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### Bank of Canada Releases Background Information on Renewal of the Inflation-Control Target

**OTTAWA, Ontario, November 27, 2006** — The Bank of Canada today released the document *Renewal of the Inflation-Control Target: Background Information*, which describes Canada's experience with inflation targeting, reports on some key issues bearing on the framework for conducting monetary policy, and identifies issues warranting further research.

This release follows the 23 November announcement by the Government of Canada and the Bank of Canada that the inflation-control target has been renewed for a period of five years to the end of 2011. Under the agreement, the Bank will continue to conduct monetary policy aimed at keeping inflation, as measured by the consumer price index (CPI), at 2 per cent, with a control range of 1 to 3 per cent around this target.

Key elements discussed in the *Background Information* document include the following:

**Canada's experience with inflation targeting:** Since Canada adopted inflation targets in 1991, total CPI inflation has averaged very close to 2 per cent, and the variability of inflation has been significantly lower than was the case in the 15 years before inflation targeting. Success in reducing inflation, coupled with an explicit commitment to keep inflation low, stable, and predictable through time, has helped to anchor inflation expectations to the 2 per cent target. A low-inflation environment has contributed to sound economic performance and the well-being of Canadians in a number of important ways. Consumers and businesses have been able to manage their finances with greater certainty about the future purchasing power of their savings and income. Nominal interest rates, both short and long term, have been much lower and more stable. Output growth in the economy has been generally higher and significantly more stable, while unemployment has been lower and less variable. The more stable price environment provided by inflation targeting has also helped the economy adjust to economic shocks, such as the global high-tech bubble, 9/11, SARS, and the rapid rise in oil prices, allowing businesses and households to allocate resources more efficiently.

**Total inflation and core inflation:** The inflation target will continue to be set in terms of the 12-month increase in the total consumer price index. This reflects its role as the most commonly used indicator of inflation in the Canadian economy and the most relevant estimate of the cost of living for most Canadians. Total CPI inflation, however, is subject to considerable variability and so is not always the best indicator of the underlying trend in inflation and, therefore, of where inflation is likely to be in the future. For this reason, core inflation - which removes volatile price components - provides a useful guide for the conduct of monetary policy. In the context of the new inflation agreement, the Bank intends to continue using CPIX as its preferred measure of core inflation. CPIX strips out eight of the most volatile components of total CPI, as well as the effect of changes in indirect taxes on the remaining CPI components. As in the past, the Bank will continue to look at a range of measures in order to assess the underlying trend of inflation.

**The target time horizon:** Based on recent research, the Bank has concluded that the present policy of bringing inflation back to the 2 per cent target within six to eight quarters (18 to 24 months) is still appropriate generally, although specific occasions may arise in which a somewhat shorter or longer time horizon might be appropriate. For example, the

persistence of lower observed inflation might suggest, in some instances, a shorter time horizon. Similarly, the longer-lasting nature of some shocks, such as large asset-price movements could, in some instances, suggest a longer horizon. A full discussion of the shocks to the Canadian economy, and of the Bank's policy response to them, will be provided in the Bank's *Monetary Policy Reports*.

**Asset prices and the inflation target:** It remains the Bank's view that no explicit recognition should be given to asset prices in the inflation-target index, beyond the recognition already accorded the price of housing services in the CPI. The Bank will focus on the inflation and output consequences of any economic disturbance, including asset-price shocks, and will continue to respond in a manner consistent with meeting its long-run inflation objective. However, as noted above, some flexibility might be required with regard to the time horizon over which the target is achieved. This might involve sacrificing something in terms of inflation performance over the usual horizon, but could lead to greater financial, economic, and inflation stability over a somewhat longer horizon. If the Bank judged that the time horizon should be adjusted relative to the usual six to eight quarters, it would communicate the reasons for the change and how it planned to respond.

**Issues warranting further research:** While Canada's 15 years of experience with inflation targeting have been very positive, there remains the question of whether the specific regime established in the 1990s will deliver the greatest contribution to economic performance and to the well-being of Canadians in the decades ahead. With this in mind, the Bank plans to lead a concerted research program to learn from our experience and the experience of others, and to examine whether and how the monetary policy framework in Canada might be improved. Building on recent research on inflation-targeting frameworks, the research program led by the Bank will focus on the potential costs and benefits of targeting a lower rate of inflation or of pursuing a price-level target instead of an inflation target. The research program will also consider any necessary reassessment of issues covered in the past and assessment of any new issues that may arise. Other interested researchers are invited to join the effort. The goal is to complete this research well in advance of the next renewal date in 2011 so as to ensure sufficient time for open discussion of the results and their implications.

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