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Date: 29 September 1992
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"THE GOVERNMENT'S INFLATION OBJECTIVE" - SHOULD WE TARGET INFLATION DIRECTLY?

1. I note that the Chancellor has indicated his intention to hold a meeting concerning the Government's inflation objective. As we discussed in passing, an issue I think we should raise is that of inflation targeting.

2. With the exchange rate now floating, it appears that monetary policy has no firm anchor. While the Government has announced its intention to monitor a range of indicators, experience has shown this approach can easily result in an inappropriate stance for monetary policy. This is partly because some of the indicators are of doubtful value and there is no rigorous means of weighting them. Perhaps more importantly, "check-list" approaches to monetary policy have allowed governments to seize upon any variables showing activity is weak so as to justify cuts in interest rates (or to resist increases).

3. I also doubt that there is a suitable single intermediate target upon which to base monetary policy:

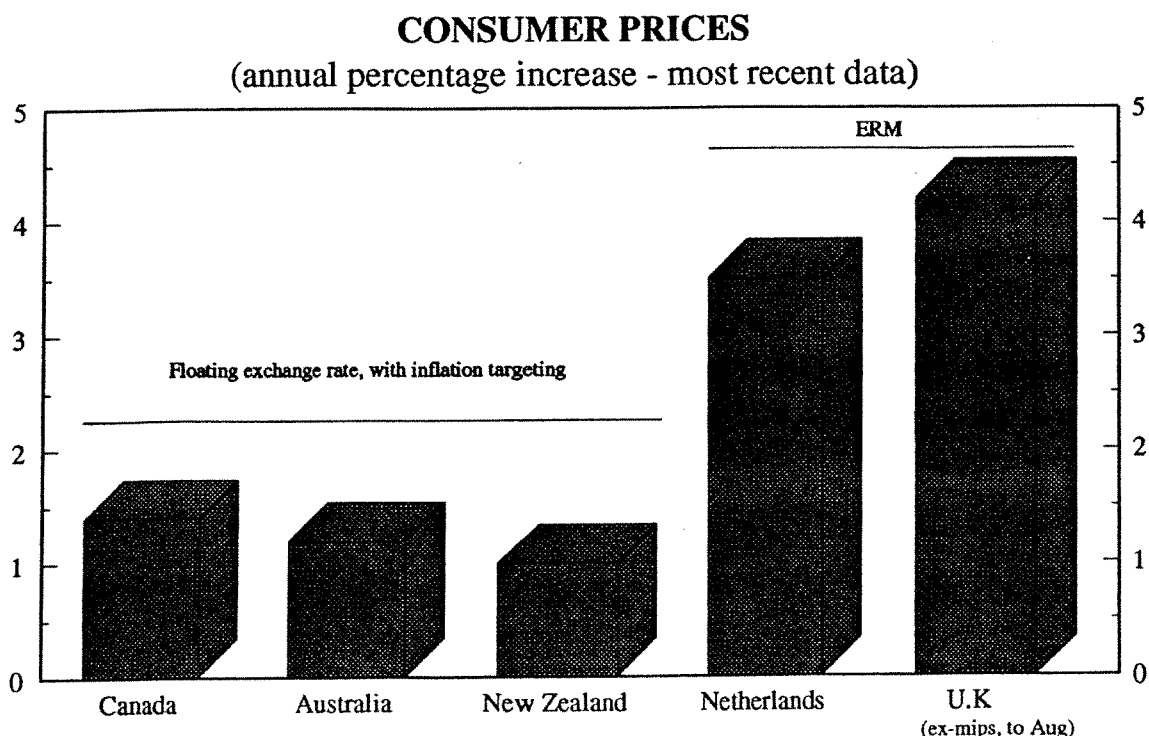
- M0 lacks market credibility, and its prime value appears to be as a contemporaneous indicator of nominal GDP;
- there are continuing doubts concerning the implications of movements in broad money; and
- the exchange rate has been ruled out for now as being an appropriate target variable.

4. This lack of suitable intermediate targets enhances the case for the direct targeting of inflation.

5. Public commitment to an inflation target could have substantial benefits: in providing an anchor for monetary policy (even if a range of indicators are being monitored), in disciplining government actions, and in soothing nervous financial markets and foreign investors. There are clearly drawbacks to such an approach - most notable being the difficulties in forecasting inflation. However, it could be our least-worst alternative, especially given the authorities can respond to an inflation performance which is proving inconsistent with any target.

International Experience

6. MPI's recent review of foreign budget papers revealed at least two countries which have floating exchange rates while directly targeting the inflation rate - notably Canada and New Zealand. Australia also claims that monetary policy is aimed directly at reducing inflation, although its resolve is dubious. However, the chart below suggests that all three of these countries are outperforming (current and recent) ERM members with respect to price stability.



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7. The experience of these countries also suggests that any targeting of inflation is more effective if bolstered by public commitment to a specific inflation target. This is apparent in that long-term interest rates are significantly higher in Australia (where the lack of a specific inflation target facilitates continuing flirtations with fine tuning) than in Canada and New Zealand.

Presentational Issues

8. If we were to adopt inflation targeting, presentational issues would be important.

9. For an inflation target to be fully effective would require that the target(s) are credible. Rhetoric can be helpful, although markets usually require more than this. One approach has been to give the central bank independence, while charging it with achieving a specific inflation target.

10. Although there would be resistance to an early move to granting independence to the Bank of England, we could still reap dividends by explaining the means by which any inflation target would be met. Aspects of the Canadian approach to this may be worth emulating.

11. MP argued earlier this year that there were good prospects for continuing falls in inflation. This was on the basis of our ERM membership (and consequent high interest rates) coupled with output being below trend. I doubt that there would be support for following the Canadian approach of publishing interest rate forecasts, although indications of a willingness to maintain relatively high interest rates could boost the credibility of a tough inflation target. There may, however, be more support for following the Canadians in publishing estimates of the output gap. Attached are extracts from the Canadian budget papers.

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12. I am unaware of any work done in-house on directly targeting inflation. Should we prepare something for the meeting proposed by the Chancellor?

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Chart 2.16
Growth in real GDP and final domestic demand

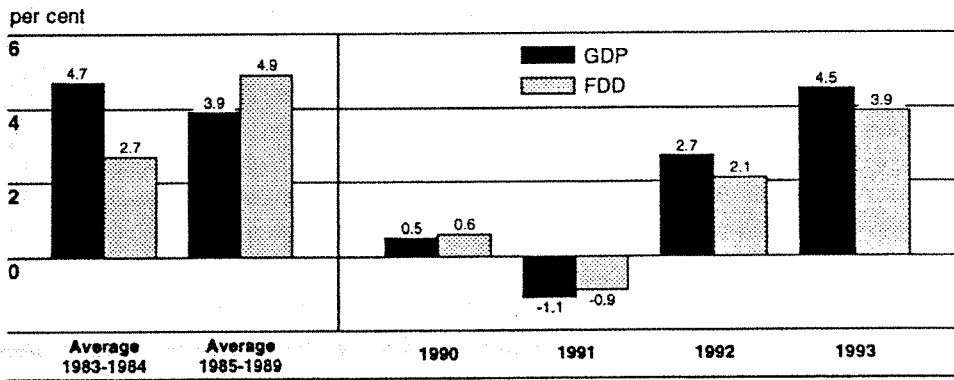


Chart 2.17
Comparison of current recovery with past sustained recoveries:
Cumulative growth in real gross domestic product

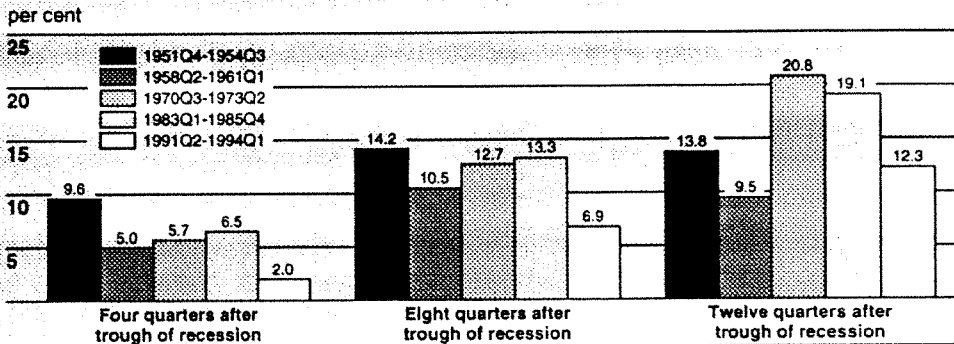
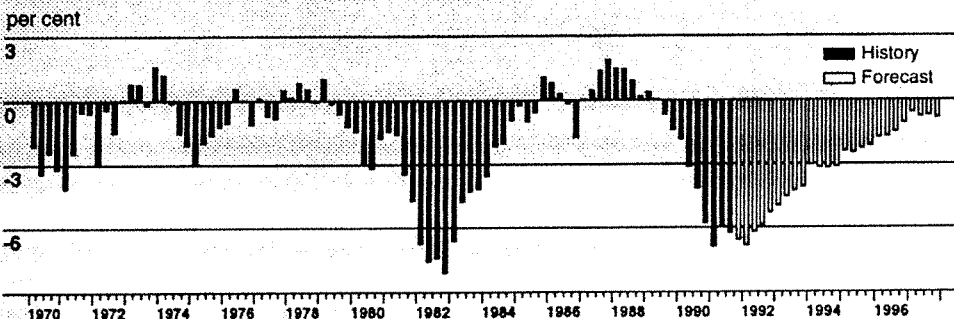
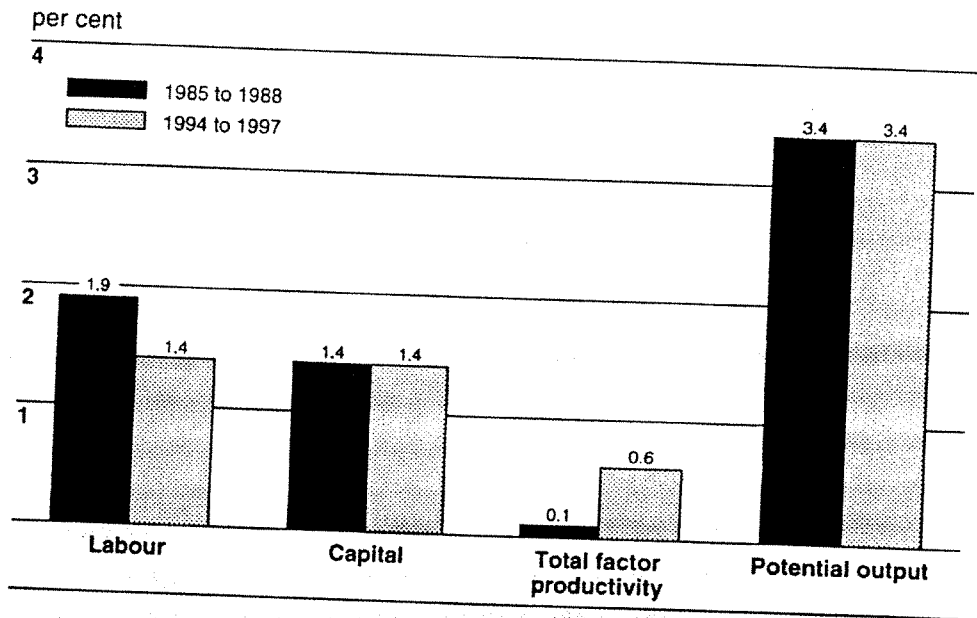


Chart 2.18
Output gap¹



¹ The "output gap" measures the percentage difference between actual GDP and "potential GDP" where potential GDP is defined as the maximum sustainable (non-inflationary) level of output that can be produced by the economy's existing stock of labour and capital using existing technologies.

Chart 2.26
Sources of potential output growth



Although the participation rate will grow more slowly than it did in the corresponding years of expansion in the 1980s, increased immigration levels will add to the growth rate of the labour force.

- Replacement of the outmoded federal sales tax makes new investment more affordable, particularly in the fast-growing service sectors. The opportunities created by the FTA and a more liberalized world trading environment also encourage new investment to take advantage of the scale economies made possible by much larger markets. The capital stock will grow by 4.4 per cent a year over the medium term, up from 3.7 per cent during the 1980s expansion.
- The adjustment already occurring as Canadians respond to the opportunities created by these structural initiatives will pay off significantly over the medium term, boosting total factor productivity growth to 0.6 per cent annually, compared with only 0.1 per cent annually in the 1980s.
- Substantial gains in productivity and investment when inflation stops distorting economic decisions will support further gains in potential output beyond the medium term.

Excess capacity permits above-potential medium-term growth

This forecast takes a cautious approach to projecting medium-term growth, assuming that the excess-supply gap will persist much longer than usual. As Chart 2.18 demonstrates, excess-supply gaps created by Canadian recessions have typically closed rather quickly once recovery got under way. For example, the large output gap that emerged as a result of the 1981-1982 recession was completely absorbed over the first three years of the expansion that followed. The assumption of a persisting gap in this forecast is based both on prudence and the possibility that the restructuring now under way could slow output