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I am very pleased to be with you today as a member of this very distinguished panel. In my prepared remarks, I would like to focus on two topics -- the advantages of having clear objectives and targets in formulating policy, and the advantages of transparency and clear communications in achieving policy objectives. In discussing these topics, I will refer to the experience of Canada¹ and that of other countries with inflation targets and monetary policy communications.

Inflation targets²

It is now just over ten years since Canada introduced inflation targets, the second country (following New Zealand) to do so. Looking back over the experience of the decade, I would conclude that the targets have been very successful in providing a

¹ For a detailed discussion of some of the mechanics of the monetary policy decision-making process in Canada, see David Longworth and Charles Freedman, “Models, Projections, and the Conduct of Policy at the Bank of Canada”, paper prepared for the conference Stabilization and Monetary Policy: The International Experience, Bank of Mexico, November 2000.

² This section makes considerable use of material in C. Freedman, “Inflation Targeting and the Economy: Lessons from Canada’s First Decade”, Contemporary Economic Policy, January 2001, pp. 2-19.

nominal anchor for the conduct of monetary policy in Canada and in tying down the inflation expectations of savers, investors, businesses and workers.

Inflation targeting is a clear and effective way of achieving low inflation. And low inflation is simply a means to an end - - the end being a better-functioning economy with a higher standard of living than one facing a persistently high rate of inflation.

There are other nominal anchors that have been used to try to achieve low inflation - - the two most commonly used being monetary aggregate targets and an exchange rate that is fixed to the currency of a country that has had a history of low inflation. But the countries that have chosen to use inflation targets have typically had three key characteristics in common: a history of relatively high rates of inflation, floating exchange rates (either voluntary or forced), and monetary aggregates without sufficient stability to serve as intermediate targets. Because neither the exchange rate nor a monetary aggregate was available to serve as a nominal anchor, these countries decided to focus on the longer-term goal of policy, a low rate of inflation, as the anchor for the system. Unlike countries with a history of relatively low inflation, their own history and lack of central bank credibility meant that they were unable to rely on a simple qualitative commitment to low inflation. Instead, they announced an explicit quantitative target for

either the downward path to very low inflation or the maintenance of very low inflation, and the target has enabled them to achieve a low-inflation outcome.

What has been the overall experience of the industrialized countries with inflation targets? First, the countries with targets moved from being in the relatively high-inflation group of countries to being in the low-inflation group, and they achieved this in a fairly short time. Second, as these countries achieved their announced goals over time, financial markets adjusted their longer-term inflation expectations and built these expectations into longer-term interest rates. The risk premiums that compensate investors for inflation uncertainty declined or vanished. Moreover, participants in product and labor markets adjusted their expectations of future rates of inflation downward as the inflation targets were achieved. At the same time, inflation expectations became partly linked to the target and were less sensitive to movements of inflation away from the target. Third, despite these adjustments, one cannot find improvements in the sacrifice ratio in the data of the countries with inflation targets. Fourth, the targets have been extremely helpful in explaining central bank actions (and, sometimes, inactions) to the financial markets and the public. Fifth, the forecast of inflation has effectively become the intermediate target of policy in countries with inflation targets, and the framework for the analysis of new economic information has shifted to its effect on inflation one to two years into the future; in other words, the framework has become more forward-looking.

Moreover, by focussing on bringing the rate of inflation back to the target over a one to two year horizon when it deviates from the target, the policy approach results in relatively low variability of both output and inflation. Sixth, according to the staff at a number of central banks with inflation targets, the quality of monetary policy discussions within the central bank has been significantly improved by the introduction of explicit targets.

I would not argue that inflation targets are necessary for achieving and maintaining low inflation. Indeed, a number of countries, such as the United States and Germany, that had a long history of relatively low inflation and had central banks with credibility have been able to post good inflation records without them. But, for countries like New Zealand, Canada, the United Kingdom, Sweden, Australia, and Finland (before it entered the euro zone), countries with a history of higher rates of inflation, the targets were very helpful in bringing down and holding down the rate of inflation.

With the success of inflation targets in containing inflation in industrial countries, a number of emerging-market economies have either adopted or are considering adopting inflation targets as the centerpiece of their monetary policy framework. Included in this group are Brazil, Chile, Mexico, South Africa, South Korea, and Indonesia.

Let me now turn more specifically to the Canadian experience with inflation targeting.

In February 1991, the Bank of Canada and the Government of Canada issued a joint statement setting out a target path for inflation reduction – starting at 3 per cent at the end of 1992 and falling gradually to 2 per cent at the end of 1995, with a range of plus or minus 1 per cent.

The targets were intended to achieve both short-term and longer-term objectives. In the near term, the targets were intended to prevent the price shocks that were then buffeting the economy from leading to a further wage-price spiral and to help reduce prevailing inflation expectations. In the long run, the inflation targets were designed to demonstrate a concrete commitment by the authorities to the goal of achieving and maintaining price stability while at the same time enhancing the credibility of that goal. By laying out an explicit path to price stability, the announcement of the targets was aimed at facilitating the actual achievement of the longer-term goal of price stability.

In December 1993, the Bank and the government agreed to extend the 1 per cent to 3 per cent range (the target for the end of 1995) for three more years, through to

the end of 1998. In February 1998, the government and the Bank again extended the 1 per cent to 3 per cent target range, this time to the end of 2001.

On May 17, 2001 the Government and the Bank again agreed to renew the inflation-control target. Under the renewed agreement:

- The inflation-control target range will continue to be 1 to 3 per cent;
- Within this range monetary policy will continue to aim at keeping inflation at the 2 per cent target midpoint;
- The length of the agreement will be 5 years, until 31 December 2006.

Before the end of 2006, the Government and the Bank will review the experience over the period and determine the appropriate target for the period ahead.

In a document giving background information on the renewal of the targets, the Bank of Canada gave additional information on the target arrangements and on the way that it plans to implement these arrangements to increase long-term inflation predictability.

I would just highlight a few of the key points in this document, which is available on the Bank's web-site (www.bankofcanada.ca).

First, in retaining the 1 to 3 per cent target range and 2 per cent target midpoint, the Bank carefully examined the arguments that the target should be raised. These arguments relate to concerns about downward wage rigidity, the inability of nominal interest rates to decline below zero, and the potential risk of deflation. The Bank concluded that the evidence does not support these concerns for the current target range. The Bank also carefully examined the arguments for a lower target. Good theoretical arguments can be made in support of a further reduction in the target but it has thus far proven difficult to quantify the longer-term benefits deriving from such a change. As a consequence, the Bank decided it was best to maintain the current target range.

While the earlier target agreements had a 3-year horizon, on this occasion the Bank and the Government have agreed on a 5-year horizon. This reflects the fact that after almost a decade of operation, the targets have become a widely-accepted and indeed a central element in the Canadian economic policy framework. A longer period for the agreement will give the Canadian public greater assurance that the era of low inflation will be a continuing feature of the Canadian economic environment. It will therefore facilitate long-term planning.

The inflation target will continue to be set in terms of the 12-month increase in the total consumer price index (CPI). But the Bank finds it helpful to use a core measure of inflation as a shorter-term operational guide to policy. The Bank has changed its core measure from the CPI excluding food, energy and the effects of changes in indirect taxes to a measure that excludes the eight most volatile components of the CPI as well as the effect of indirect taxes on the other CPI components. There will also be some refinements in the way inflation developments will be explained to the public, which I will discuss in the section of my remarks devoted to transparency.

The Canadian experience shows that inflation targets provide an effective nominal anchor for monetary policy and that they can make an important contribution to the reduction of inflation and then to its maintenance at a low level. The average rate of inflation over the 20 years preceding the introduction of the inflation targets in February 1991 was over 7 per cent. Since the introduction of the targets, the 12-month change in the core CPI, the operational guide for monetary policy, has been within the target range for most of the period.

One final point. Low inflation is a necessary, but not sufficient, condition for good economic outcomes. It is, of course, essential that other policies, both macro and micro, also have the appropriate focus in order to achieve the best economic

outcomes. But low inflation provides the crucial underpinning that enables the economy to perform well.

Transparency and communications³

Transparency and communications play two important roles in the conduct of monetary policy. First, by enhancing the understanding by financial market participants and the general public of the goals of policy, the way policy actions are transmitted, and the current outlook of the central bank, they facilitate the achievement and maintenance of low inflation outcomes. Second, they contribute importantly to the accountability of the central bank for monetary policy, which is an essential element in the framework supporting the independence of the central bank.

Let me begin with a brief backward glance. It is not so long ago that central banks did little to let people know what they were up to and why. Indeed, in the conduct of monetary policy, little emphasis was placed on trying to explain the objectives of

³ Much of this section is taken, with permission, from Paul Jenkins, “Communicating Canadian Monetary Policy: Towards Greater Transparency”, remarks prepared for a presentation to the Ottawa Economics Association, May 22, 2001.

policy because those objectives were not well defined. Without clear objectives for monetary policy, central bank actions were less predictable. And the conventional way of thinking among central banks was that it was best to say nothing and let actions speak for themselves.

It is a very different story today. Indeed, there has been nothing less than a sea-change in the way central banks view the role of communications in monetary policy. What we have seen in recent years is a broad and continuing trend among central banks toward greater openness and transparency in the conduct of monetary policy. And the principal reason that this trend has occurred has been the recognition that, to be effective, monetary policy must be more transparent. And to be transparent requires proactive and well-planned communications.

Good communications are important in helping to put the Bank and financial markets on the same wave length since, generally speaking, monetary policy is more effective when financial markets understand how the central bank assesses economic developments in relation to its policy objectives. When everyone is on the same wave length, markets can anticipate, rather than simply react to, interest rate actions by the central bank.

If the central bank does a good job of keeping market expectations broadly in line with the direction of policy, there tends to be less volatility in financial markets and a smoother, more rapid incorporation of any shifts in policy into interest rates and exchange rates. In other words, effective communications improves the monetary policy transmission process and leads to responses in exchange rates and in the term structure of interest rates that are more consistent with the central bank's intentions. This greater stability and predictability is in everyone's interest.

In addition, by influencing the expectations and behaviour of the general public, increased transparency and good communications enhance the central bank's ability to meet its policy objectives. Greater public understanding and acceptance of what the central bank is trying to do increases the chances of success in achieving the inflation objective with as little economic disruption as possible.

Let me be more specific. If a central bank has a target for inflation and if consumers, investors, workers, businesses and governments believe that action will be taken to ensure inflation remains close to its target, they are more likely to make economic and financial decisions accordingly. Pricing decisions by producers and suppliers will reflect inflation expectations consistent with the target. Wage bargains between employees and employers will tend to be in line with the inflation target. The

net effect will be a more stable macro-economic environment and greater success in keeping inflation low.

Well, what has the Bank of Canada done to increase transparency and improve communications? An important step towards increased transparency, and thus toward clear and focussed communications, was taken in 1991 when explicit inflation-control targets were adopted in Canada. The announcements of the targets clarified the objective of monetary policy and provided, as I explained earlier, a nominal anchor for economic decisions. The Bank of Canada has also made clear its views of the workings transmission mechanism and has emphasized the role of both interest rates and the exchange rate in the process.

While the targets continue to define our inflation objective, conditions in the economy are constantly changing. Both international and domestic developments can affect the economic outlook in Canada. The Bank has to continually assess these changes and their implications for future inflation. When required, the Bank takes appropriate policy actions that are consistent with achieving the inflation target mid-point over the medium term. The role of communications is to explain how and why circumstances have changed, and to relate the Bank's actions to the inflation target and hence to the well-being of the economy. The main vehicles for setting out the Bank's assessment of

the outlook for the economy and inflation, and for explaining its actions, are the Monetary Policy Report, issued every May and November (since 1995), and Updates to the Report, issued every August and February. The Governor holds a press conference after the four releases and testifies before the House of Commons following the release of each Monetary Policy Report.

With the introduction last December of eight fixed announcement dates each year for monetary policy actions the Bank now also issues eight press releases each year, explaining why it changed or did not change its policy rate.

The Reports, Updates and press releases, along with speeches by the Governor and other senior officials of the Bank, are intended to provide the markets and the public with a regular, continuous and integrated flow of information throughout the year of the Bank's views of the outlook for the economy and inflation. They are also closely linked. Thus, the MPR and Update, which are completed on the fixed announcement dates and released two weeks later, give a complete assessment of the situation underlying the decision taken by the Bank on those dates.

In the document giving background information on the renewal of the inflation-control target, the Bank also set out some refinements in the way it will explain

inflation developments for the Canadian public. Henceforward, when CPI inflation persistently deviates from the target midpoint, the Bank will give special attention in its *Monetary Policy Reports* or *Updates* to explaining why inflation has deviated to such an extent from the target midpoint, what steps (if any) are being taken to ensure that inflation moves back to the target midpoint, and when inflation is expected to return to the target midpoint. These explanations will focus on the movements in total CPI inflation, core inflation, and the components excluded from core, as well as changes in indirect taxes.

The Bank also noted that predictability of average inflation over longer time horizons is desirable. Because unpredictable shocks to inflation should tend to average out over time, monetary policy can deliver this predictability by consistently aiming at 2 per cent for the 12-month rate of inflation. In these circumstances, the longer the averaging period, the more likely it is that average inflation will approach 2 per cent. That is, the interval for the likely outcomes for the average of CPI inflation (excluding the effect of indirect taxes) is narrower, the longer is the averaging period

On the operational side, in 1994 the Bank introduced an operating band for the overnight rate of interest to give greater clarity to financial markets about the Bank's desired rate setting. In 1996, it set the Bank Rate -- the rate at which it lends to financial institutions -- at the upper end of the operating band. And, in 1999, it set the target for the overnight rate as the midpoint of the band. Currently, the Bank is moving to place

more focus on the target for the overnight rate in its announcements since it is the appropriate policy rate for international comparisons. That is, the overnight rate target corresponds to the target for the Federal funds rate in the United States and equivalent targets in other countries.

The Bank has also put a lot of emphasis on developing and maintaining its Web site. This gives the public at large direct access not only to publications and speeches, but also to easily understandable information about the Bank and monetary policy.

Transparency and communications are also important in the accountability of a central bank. As a public institution with a high degree of autonomy for the conduct of monetary policy, the Bank of Canada bears an obligation to account to Canadians for how well it is doing its job. An explicitly defined and agreed-upon inflation target provides a clear basis for accountability. This clear basis for judging the Bank's performance is also extremely important for credibility. But for the Bank to be fully accountable, it must provide the public with the information it needs to be aware of, and understand, the Bank's policy objectives, the factors it takes into account in making decisions, and its progress in meeting its objectives. That is the job of communications.

Concluding remarks

The 1990s turned out to be a very innovative decade in central banking, with a significant number of countries adopting a clear inflation-targeting framework (in the context of a floating exchange rate regime) and, related to some extent, a movement to enhanced transparency. While it is always harder to predict the future than to explain the past, I expect that these developments will remain key elements in central banking for a long time to come.