Inflation and Price Stability

BACKGROUNDER

Inflation is a persistent rise over time in the average price of goods and services—in the “cost of living.” Inflation and the risk of inflation encourage certain types of spending and investment decisions. A situation where inflation is low enough so that it no longer affects peoples’ economic decisions is referred to as price stability.

The most widely used measure of inflation is the *consumer price index (CPI).* It reflects changes in the price of a representative “basket” of goods and services sold in Canada—food, housing, transportation, clothing, recreation and other items that Canadians buy.

The inflation rate is expressed as a percentage increase in average prices over a year. For example, if the cost of the CPI “basket” rises from $100 one year ago to $102 today, the current inflation rate is 2 per cent. When the CPI rises, the purchasing power of the average consumer dollar falls.

High inflation is costly

Over the past 40 years, Canada’s average annual inflation rate has varied. It reached a high of 12.4 per cent in 1981 and has averaged 1.5 per cent since 1992. The annual inflation rate was 0.9 per cent in 1998.

Prices tend to go up when demand from consumers for goods and services exceeds the normal capacity of producers to supply enough output to satisfy demand. Excess supply of goods and services tends to put downward pressure on prices.

The *costs of high and unstable inflation* can be severe. High and unstable inflation undermines our ability to generate long-lasting growth and job creation. It creates uncertainty for consumers and investors and can lead to painful cycles of economic “boom and bust” that cause hardship for many Canadians. High inflation erodes the value of incomes and savings. People on fixed incomes, including many elderly and poor Canadians, are particularly vulnerable to inflation.

Commitment to low-inflation

The *monetary policy* of the Bank of Canada is aimed at harnessing the *benefits of low inflation.* Among other things, a credible commitment to keeping inflation low helps create a positive climate for low interest rates and productive long-term investment. This in turn strengthens the growth of the economy and its capacity to generate new jobs.

Monetary policy in Canada is guided by a set of *inflation-control targets.* These targets set out a range—currently from 1 to 3 per cent—within which the Bank aims to contain annual inflation as measured by the CPI. The targets have played an important role in reducing inflationary expectations in Canada. This has contributed to keeping inflation within the target range in recent years.

The target range for inflation also commits the Bank to prevent allowing significant *deflation* to develop when disinflation occurs.