Commentary: Future Trends in Inflation Targeting

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1. Introduction

As Murray demonstrates, Canada's inflation-control program has worked extremely well for 15 years, a long time as monetary policy regimes go, already close to half the lifespan of the international gold standard, which was barely in place by 1880 and effectively collapsed in 1914. In what follows, I shall take up four topics that I think might benefit from a little extra attention. The first two—the role of core inflation and the question of financial stability—relate to the actual conduct of monetary policy under inflation targeting, and the others—fiscal policy and international monetary considerations—concern the interaction of that regime with other policy issues.

2. Core Inflation

There are good reasons why most targeters aim at CPI inflation. This index is widely understood, regularly reported, and not subject to revisions. Some of its component prices are quite volatile, however, and it is vulnerable to one-off shocks from indirect tax changes. A core index, which abstracts from indirect tax changes and strips the CPI of its most volatile components, principally food and energy prices, is widely believed to give a more reliable reading of inflationary trends over the short time intervals at which monetary policy decisions are made, and the Bank of Canada uses it as an "operational guide."

Most of the time this has worked quite well (Macklem 2001) but not always. Since the end of 1999, core inflation in Canada has been right on the 2 per cent target, but the "headline" CPI rate has run closer to 2.4 per cent, a discrepancy mainly due to an upward trend in the relative price of energy. It is arguable that, over this period, the Bank of Canada has paid too much attention to core inflation in setting its polices.

When the relative prices of particular goods change, their money prices adjust relative to a time path for the overall price level that is determined by monetary policy. Thus, when the relative price of an important item excluded from the core index rises, as that of energy has done in the last few years, the core index itself will, for a given monetary stance, deliver a misleadingly low

reading of overall inflationary pressures. Even so, the cumulative effect of the inflation overshooting that has occurred in Canada over the last six years amounts to only about 3 per cent, and the Bank of Canada is an inflation targeter, for whom bygones of this sort are bygones. For obvious reasons, however, such an overshoot would present a more serious policy problem under price-level targeting, where past inflationary errors would have to be corrected. Should the Bank of Canada move closer to such a regime in the future, then, it would have to pay more attention to core inflation's potential to mislead. Though core inflation remains a useful device for "looking through" the effects of short-run CPI volatility, perhaps we should try harder than we now do to distinguish, for example, movements in energy prices that are simply random from those that reflect longer-run trends, and then to adapt policy to the results of such assessments.

3. Financial Instability

Under the gold standard, convertibility took care of price-level behaviour, and the central bank's principal role (in economies that had one) was to maintain financial stability in times of crisis by standing ready to provide liquidity to the market (and sometimes to individual institutions). Nowadays, under inflation targeting, the central bank looks after the price level, and financial stability issues are delegated to regulators. Some commentators, notably at the Bank for International Settlements (e.g., Borio and White 2003) are uneasy about this, and would like central banks to try to identify developing asset-price bubbles, and then deflate them before they get out of hand, even if such actions require a few compromises with inflation-rate stability. Murray notes that some central banks seem to be leaning in this direction, and this makes me nervous.

Successful inflation targeting itself contributes to financial stability more broadly; and, even when asset-price bubbles have developed and burst under conditions of stable inflation—e.g., in the United States in 1929 or Japan in the early 1990s—the real damage has emerged not from the bubbles themselves, but from the stagnation that has followed when, after the event, the central bank has failed in its traditional "lender of last resort" role. I suspect, therefore, that, in the rare circumstances in which an asset-price bubble seems to be developing under inflation targeting, a simple readiness to play this role ex post if it bursts is safer than trying to "fine-tune" it out of the financial system *ex ante*. This is especially likely to be true where reliable systems of prudential regulation are in place.

I am aware of suggestions that the U.S. housing market is currently experiencing a bubble that is the result of the Fed's reaction to the bursting of the earlier "dot com" bubble, and that it might have been better to attempt to prick the latter in advance, but I remain unconvinced. Local experts know more about how strong a case can be made for the existence of a housing market bubble, and about how much of it can be attributed to monetary policy as opposed to other features of the U.S. scene, such as the generous tax treatment of mortgage interest; but even so, perhaps a Fed constrained by, say, a 2 per cent inflation target for the CPI (as opposed to some measure of core inflation), would not have responded to the "dot com" collapse quite so vigorously and for quite so long, while still managing to maintain financial stability in its wake.

Let me then summarize my own views on this question: simplicity is a great virtue of inflation targeting; no one ever claimed that such a regime would cure all monetary and financial ills; and

it would not be the first time in monetary history that an attempt to improve a policy regime by complicating it a little has ended up making it worse.

4. Fiscal Policy

Though Canada's economy began to look up immediately after the introduction of inflation targeting, the pace of improvement quickened noticeably somewhere around 1997. It is no coincidence that this was the year in which the fiscal reforms instituted in Canada's 1995 federal budget resulted in the first surplus since the early 1970s, the first of a subsequent, and still unbroken, string of surpluses that have markedly reduced the country's public debt and foreign debt-to-GDP ratios.

Canadian experience yields a number of lessons about the interaction of inflation targeting and fiscal policy. (See Laidler and Robson 2004.) First, targets were introduced in 1991 at a time of pre-existing fiscal stress and in the wake of a period of extremely tight money. In such circumstances, it was inevitable that high nominal interest rates would have unpleasant consequences for the debt-servicing component of the budget, and that an explicit medium-term commitment to the achievement of low inflation would attract attention to the country's fiscal stance. Second, politicians initially resisted pressure to put the fiscal house in order, and though they were publicly committed to inflation targeting, the durability of that commitment therefore remained in question, and more monetary stringency than would otherwise have been necessary was required to meet the targets. Third, when this policy contradiction was eliminated by the fiscal reforms of 1995, a virtuous circle of falling nominal interest rates, reduced debt-service pressure, and so on, was set in motion.

A Canadian discussant of a paper dealing with Canadian monetary policy should not pass detailed judgment on the current stance and likely future course of fiscal policy in the United States. One broad prediction and a conclusion to go with it, might, however, be in order; namely, that if the Fed does move closer to formal inflation targeting, the interrelationship between monetary and fiscal policy will be brought closer to the centre of U.S. debates about macroeconomic policy than it now is, and that this would be a most desirable, even if unintended, consequence of such a move.

5. International Monetary Issues

An inflation-targeting central bank must allow its exchange rate to fluctuate (more or less) freely, and because the Canadian dollar is a purely national currency, that is the end of the story as far as Canada's international monetary relations are concerned under the current regime. Though the United States is also a floater, and would have to remain one under inflation targeting, parallels with Canada in the international sphere end here.

Goods, services, and capital nowadays move across national borders in prodigious amounts, and this international economy requires a money. The U.S. dollar has become the dominant international money as the result of choices made by participants in this economy, not by the Fed or the U.S. Treasury, and both institutions have made it clear in recent years that they have no intention of allowing this fact to change the way in which U.S. monetary policy is conducted. That is fair enough. Among other things, the Fed has a legislated mandate to serve the U.S.

economy. To a historian of monetary economics, however, there is more than a passing resemblance between the position of the Fed in today's international monetary system and the position of the Bank of England in that of 19th-century Britain.

The Bank was a privately owned for-profit enterprise, which, for a variety of reasons emerged during the 18th century as the British monetary system's ultimate source of liquidity, but it long continued to set its policies with its own interests in mind rather than those of the financial system at large. Beginning in 1793, the potential for conflict here began to be recognized and the case to be made that the Bank should take a broader view of its responsibilities. Finally, almost a century later, with its management of the Baring crisis of 1890, the Bank of England emerged as the fully self-conscious central bank of the British economy.

The Fed is already the international monetary system's ultimate source of liquidity (which is the fundamental fact that prevents the IMF acting as an international central bank) and arguments that this creates international responsibilities that should sometimes supercede purely domestic interests have long been heard. If the Fed becomes a more formal inflation targeter, with Canadian-style consequences for U.S. fiscal policy, this will only further increase the U.S. dollar's attractions as an international money, so such a development is likely to create renewed interest in schemes for monetary co-operation led by U.S. authorities who take on explicit international responsibilities.

Let me end, then, by responding to an answer to an extremely interesting question raised by Murray. He wonders whether the long development of the theory and practice of monetary policy has ended with inflation targeting. Maybe not; maybe the U.S. adoption of such a regime would be the catalyst for renewed debates about the desirability of a truly international monetary system, overseen by a monetary authority with explicit responsibility for its operation. I hope I may be excused on this occasion from offering even tentative answers to the many further questions that this conjecture must prompt about where such debates might lead.

References

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