TD Bank Financial Group

TD Economics

Special Report

March 24, 2006

A LOWER INFLATION TARGET? DON'T BET ON IT NOW

Although largely overlooked during Bank of Canada Governor David Dodge's press conference on Tuesday, his comments on the possibility of a lower inflation target for Canada have since created some buzz. The comments raise several questions. What are the costs of a lower inflation target? What are the advantages? What target might the Bank of Canada pick? What implications would this have on financial markets? And what are the odds of this happening? Let us address each of those.

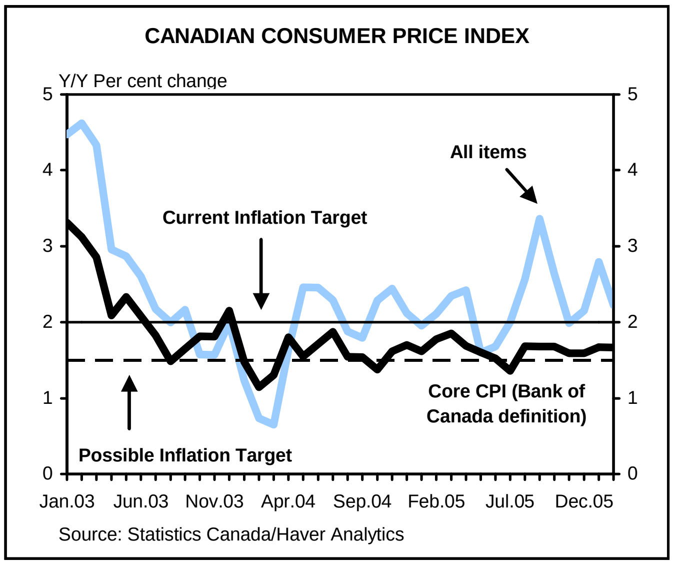
But first, Dodge's exact comments:

"*We will have to have discussions with the government before the end of 2006 to renew the arrangement going forward [the inflation targeting agreement with the government, which is renewed every 5 years; most recently in 2001]. As we have said in our research this time, we have seen a little more evidence that a slightly lower target might be appropriate going forward. But as I have said, we would have to see pretty strong evidence before this renewal that this was the case before we would propose it.*

But let me make one more point. By the time we reach the end of this renewal, we will have been either 18 or 20 years since we started out, and we really do have to think about where we think the appropriate target would be over the very long haul; that is probably something we will have to do quite quickly, not necessarily before we make the renewal, but certainly early in the period of the renewal."

Disadvantages of a Lower Inflation Target

Too low an inflation target has several disadvantages for the economy. It risks bumping up against deflation, which can slow an economy drastically by encouraging individuals and businesses to delay spending since a dollar spent tomorrow can buy more than a dollar spent today.



Another risk is that to achieve lower inflation, interest rates might have to rise in the short term to dampen prices. This would result in a temporarily slower pace of economic growth, and a higher level of unemployment. Eventually, these costs would diminish as inflation expectations recentered around the new level, but in the interim, the economy would suffer.

Furthermore, it is important to recognize that the Canadian measure of CPI is biased upward by about 0.5 per cent, meaning that the current 2.0 per cent target actually represents something closer to 1.5 per cent (as an aside, this is a reason why a 0 per cent CPI target would be folly – it would guarantee perpetual deflation). The reason for the bias is that the basket of goods and services underlying the CPI is updated infrequently, such that new products like cell phones and DVD players aren't included in the basket when their prices are plummeting as they gain critical mass.

Lastly, a lower inflation target could decrease the ability of the Bank of Canada to stimulate the economy in a time of crisis, since nominal interest rates are effectively bounded by 0 per cent on the lower end, and a 0 per cent nominal interest rate with lower inflation is less stimulative (i.e. represents a higher real interest rate) than one with higher inflation.

Advantages of a Lower Inflation Target

On the flip side, there are a variety of advantages to lower inflation, as well. A lower inflation rate would minimize the pernicious effects of inflation, for instance the cost to businesses of having to change their prices frequently, and the cost to individuals of having to rush to the store to buy an item today instead of tomorrow (when the item might become more expensive). There is also a redistributive effect, whereby those on fixed, unindexed income lose out with higher inflation, and win with lower inflation.

Obviously, at the margin, the advantages derived from a slight drop in the inflation rate aren't all that large, but they do add up, and possess the potential to increase the long-term potential pace of economic growth in Canada.

What Inflation Target

Dodge's comments make it sound like the only change to the Bank of Canada's modus operandi being even casually considered is a cut to the current inflation target. Alternative approaches like price level targeting don't appear to be on the radar.

Given the aforementioned bias inherent in the CPI, the Bank of Canada would be unlikely to pick a CPI target below 1.5 per cent. Keep in mind that 1.5 per cent CPI means about 1.0 per cent true inflation. Anything less than that would be awfully close to zero, and would push the Bank's inflation-control target range (currently bounded around +/-1 per cent of the target) into a dangerous dance with negative territory, and all of the unpleasant deflationary implications associated with that.

On the other hand, any number between the current inflation target of 2.0 per cent and 1.5 per cent is unlikely, simply because such a move would be perceived as too small to matter, and would generate a messy target (for instance, 1.75 per cent would necessitate an additional significant digit for calculations).

LOWERING THE INFLATION TARGET
PROS
•Minimize negative consequences of inflation
•Aid those with unindexed fixed incomes
•Potentially faster economic growth in long term
CONS
•Risks deflation
•Slower economic growth in near term
•Less ability to stimulate economy with monetary policy

In short, if the inflation target were to be reduced, 1.5 per cent is the best bet, likely couched in the framework of a slightly tighter operational band of 1.0 – 2.0 per cent.

Implications for Markets

A lower inflation target rate could have several implications for financial markets.

Over the short term, Canadian interest rates might have to rise to push inflation down to the new, lower target. Keep in mind that with core inflation currently running at 1.7 per cent and the 3-month and 6-month annualized pace at 1.9 per cent, there would be some monetary dampening required. But as inflation expectations adjusted to the new, lower level, interest rates could presumably return to normal over that time. And the potential exists that nominal rates could eventually wind up even lower than where they started, since a lower rate of inflation would mean that to sustain a constant real rate, the nominal rate could be lower than before.

In the short term, the Canadian dollar would presumably strengthen in response to further rate hiking by the Bank of Canada. Similarly, over the long term, the Canadian dollar might appreciate since Canada's lower rate of inflation would mean that the purchasing power of the Canadian dollar would erode less quickly than before.

Odds of a Lower Target

Of course, all of the discussion above is contingent on the odds that Dodge and company lower Canada's inflation target. This is far from certain, in our opinion.

First, this is not the first time that the Bank of Canada has contemplated a lower inflation target. A similar discussion arose in 2001 (during the last inflation target renewal), and a whole slew of research papers, conferences, and opinions were generated. But in the end, the Bank decided that it was best to remain unchanged at 2.0 per cent. In our view, the pros and cons of a lower inflation target haven't changed much since then, and so there isn't much reason to think the outcome will be any different this time.

Second, Dodge said yesterday that he would have to see "pretty strong evidence" supporting the merit of a lower inflation target, and yet admits that, to date, there has only been "a little more evidence" than before. For those concerned that we are reaching conclusions based only on a possible slip of the tongue, Dodge expressed a strikingly similar sentiment in a November 2005 speech, saying that, in 2001, "our research could not convincingly demonstrate that the benefits of moving to a lower target would outweigh the costs. More recent research, while still inconclusive, provided a little more support for a lower target. Of course, we continue to look at this question, but the evidence will have to be quite compelling before we would change our target." Since the evidence has been neither "strong", nor "compelling", the burden of proof thus appears to be lacking even from Dodge's own perspective. This argues rather forcefully against a wholesale shift in the Bank of Canada's target.

Fourth, although there are several advantages that may arise from a lower inflation rate, the transition costs are not trivial. The Bank of Canada forecasts 2.0% inflation by early 2007, and this would be considered undesirably hot under a new regime. The higher interest rates that would be necessary to push inflation downward in the short term would not be pleasant for the Canadian economy, especially at a time when the Bank of Canada is trumpeting downside risks to the 2007 outlook.

The Bottom Line

In conclusion, we'll keep our eyes open for signs that the Bank of Canada is serious about changing its inflation target. But we view the odds as rather miniscule that the inflation target will be changed for this year's renewal. And with the subsequent inflation target renewal not scheduled until 2011, that could put the subject off for some time.

Despite the low odds of a near term move, it would not surprise us if the Bank of Canada's inflation target were eventually tweaked. There has long been an undercurrent of support at the Bank for a lower target. And if evidence were to mount in favour of such a switch, then a change would certainly be possible. Keep in mind that, far from being entrenched in its ways, the Bank of Canada has cycled through a variety of different approaches to monetary policy over the years. One more would not be unprecedented. Of course, by the time 2011 rolls around, the debate may be framed in a slightly different fashion than the options we have discussed above. Instead of just a 2.0 per cent target versus a 1.5 per cent target, the idea of price level targeting (whereby the Bank would pursue abnormally low inflation after a period of abnormally high inflation to regain an even keel) might also be on the table. And by then, our neighbour to the south may have a quantitative target of its own if Chairman Bernanke has his way.

MARKET REACTION TO A LOWER INFLATION TARGET

SHORT TERM
- Interest rates and bond yields would rise to push inflation down to the new target
- Canadian dollar would strengthen as interest rates rise

LONG TERM
- Nominal interest rates and bond yields might wind up lower than where they started due to a lower inflation environment
- Canadian dollar might appreciate as the purchasing power of the Canadian dollar erodes by less over time than before

Eric Lascelles
Strategist
FX & Fixed Income Research and Strategy
TD Securities
416-982-8979