Notes for a Panel Discussion on Monetary Policy
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As Paul Jenkins has reminded us Canada's experience under inflation targeting has been favourable. His presentation rests on the implicit and, I believe, correct, presumption that there is no appetite to abandon the regime. There may, however be a case for modifying it, in three directions. (1) By lowering inflation from 2 per cent., presumably, given the importance of round numbers, to 1 per cent. (2) By targeting the time path of the price level, rather than inflation, and (3) By making the regime flexible enough to accommodate other goals – for example the maintenance of financial stability.

(1) The case for lowering the target inflation rate is harder to make these days than is often supposed, and I say this as someone who, at the outset of Canada's experiment, supported 1 per cent inflation as its ultimate goal.

(a) The improvements in the economy's productivity performance that were anticipated in the early 1990s either have not materialized, or have proved much harder to isolate than anyone expected. Once allowance is made for the benefits from the FTA/NAFTA there is not much left over to attribute to lower inflation. It is hard, therefore, to make the case that there is now much to be expected in this regard from moving from 2 per cent to 1 per cent. Note that this is an empirical issue. That there are strong theoretical arguments for expecting some increases in economic efficiency as inflation is reduced, even from its current modest level, is not in dispute. The question is how big they might be.

(b) When Canada adopted inflation targeting, it did so in virtual isolation. Now such policies are widespread, and, as Jenkins notes, targets are tending to converge around 2 per cent internationally. Andrew Rose has recently suggested that we might think of inflation targeting as forming the basis of a new international monetary system that turns Bretton Woods on its head. To the extent that this intriguing idea has merit (and I think it does) then perhaps there is something to be said for Canada not disturbing an emerging international consensus.

(c) But – even at two percent, inflation has noticeable redistributive consequences, particularly important, perhaps, in an economy whose population is aging and where the indexation of pensions is highly imperfect. Moreover, when real interest rates are already low – has low inflation itself helped to cause this? – the interaction of the Fisher effect with the taxation of the nominal returns on savings can have striking effects on after-tax-real-rates-of-return even at inflation rates that vary between, say, 1 and 3 per cent.

(d) Furthermore, as Jenkins says, old arguments about downward wage stickiness, etc. do not seem to carry much empirical weight.

(e) My own guess is that this issue overall will hinge, first, on whether the productivity benefits of low inflation really have been a meagre as currently seems to be the case - - further work might just reveal that we have underestimated them – and second on the

extent to which distributional issues begin to gather extra resonance as the Canadian electorate ages and become politically important.

(2) The case for moving to a price level target, which I also supported in the early 1990s still has it attractions.

(a) Successfully implemented, it would reduce price level uncertainty at the time horizons that seem particularly relevant for longer-term investment decisions. Qualitatively, this should contribute to the economy's efficiency - but see 1(a) above, where this point might cut both ways!

(b) Such a regime, if credible, would generate expectations that would have certain well known and attractive stabilizing features.

(c) Though the zero lower bound issue's significance is often exaggerated, it is nevertheless an issue, and credible price level targeting would take some of the sting out of it, thus making it easier to make a case for lowering the inflation rate in conjunction with the adoption of price level targeting.

(d) However, price level targeting makes more acute the problems that Mishkin has discussed so thoroughly, namely those that arise from short term-inflation volatility and the use of core price indices in policy formation to overcome them. In particular, when the relative prices of goods that are excluded from core measures of inflation change permanently, bygones do not become bygones once this adjustment in question is complete under price-level targeting. The problem of distinguishing between permanent and transitory relative price changes thus becomes much more challenging under price-level targeting

(e) Furthermore, the international consensus question arises again in this context. There currently seem to be 23 informal inflation targeters in the world, and no price-level targeters. Nor am I impressed with the evidence from Sweden in the 1930s, where the exchange rate was fixed against sterling about 18 months after price-level targets were introduced.

(e) Recall, however, that the line between inflation and price level targeting is a little blurry. The former approaches the latter as its time horizon is lengthened. Even so, before we become too enthusiastic about this option, we should recall the temptations inherent in long time horizons to defer painful policy decisions in the hope that things will correct themselves before they need be implemented – some of us still blush when we remember what five-year-horizons did to the Canadian federal government's budget planning in the 1980s.

(3) The case for more flexibility in inflation-control policy that will enable other goals to be met is particularly attractive right now, in the middle of what I suspect is a still ongoing episode of financial instability.

(a) However, the pursuit of multiple policy goals always looks attractive in the abstract, but is prone to a host of well known problems in practice. It's easy to fine tune an econometric or calibrated model, but altogether more difficult with a real economy.

(b) It is particularly hard to judge what effect keeping a systematic eye on financial stability issues might imply for the performance of an inflation or price level targeting regime when the standard model employed to guide the latter does not even include a financial system, except perhaps to the extent that it might be buried in the parameters of the "IS" curve and the Taylor rule.

(c) If inflation targeting now appears to be reasonably easy, and therefore capable of withstanding the addition of a few complications to the policy menu, we should perhaps recall that, in the early 1990s, it seemed to be outrageously ambitious. A little humility about just how much we can reasonably expect monetary policy to accomplish, along with an acknowledgement that the successes of the last fifteen years or so might owe something to the luck as well to the good judgement of central banks is perhaps in order.