BANK OF CANADA
BANQUE DU CANADA

Mark Carney
Governor - Gouverneur

14 April 2008

Mr Jay Shepherd
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Dear Mr. Shepherd,

This is in regard to your recent letter concerning the effect on the Bank of Canada monetary policy of pervasive corporate tax changes.

You correctly indicate that the Government of Canada and the Bank have an inflation-control targeting agreement in place up to the end of 2011. However, as a point of clarification, the Bank will endeavour to keep total CPI inflation on average at 2 per cent over this period and not core inflation. Since total CPI inflation is subject to considerable variability, however, core inflation has been shown to be a more useful indicator of underlying inflation and, hence, of where total CPI inflation could be in the future. All the same, if there were likely to be persistent changes in the CPI components that are excluded from the core measure, total CPI inflation would take precedence over the core rate.

It would be useful to discuss in more detail why the Bank focuses on a core measure of inflation as a shorter-term operational guide to monetary policy. One reason for this focus on core measure is the considerable short-run volatility in certain components of the CPI. Since movements in these volatile elements generally tend to reverse themselves fairly quickly, and since monetary policy actions affect inflation over a longer period of six to eight quarters, it would be inappropriate for monetary policy to try to offset such short-run movements in the total CPI caused by these fluctuations.

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As you also noted in your letter, the core inflation measure also adjusts for the impact of changes in indirect taxes. Similar to its treatment of changes in volatile CPI components, the Bank accommodates the first-round effects of changes in indirect taxes. However, the Bank would act to prevent the tax- induced rise or fall in the CPI having broader, second-round effects on wage and price inflation.

In your letter, you next discuss what the Bank might do in the event that reductions in corporate income taxes or capital taxes tended to reduce inflation. First, it is not clear to me through what channel such tax reductions would directly affect inflation. Unlike sales or excise tax changes, these tax changes do not directly affect particular components of the CPI. In the short run, it would seem unlikely, for instance, that retailers would pass on either a cut in corporate income taxes or capital taxes in the form of lower prices; in the first instance, corporate cash flow would tend to be higher than would have otherwise been the case.

Second, I would suggest that it would be important to place these tax initiatives in a broader context and consider to what degree these tax changes affect the overall stance of fiscal policy and hence the level of aggregate demand and inflation over the period of the Bank's policy horizon of six to eight quarters. If the Bank perceived that these fiscal policy actions were likely to cause inflation to deviate from its 2 per cent target six to eight quarters ahead (for instance by stimulating aggregate demand), the Bank would act to adjust interest rates so as to bring its forecast of inflation back to the 2 per cent target over the policy horizon.

I hope you find this information useful.

Best wishes,