Bank of Canada

Inflation-Control Targets

BACKGROUNDER

Inflation-control targets were adopted in February 1991 for a five-year period by agreement between the Government of Canada and the Bank of Canada. The inflation rate in 1991 was 5.9 per cent as measured by the *consumer price index*.

The initial goal was to reduce inflation to progressively lower levels, first to 3 per cent, then to 2.5 per cent, then to 2 per cent, to ensure a climate favourable for long-lasting economic growth. By December 1993, inflation had been reduced to 2 per cent. At that time, the government and the Bank agreed to extend targets for three more years to the end of 1998. The target range was 1 to 3 per cent.

In February 1998, with inflation well-contained in the range, the existing targets were extended to the end of 2001. The government and the Bank agreed that before that time they would jointly determine an ‘‘appropriate long-run target consistent with price stability.’’

An important tool for monetary policy

The inflation-control targets assist the Bank in determining what *monetary policy* actions are needed in the short and medium term to maintain a relatively stable price environment.

To achieve a rate of monetary expansion consistent with the target range, the Bank of Canada uses its influence on short-term interest rates. If inflation is moving towards the top of the 1 to 3 per cent target range, that is usually a sign that demand in the economy for goods and services needs to be restrained through a rise in *interest rates*. If inflation is moving towards the bottom of the range, it is often a sign that demand is low and needs some support through a reduction in interest rates.

In this way, monetary policy tied to inflation-control targets tends to act as a growth stabilizer. Ensuring economic growth at a sustainable pace means preserving past gains by avoiding a recurrence of the inflationary “boom-and-bust” cycles of the early 1980s and 1990s. It also means encouraging long-term investment in future growth and job creation by maintaining a stable, low-inflation environment.

More understandable and self-reinforcing

Inflation-control targets have helped to make the Bank’s monetary policy actions more readily understandable to financial markets and the public. The targets also provide a clear measuring stick for evaluating the effectiveness of monetary policy.

One of the most important benefits of clear inflation targets is their role in focusing expectations of future inflation. This in turn feeds back into the kind of economic decision-making -- by individuals, businesses, governments -- that tends to reinforce the capacity of the economy for continuing non-inflationary growth.