Flexible Inflation Targeting: Past, Present, and Future

“The Evolving Role and Limits of Monetary Policy: New Perspectives for Emerging Market Economies”
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Outline

• Canada’s experience with flexible inflation targeting before and after the crisis
• Renewal of Canada’s inflation targets in 2011
• Outstanding issues related to the monetary policy framework
• Monetary policy as a culprit, a captive and a savior
• Optimal monetary policy, history dependence and price-level targeting
Canada’s Experience with Flexible Inflation Targeting

• Canada an early adopter of inflation targeting
• Performance over the 1991-2007 period – better than we expected [Chart 1 and Table 1]
• Performance during and after the crisis – better than most other countries [Charts 2 and 3]
• Is this as good as it gets? Is this a game that only AEs can play?
Renewal of Canada’s Inflation Target

• Extensive research program prior to the 2011 renewal looked at three questions:
  1. Is 2 per cent the right inflation target?
  2. Would a price-level target be better?
  3. Should financial stability concerns get more recognition?

• Promising results, but in the end, no change to the existing framework

• Renewed appreciation for what we already have
Outstanding Issues Related to the Framework

• Many issues nevertheless remain unresolved and are being re-examined in the run-up to our 2016 inflation targeting renewal:

  1) Are encounters with the zero-lower-bound going to be more frequent?

  2) Does this suggest the need for a higher inflation target?

  3) Does it increase the attractiveness of price-level or GDP level targeting? [Charts 4 and 5]
Outstanding Issues Related to the Framework (cont’d)

4) Can unconventional tools play a useful role in “peace time”?
5) Is forward guidance only helpful in emergency situations?
6) How long should emergency liquidity measures be kept in place?
7) Do financial stability concerns need to be given more explicit recognition in the monetary policy objective function?

• Tools, targets and the assignment problem
Monetary Policy as a Culprit, Captive and Savior

• Some exaggerated and unhelpful characterizations of monetary policy:
  1) A culprit – a major contributor to the crisis?
  2) A captive – at risk of losing its independence?
  3) A savior – too popular for its own good and asked to do too much?

• Where does this leave us? Is there scope for improvement?
Optimal Monetary Policy and History Dependence

• The advantages of history dependence and inflation overshooting
• Links with price-level targeting and inflation averaging
• History-dependent monetary policy as a rainy-day tool
• Backdoor history dependence via forward guidance and thresholds
• Expectations formation – some preliminary experimental evidence
Chart 1: Inflation performance was better than we expected

12-month rate of increase, monthly data

Sources: Statistics Canada and Bank of Canada calculations  Last observation: December 2007
Table 1: Canada’s economic performance (1970-2013)

<table>
<thead>
<tr>
<th></th>
<th>Average (%)</th>
<th>Standard Deviation</th>
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<tbody>
<tr>
<td>CPI: 12-month increase</td>
<td>6.8</td>
<td>2.1</td>
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<tr>
<td>Real GDP growth</td>
<td>2.9</td>
<td>2.8</td>
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<tr>
<td>Unemployment rate</td>
<td>8.9</td>
<td>8.4</td>
</tr>
<tr>
<td>3-month interest rate</td>
<td>10.0</td>
<td>4.7</td>
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<tr>
<td>10-year interest rate</td>
<td>10.1</td>
<td>6.1</td>
</tr>
</tbody>
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Chart 2: Canada’s performance has been better than other advanced economies

Real GDP Levels
Quarterly data, seasonally adjusted, 2007 Q4 = 100


Last observation: 2013Q4
Chart 3: CPI inflation has been subdued but generally well-behaved.

Year-over-year percentage change, quarterly data

- Total CPI
- Core CPI*
- Target
- Control range

*CPI excluding eight of the most volatile components and the effect of changes in indirect taxes on the remaining components

Sources: Statistics Canada and Bank of Canada calculations and projections

Last observation: 2013Q4
Chart 4: PLT and IT stabilize inflation

Inflation Rate

%  0  13  17  21
Quarters  1  5  9  13  17  21

PLT  IT
Chart 5: However, smaller movements in the interest rate are required under PLT.