

Intelligence MEMOS



From: Steve Ambler, Thorsten Koeppl and Jeremy M. Kronick
To: Bank of Canada Observers
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Re: **WHY IS AN INCREASE IN THE INFLATION TARGET OFF THE TABLE?**

In his February 21 speech, Bank of Canada governor Tiff Macklem firmly endorsed the centrality of the Bank's 2 percent inflation target anchor as he previewed the 2026 renewal of its monetary policy framework: "In my view, now is not the time to question the anchor that has proven so effective in achieving price stability."

Delivered at a time when the threat of another crisis looms – namely, volatile inflation as a result of a potential tariff war – his remarks underscored the importance of a steady hand at the Bank.

We believe the Bank of Canada is justified in not reopening the question of the choice of target, but it's important to understand the reasons for taking an increase off the table.

Let's review them.

First, a higher target means both higher inflation and a higher central bank policy rate on average. Supporters argue this gives the central bank more room to cut its policy rate in response to a negative shock before it hits its effective lower bound (the Bank considers this lower bound to be 25 basis points) and can no longer be used to provide more stimulus to the economy. Much of the push for central banks to increase their targets came after the financial crisis, when the Bank's policy rate was in fact at the lower bound for more than a year, and during a period when world real interest rates (net of inflation) were gradually declining, implying a lower central bank policy rate on average.

Currently, however, factors such as demographics (an aging population spending its built-up savings) and deglobalization are pushing real interest rates back up. As this occurs, central banks will have more room to cut the policy rate without needing to raise the target.

Second, higher inflation, even moderately higher inflation, may be much more costly than is generally thought. Even moderate inflation will badly harm an economy, according to empirical work using economic models incorporating realistic features such as slow-moving wages (wage stickiness in economic parlance). [One estimate](#) indicates that an increase in the target to 4 percent could cost the equivalent of approximately 4 percent of one year's consumption. Wage stickiness means businesses aren't able to adjust quickly to the realities of the economic cycle, leading to inefficient production.

Third, an increase in the inflation target would damage the Bank's credibility. Inflation expectations are well-anchored in Canada; even high inflation starting early in 2021 and ending late last year did not damage this anchor, as Governor Macklem noted in his speech. However, an increase in the target could very well lead to fears that, if the Bank is willing to raise the target once, it might raise the target again. This could de-anchor inflation expectations, which would make it harder to bring inflation down if we are faced with a return to the inflationary environment we just experienced.

Fourth, and last, many financial and wage contracts stipulate payments in nominal terms (they are not adjusted for inflation). In the case of financial dealings, an increase in the target would lead to unanticipated wealth transfers from lenders to borrowers as it erodes the real value of debt repayments more rapidly. This is clearly outside the remit of monetary policy. In the case of wages, without any kind of indexing, workers would be made worse off.

As noted by Governor Macklem, there are plenty of other issues to consider in the run-up to the renewal of the inflation-targeting framework. These include:

- i) Whether the Bank needs a richer playbook for monetary policy in a world of increased supply shocks like tariffs – and, therefore, the possibility of stagflation with high inflation and stagnant economic growth;
- ii) How best to measure underlying or core inflation; and
- iii) The interaction between monetary policy and housing.

But, for now, the Governor was right to nip any discussion of raising the 2 percent inflation target in the bud.

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