Opening Remarks

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It is my pleasure to welcome you to the Bank of Canada and to introduce our conference, *Issues in Inflation Targeting*. The Bank's economic conferences are very important for us. They serve to present the results of our research and to discuss new ideas and findings with leading researchers in the fields that are of particular interest to the Bank. Many of you have participated in previous Bank conferences, and we are delighted to have you back. For those of you who are here for the first time, I hope you have an enjoyable visit and that this is the beginning of a long and fruitful relationship.

This year's conference is especially important to us, since it focuses on issues that need to be considered as the Bank and the government prepare to renew the inflation-control targets in 2006. More than ever, therefore, we will appreciate your comments regarding the issues discussed here.

Inflation targets have been extended on three occasions since their introduction in 1991, most recently in 2001. Before each revision, the Bank hosted a conference or seminar with the goal of advancing knowledge on key issues involved in decisions on the target. The most recent seminar, held in June 2000, dealt primarily with questions related to setting a long-term target level compatible with price stability.

The papers presented during that seminar concentrated on three questions:

(i) the consequences of downward nominal-wage rigidity;

(ii) the relative merits of price-level targeting versus inflation targeting; and

(iii) an overall view of the state of knowledge regarding the various elements involved in formulating a position on the optimal long-run target.

Some of the issues addressed during that seminar are on the table again this year, since they merit re-examination in light of more recent experiences and the progress achieved in the fields of modelling and estimation. This time, the conference will focus on a broader range of subjects, dealing not only with the choice of target, but also with the best way to function within a given regime.

This program was clearly influenced by certain events in recent years, within the economy and in the area of research. In Canada, inflation has become markedly less persistent, and models that were used widely to forecast it in the past are much less reliable today. The volatility of the exchange rate of the Canadian dollar has increased, and asset prices have fluctuated more in general. In the United States, the fall of the inflation rate and interest rates to their lowest level in several decades has revived concerns among some analysts about holding the zero interest rate floor and about the risk of deflation.

It is against that background that this conference returns to a wide range of issues related to inflation targeting. Although there is already an extensive literature on many of these issues, it seemed evident that further research more focused on Canada would provide useful guidance for the upcoming decision. While we are not able to touch on all of the important issues surrounding inflation targeting, this year's conference looks at the following questions.

(i) Can we better understand and predict Canadian inflation dynamics? In particular, do models with structural interpretations help us understand recent events? And, since it is important for questions regarding optimal horizons, how forward looking is inflation determination?

(ii) Should monetary policy react to asset prices and, if so, how? Why do central banks often respond to asset-price declines but not to asset-price increases? Should the policy horizon differ when reacting to asset-price shocks as opposed to other shocks?

(iii) Is the zero bound on nominal interest rates a potential problem for Canada?

(iv) And, finally: (a) What are the welfare costs or benefits of lowering our inflation targets? and (b) What are the welfare benefits arising from inflation targeting versus price-level targeting?

While we have studied some of these questions at past conferences, advances in the economics literature have made re-visiting them worthwhile. There have been, for instance, advances in structural interpretations of inflation dynamics, such as the New Keynesian Phillips curve. Also, recent microdata and survey studies have indicated that the lengths of average price contracts are a lot shorter than previously thought—giving researchers another overidentifying restriction for their models. Robust control methods now allow us to entertain the notion that policy-makers may be working with an incorrect model when formulating policy.

Finally, advances in computing power allow us, among other things, to conduct welfare-comparison experiments in a fully specified dynamic general-equilbrium setting; previous research on optimal policy typically focused on inflation-output variance frontiers rather than on welfare.

Before concluding, I would like to point out that a number of issues related to the renewal of the inflation target agreement have not been included as separate topics for this conference but are part of our research agenda. For instance, we are currently conducting research on the appropriate definition and the role of a core inflation measure for operational purposes, as well as updating work on the measurement bias in the consumer price index. I hope that this conference will help us identify other potential research topics.

So, I strongly encourage you to put our speakers to the test and provide us with material for reflection. We have before us a very stimulating agenda that will advance our knowledge and provide guidance to the Bank as we approach the upcoming renewal of the inflation-control targets.