulatory framework. This, in turn, will have consequences for the implementation of monetary policy. If these macro-prudential tools prove insufficient to achieve financial stability, monetary policy faces a difficult trade-off between flexibility and credibility” (2009, 8).

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The "if" at the beginning of the last sentence is crucial. If the macro-prudential tools *are* up to the task of delivering enhanced financial stability, then monetary policy can remain in familiar territory.

Or can it? One can argue for leaving unaltered the Bank's inflation target while also arguing that the Bank needs to change its behaviour in ways more fundamental than merely researching more fully the nature of the transmission mechanism. While the financial crisis was caused *mostly* by problems of inappropriate regulation, White (2009) and Laidler and Banerjee (2008) argue convincingly that an important part of the problem was that central banks in many countries were too unwilling to "lean" against growing financial excesses – such as dramatic increases in financial leverage in the household and corporate sector – implicitly preferring to "clean up" whatever messes were created by the eventual financial collapse.

White (2009), Parkin (2009), and others argue sensibly that we should not think of "leaning" in terms of the Bank's formally targeting a set of asset prices. Not only is it unclear which small set of prices to target, it is also unclear how to identify any given price increase as "inappropriate" or somehow disconnected from the underlying "fundamentals." White's concept of leaning is far less formulaic and more subtle than formal targeting would ever permit – in short, a central bank that chooses to lean against financial excesses needs to look broadly at financial markets and use its discretion and judgment very carefully. It needs to cast its eyes over asset prices and financial leverage that are deviating from their longer-run trends, and to examine the growth rates of monetary quantities and flows of credit that appear to be unusually large (Laidler and Bergevin 2010). White (2009) reminds us that many financial crises through history were preceded by the development of financial excess, and his guiding principle for policy is that careful but significant pre-emptive policy tightening is more effective than the massive and sudden monetary expansions that typically follow financial crises. Furthermore, both he and Laidler and Banerjee (2008) argue that the practice of leaning against financial excess is entirely consistent with maintaining the credibility of a formal inflation target.

As sensible as leaning appears to be, it would not require a change in the central bank's formal inflation objective. Rather, it is an important issue of the implementation of monetary policy. In other words, with the possible exception of having the new inflation-targeting agreement explicitly state that the Bank will pay more attention to financial stability (and presumably what that means), the issue of "lean versus clean" is unlikely to form a case for changing the Bank's formal policy target. Carney (2009) raises the possibility that the adoption of price-level targeting might make aggressive leaning more feasible because agents know we eventually would return to the targeted price-level path; this is another example of the (possibly) better stabilizing properties of price-level targeting discussed earlier. But we probably do not yet know enough about leaning or price-level targeting or the formation of agents' expectations to make a strong case for a policy switch.

Political Economy and the Case for the Status Quo

Many economists, if they have any opinions at all about political economy, view it as rather "soft" or "fuzzy," and certainly less rigorous than what they are used to studying. It follows for many that political economy is easy – maybe even so obvious that it need not take up their valuable time. I do not share this view; I find political economy neither easy nor obvious. My limited time in Ottawa has taught me two things in this regard. First, mainstream economists like me are often quite poor at predicting which issues will catch the attention of elected officials. Our minds seem to operate along different planes, and we are attuned to different concerns. Second, the political element often plays a bigger role in the design and implementation of policy than does the economic one. For governments across the spectrum, political efficacy often trumps economic sensibility.

So, while economists might not be the best placed to analyze the political economy aspects of

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real-world policy, we should be under no illusion that doing so is unimportant. We should admit that it is worth thinking through the relevant issues, in the hope that we will better understand the decisions of elected officials. For anyone who truly believes in democratic systems and processes, "political" should not be considered a dirty word.

My comments here are in three parts. First, I briefly examine the conditions that motivate policy changes. Second, from the perspective of political economy, I examine the desirability of each of the proposed changes from the previous section. Finally, I address the important issue of the *timing* of policy changes.

Motivating Policy Changes

What motivates significant policy changes? I focus on two essential considerations: the importance of garnering political support and the importance of resolving genuine policy problems. With these considerations in mind, one can identify three general situations that motivate a change in policy.

First, policies might be changed because there is a perception that a genuine policy problem needs to be fixed, and that the fix is so important that political concerns are largely ignored. Past and present governments have shown their willingness to suffer considerable political unpopularity when a policy problem really does need to be addressed. An obvious recent example is the Conservatives' decision on income trusts in fall 2006; the current push for a Canadian securities regulator also might fall in this category, given strong and apparently growing opposition in Alberta, Manitoba, and Québec.

In the second category are situations in which policies are changed primarily for reasons of electoral advantage, even though there is no indication that the policy is in need of repair. In more extreme circumstances, policies are changed to garner public support despite the clear possibility that the change might actually worsen the underlying policy. The cuts in the Goods and Services Tax in 2006 and 2007 and the more recent elimination of the mandatory long-form census are examples where the government was prepared to change policies even in the face of strong and united opposition by the policy community.

Finally, consider those situations in which a genuine need to repair or improve a policy is aligned with an electoral case for doing so. In such cases, the policy wonks are in agreement with the voters, though perhaps for different reasons. There are many examples from recent years. The fiscal stimulus contained in the 2009 and 2010 budgets is in this category, as is the planned return to budget balance by fiscal year 2014/15. The tariff cuts in the 2010 budget enter here, and so does the government's successful arguments within the G20 against a bank tax.

To summarize, one of two conditions appears to be necessary to motivate elected officials to make a significant change in economic policy: there must be either a genuine need to repair a broken policy or some electoral payoff from a policy change, or perhaps both. But a situation in which neither condition is satisfied is likely to be one where the ministers involved decide to spend their valuable time and political capital on other concerns.

Political Economy Objections

When evaluating the political economy objections to the policy changes proposed earlier, one must emphasize three principles. First, as just stated, policy changes generally require either the need to fix a real policy problem or the belief that a policy change will lead to political gains. Second, effective communications are often challenging in the political arena, especially with subtle economic ideas. The more subtle the idea, the more effort it takes to communicate the reasons behind the policy change; and the more time spent communicating, the more likely it is that a minister will say something unintended and possibly contentious, thus sparking debate and perhaps worse. Difficult communications can erode valuable political capital, which brings us to the third principle: political capital is a scarce resource, and elected officials seek to preserve theirs and spend it only when it is most needed, preferably in the pursuit of favoured projects.

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Consider, first, the case for switching the Bank of Canada's formal objective to a price-level target. There would be a clear, long-run benefit in terms of reducing uncertainty about the price level, but this might not resonate with many people, elected or not. There might be short-run benefits from better stabilization of output, but only to the extent that the public fully understood the workings of the regime. Perhaps the Bank could successfully explain the details to the public, and the stabilization benefits of the regime therefore would come to pass. But it is reasonable to be skeptical that such a system would ever be as well understood as the current system is now. Perhaps the adoption of price-level targeting would allow the Bank to lean against financial market excesses while maintaining its credibility regarding its price-level objective. Based on our current research and knowledge, however, these gains are hard to assess. Finally, the switch from inflation targeting to price-level targeting is hardly a policy designed to win votes with ordinary Canadians. In terms of political economy, there is a forceful case for not adopting a price-level target.

Reducing the inflation target would offer clear, long-run gains by better preserving the value of money, and these gains likely would rise over time as the population ages. For some, however, the case against this policy has strengthened in the past two years, since it is now clear that large shocks can drive the policy interest rate to zero and force the Bank into contemplating unconventional policy actions that leave some people uncomfortable. Though the technical communication of this policy change ought to be straightforward, the minister of finance would have to explain why a reduction in the inflation target is a good idea in 2011, especially when Canada's current 2 percent target is as low as inflation targets elsewhere and no other inflation-targeting country has reduced its target recently (Roger 2009). "Sticking with a winning model" is unlikely to lose many votes, while making a switch to a lower inflation target might lose votes from those who view the policy change as imprudent. Political economy thus offers a solid case for not reducing Canada's formal inflation target.

Correcting the existing bias in the CPI would generate obvious economic benefits. The unsurprising, though hard to measure, benefits would flow from having a more accurate measure of changes in the genuine cost of living and from the better monetary policy that presumably would result from using a more accurate measure of inflation to gauge excess demand and supply pressures in the economy. The benefit that would be easier to measure is the fiscal gain that would result from eliminating the overindexation of current spending and taxation. Some will observe rightly that these fiscal benefits would not accrue to the overall economy since they really would be just a reduction in public spending and an increase in tax revenues; others will view it more like the desirable closing of an existing loophole.

Whatever benefits came from correcting the CPI measurement, however, we should not think that making such a change is a small thing for monetary policy. The three options detailed above make it clear that we must either adjust the formal inflation target when making this correction or accept the higher inflation by stealth. But policy changes should not be implemented if their acceptance relies on public ignorance or confusion. The minister and the government need to think through the implications of adjusting the inflation target before deciding to correct the bias in the CPI; these two policy adjustments should be undertaken, or not, together.

As for electoral support, correcting the CPI bias would present a real challenge. If government outlays – especially elderly and children's benefits – have been rising too quickly because measured inflation exceeds true inflation, then correcting the CPI bias would reduce these payouts relative to what would otherwise occur. The government could sensibly claim that past payouts have been excessive and that the correction merely would put them back on their intended path.[6] Whatever

6 If the price index relevant to seniors (or children) systematically increases faster than the overall CPI, then one might argue that the current system contains no such overpayments.

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the government's argument, however, the truth is that the growth of these payments in real terms would fall as a result of a CPI correction, and the government needs to be mindful of the likely opposition to this policy. So correcting the CPI bias, despite the aggregate benefits it would generate, offers a way to *lose* some votes among specific groups of Canadians, but few votes would be won or lost by ignoring the issue and maintaining the status quo.

Efforts to enhance financial stability are clearly important. But of all the issues I review in this *Commentary*, we know the least about financial stability – what it means, how to improve it, and how monetary policy can be used to enhance it. The minister of finance or the government might view three aspects of the issue separately: the choice of an inflation (or price-level) objective and how this would relate to financial stability, the need for the Bank of Canada to have greater regulatory or oversight powers in financial markets, and the case for having the Bank lean more aggressively against financial excesses in the conduct of its regular monetary policy.

As for the idea that pursuing a price-level target (rather than an inflation target) is likely to enhance financial stability, there are two immediate objections. First, as argued earlier, one can be skeptical of whether the public would understand a system of price-level targeting sufficiently to generate the predicted benefits. Second, our collective ignorance about how price-level targeting would contribute to financial stability suggests delaying such a policy change until we are able to make a more informed choice.

Regarding the expansion of the Bank's formal role in the regulation or oversight of financial markets, a powerful political economy objection might come from those on Parliament Hill who believe that any enhanced power should lie with elected rather than appointed officials. In addition, one can argue that getting the Bank directly involved in regulatory affairs might expose it to excessive political influence and thus threaten its valuable operational independence. From a technical perspective, however, two observations make it easy to argue for an increased role for the Bank (Crow 2009a). First, the Bank's expertise in macroeconomics and the macro role of financial markets likely exists in no other Canadian institution, so giving it some increased responsibilities in dealing with macro-prudential regulations seems only logical. Second, if new financial-market regulations involved cyclical capital requirements, it would be incumbent on *someone* to determine when to pull the cyclical "trigger"; given that the Bank controls the most important countercyclical tool in the government's policy arsenal, the Bank clearly should be involved in this decision. The Bank's appropriate role in this domain is clearly a complex and contentious issue, and it needs to be examined and debated thoroughly.

Finally, consider the case for the Bank's enhancing financial stability by modifying its regular conduct of monetary policy. Even if there were no change in its inflation objective and the Bank played no greater role in the regulation or oversight of financial markets, it could genuinely embrace the idea of leaning against financial excesses. This would require work on the part of the Bank, including clear and effective communication about what it was doing and why, but this kind of change would be about how the Bank pursues its existing inflation objective; it would not require a fundamental change to that objective.

More to the point for the discussion here, the minister of finance and the government likely would be in favour of such a change in the Bank's behaviour. If the inflation-targeting agreement included an explicit statement regarding the importance of financial stability, as well as the need for the Bank to consider this as part of its monetary policy, the public and financial press would view this as an obvious and sensible response to the events of the past few years: if anything, any new inflation-targeting agreement that *excluded* such considerations probably would be viewed as imprudent. At the same time, the details of how the Bank built its concern for

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financial stability into its monetary policy decisions could be left for the Bank to determine, based on its evolving expertise on such matters.

Timing, Timing, Timing!

If "location" is the cardinal rule in real estate, then perhaps "timing" is the cardinal rule for politics and policy changes. For decision makers governed by the forces of political economy, the current timing provides a compelling argument for renewing the inflation-targeting agreement in its existing form.

In 2006, at the time of the last renewal, the adoption of price-level targeting or a reduction in the inflation target would have been an easier sell. The inflation-targeting regime had been a clear success for 15 years, and the traditional arguments for the modest long-run benefits would have been as compelling as they are today. The policy regime had responded very well to various economic and financial shocks, and most people thought it quite unlikely that future events would ever push the Bank of Canada's policy rate to its effective lower bound. The problem was that, in 2006, the Bank's own research on the details of alternative regimes was incomplete, and not advanced enough to justify a well-informed change of policy (Ragan 2005).

Since then, the Bank's research has progressed considerably (see, for example, Amano, Carter, and Coletti 2009), and we are better positioned than before to make an informed judgment about the issues that eluded us in 2006. Indeed, had the intervening years been smooth and uneventful, we would now be in a better position to improve the monetary policy regime. In such a world, one could make reasonable arguments for adopting price-level targeting and, even better in my view, very compelling arguments for reducing the inflation target.

Yet the world economy has been anything but smooth and uneventful since 2006, and new issues have arisen. The global financial crisis and subsequent recession led to an aggressive response by central banks, which found their policy rates pushed against the floor for an extended period. The world has been introduced to quantitative and credit easing, making some people uneasy. And financial stability has become the multifaceted premier issue, about which we still have much to learn. These developments make it more difficult to advocate changes in the Bank's inflation objective. They certainly argue for research, deliberation, and debate – but perhaps not yet for changing the Bank's policy target.

Our elected leaders might see two additional reasons why the timing is not right for changing the Bank's inflation objective. Canada's financial system has been held up as a model of both effective regulation and prudent behaviour. Our leaders boast about the quality of Canada's system and about the fact that the worst excesses clearly evident in the United States or the United Kingdom did not appear here. And the Bank has played an important role at the heart of this financial system: its response to the financial crisis and recession was creative, aggressive, and, by all indications, effective. The evident success of Canada's financial system, then, makes it awkward for a minister of finance to announce that we are soon to change the Bank's objective. Why tinker with success? Is there really a problem to which we would like to draw the world's attention?

Current developments in the US and world economies also matter. The fragile economic recovery in the United States and the unfolding debt crisis in Europe make it a politically awkward time, for example, to reduce Canada's inflation target. If Canada's recovery continues more quickly than that of the United States, policy rates will rise relatively quickly here. In the absence of credible plans to consolidate fiscal positions in the United States and Europe, inflation expectations in those regions could begin to rise. For both reasons, the Canadian dollar might continue its nominal and real appreciation against the US dollar, and there is no particular reason to think that par would be an upper limit. Choosing this time to reduce Canada's inflation target below those anywhere else in the world would merely strengthen the forces for a nominal appreciation. While economists might recognize that such a nominal appreciation should be irrelevant to the

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real exchange rate and other real outcomes, the considerable and pervasive real/nominal confusion guarantees that any appreciation of the Canadian dollar would be a genuine and troublesome issue of political economy.

A Coherent Policy Package

I have discussed several changes that could improve monetary policy in Canada. Despite the significant success of the inflation-targeting framework since 1991, further improvements in the system should be considered seriously – improvements that would deliver genuine economic benefits to millions of Canadians over the years ahead. I have also discussed why considerations of political economy might stand in the way of adopting these improvements, and I have emphasized the appeal of maintaining the status quo. It is always easy to be complacent when current policies are working well, but the cost of that complacency would be borne by future generations.

My assessment is that the potential economic gains from adopting some of these policy changes are significant enough for the country as a whole that they should be pursued, despite the real obstacles erected by considerations of political economy. The economic benefits would extend far into the future, and would apply to current as well as future generations; in contrast, the political obstacles are one-time difficulties that would be forgotten soon after they were surmounted. I therefore propose the following five-part policy package:

- The federal government should devote the necessary financial resources to Statistics Canada so that it can eliminate the most significant biases in the CPI over the course of the next few years.
- The Bank of Canada's formal inflation target should be reduced to 1 percent, perhaps gradually over the course of the new agreement.
- The federal government should announce its intention to indemnify the Bank of Canada against possible financial losses brought about through changes in the value of government bonds purchased during (possible future) episodes of quantitative easing.
- The new inflation-targeting agreement should mention explicitly the importance of financial stability, and that the Bank henceforth will take financial stability into consideration when conducting its monetary policy decisions.
- The federal government should direct the Ministry of Finance, the Bank of Canada, the Office of the Superintendent of Financial Institutions, and other relevant parties to ensure that, among them, they have the appropriate regulatory and oversight mechanisms in place, and responsibilities for actions clearly assigned, so that policy henceforth might be properly informed by concerns of financial stability.

This set of policies would provide a *coherent* package for both the Bank and the government. The argument for correcting the bias in the CPI is based partly on the gains from having a more meaningful measure of inflation and partly on the fiscal benefits from closing what is essentially a bias-produced loophole in the tax and expenditure system. In the presence of such a correction, however, it is necessary to recognize the need to change the formal inflation target so as to avoid an increase in inflation by stealth. Reducing the inflation target to 1 percent implies only a very small reduction in the true (average) rate of inflation – large enough to generate some genuine benefits but small enough to avoid potential problems from inflation's being too low.

Reducing the inflation target would generate economic benefits by reducing the ongoing erosion in the value of money, but it also would put the Bank in a position more likely to encounter the zero lower bound on its policy interest rate. In recognition of the increased likelihood of using quantitative easing at some point in the future, the Bank should be indemnified against possible financial losses. On this point, it is really perceptions, rather than genuine financial requirements, that drive the policy recommendation, but perceptions are rarely irrelevant. It would be better for the government

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to announce soon that it will henceforth indemnify the Bank of Canada, well before any crisis occurs, than to explain to a questioning public in the heat of the moment why a loss-making central bank is not really a big deal.

The last two parts of the package relate to the importance of financial stability. It probably would be reckless for the new agreement to be silent on this crucial issue, given the experience of the past few years, so the concept should make some kind of explicit appearance in the inflation-targeting agreement. That being said, one should also recognize that our knowledge about the connection between financial stability and monetary policy is unclear, preventing specific details in the agreement. The agreement should clarify that the Bank will pay more attention to enhancing financial stability; at the same time, details of implementation need to be left to the Bank to sort out over time.

For its part, the federal government needs to give more thought to whether the current institutional arrangements provide the macro-prudential regulations and oversight necessary to prevent a crisis in the face of large future financial shocks. Perhaps the current arrangements are satisfactory, perhaps not. But the prudent, sensible and responsible action for the government is to make sure that the difficult questions are being asked, the genuine debates between various parties are being resolved, and the necessary responsibilities are being clearly assigned. Given the extent to which Canadian leaders have been accepting congratulations from around the world for having such a sound financial system, it would be embarrassing indeed to discover that this system actually lacked the resilience needed to withstand the next set of shocks or pressures. No political price needs to be paid for quietly asking the right questions and making the appropriate institutional changes behind the scenes; an almost unthinkable political price will be paid if these actions are not taken soon and a future crisis occurs.

In addition to these five specific policy recommendations, I suggest one more for the Bank of Canada: it needs to place more emphasis on the kinds of "political economy" arguments I have examined here. Whether the Bank favours the policy package outlined above or a different set of improvements for the existing inflation-targeting system, it should recognize the power of political inertia and, thus, the need to pitch the arguments for economic benefits against those of political costs. The Bank needs to explain clearly to the federal government the economic benefits of any proposed change, including their scale and distribution across different segments of the population. The Bank also needs to consider how the government might convince Canadians that any proposed policy change is worthwhile.

The details of monetary policy might be fundamentally about economics, rather than politics, but to proceed as if sensible economic arguments will automatically carry the day is a sure route to having proposals rejected. Good economics *can* be the basis of good politics and good policy, but only if the economic case is clearly communicated in a manner appreciated by both the people and their elected representatives.

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