

Discussion of “Inflation Targeting: A Canadian Perspective”

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I am delighted to be part of this conference in honor of Ben Friedman. I have benefited from, and much enjoyed, my many connections and meetings with him over the last four, or so, decades. I have learnt much from him.

Let me start with a quick response to a comment that Angelo Melino made in his presentation but which was not in his paper, to the effect that the British have benefited from a higher inflation outcome and a slightly higher inflation target, because that generated a lower real interest rate. That is, indeed, an argument that I too would have used prior to reading the spring 2011 report of the UK Office for Budget Responsibility (OBR).

In this report the OBR argued that the kind of inflation which the United Kingdom now has, which largely comes from imported inflation and increases in indirect taxes (value-added taxes), does not increase domestic incomes and therefore does not increase tax revenues. On the other hand, it does feed through to all inflation-adjusted expenditures and reduces real personal incomes; so such inflation reduces demand and expenditure. The assumption that inflation under these circumstances is good fiscally and helps to keep up expenditures needs to be revised. I found this OBR argument interesting and persuasive, implying that inflation does *not* necessarily benefit the economy when one gets into the kind of debt/deficit/austerity problem that we now have in the United Kingdom.

What I would emphasize myself, slightly more than Angelo has done, is that a key reason why Canada survived the crisis so well was that it had a much better managed housing market, especially with the way that it handled housing insurance and the loan-to-value

ratio. Canada never had the combination of housing price bubble and excessive leverage that so disfigured those countries which got into difficulties.

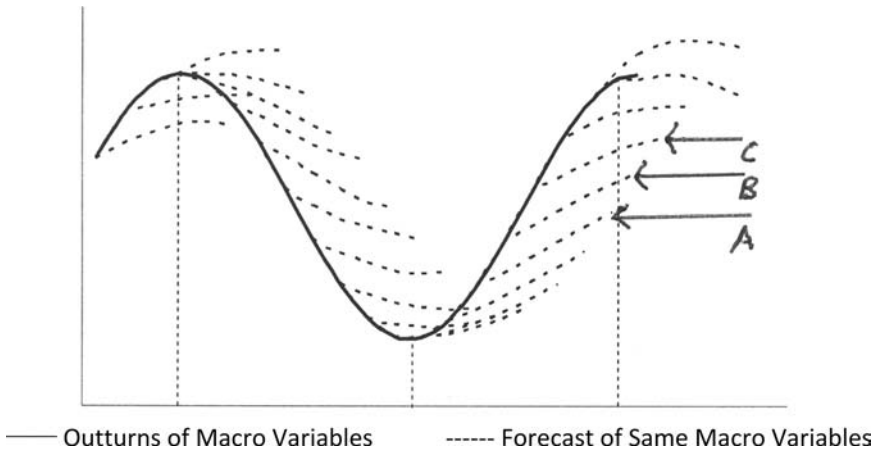
Canada also had what I would describe as a mature banking oligopoly, in that there was no incoming challenger to the main incumbent banks, introducing outrageous new types of policies, like Northern Rock's "together" mortgage or Anglo-Irish Bank's loans in Eire, in order to gain market share, thereby forcing all the other incumbent banks to follow. So what kinds of lessons do we learn from that? One might think that it would be nice if all countries of the world had Canadian financial stability, Irish charm, and Argentinean ability to dance. The problem with that is what would happen if all countries of the world had Irish financial stability, Argentinean charm, and . . . though of course Canadians dance very well anyhow.

But what seems to be a peculiarly Canadian fixation, or at least an occasional fixation at the Bank of Canada, is enthusiasm for price-level targeting rather than inflation targeting—even when the evidence is, as Angelo's paper shows, that Canada does not really need it. I usually suggest that when people go for this price-level targeting proposal they just lie down in a quiet, dark place and maybe the inflammation will go away. Indeed in the United Kingdom at the moment, commitment to a price-level target would require a promise to impose future *deflation*—not very sensible.

One of the issues in the paper (which I find very interesting) is why have the results of Canadian inflation targeting been so close to what would have happened if Canada had had price-level-path targeting? Angelo mentions three possibilities. The first is that the Bank of Canada officials are really closet price-level targeters. He dismissed that and, from all the evidence I know, is correct to do so. His second suggestion, which he gives some credence to, is that this is an automatic result of interest rate smoothing. Another that he does not mention, that I would give more credit to, is that the shocks to inflation, up and down, have by chance been quite evenly balanced.

I want to end up by referring, I fear, to some work that I have been doing arguing that interest rate smoothing—though far too many people believe in its existence—actually does not happen. One of the reasons that I assert this with some vigor, is that I was on the MPC (Monetary Policy Committee) at one stage and we did not do any interest rate smoothing that I know of; and yet the end results

Figure 1. Stylized Pattern of Relationships between Forecasts and Outturns of Macro Variables over the Cycle



come out as if we were interest rate smoothing if you do standard econometrics. Note also that in the crisis after Lehman's failure, central banks around the world did not smooth interest rates. When they saw a good reason to respond rapidly, they shot from whatever level it was down to the zero lower bound.

Then there are the Glenn Rudebusch arguments that if there was interest rate smoothing, interest rates ought to be easy to predict, and the evidence is that they never have been. So why does it appear that there is interest rate smoothing, yet in fact it does not happen? The answer, I believe (and I hope that I have demonstrated), is in an article I have in the June 2011 issue of the *IJCB*. This runs as follows: We are not very good at forecasting, and we are particularly bad at forecasting turning points. One never knows when a turning point is going to occur. So what forecasters actually do, when the technicalities are stripped away, is make their forecasts a complex combination of the continuation of the current momentum, whatever it is, and a reversion to equilibrium, so that we revert to whatever the equilibrium may be. The result is a graph that looks like figure 1, where the actual outcome is the solid line and the forecasts are the dashed lines. So we underforecast on the up, and overforecast on the down, because we always assume there is going to be some possibility of a turning point.

The members of the MPC naturally give weight to such forecasts, and as long as the cycle continues in the same direction, because the turning point has not yet arrived, then the actual forecast that would have been made on the last occasion will be updated next time. So we move from forecast A to forecast B to forecast C. So every time the cycle continues, rather than hitting a turning point, the forecast itself gets revised up, and therefore the interest rate needed during the upside cycle to get back to the equilibrium level of inflation has to rise a bit. So there *appears* to be an autocorrelation in the movement of interest rates, but this is due to the forecasting process, not at all due to any smoothing attempt by the members of the MPC itself. The members of the MPC are always working on the basis of flexible inflation targeting, trying to get back to equilibrium at some horizon. But the forecasting process will mean that this will lead to a series of steps in the interest rate, although at any moment the interest rate chosen according to the forecast *at that time* will be thought to be exactly the right one to get the right flexible inflation path to get to the desired equilibrium level.

References

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