



B A C K G R O U N D E R S

# Inflation and Price Stability

Inflation is a persistent rise over time in the average level of prices in the economy.

Prices tend to go up when demand for goods and services exceeds the economy’s capacity to supply those goods and services. Conversely, an excess supply of goods and services tends to put downward pressure on prices.

## CPI measure of inflation

The most commonly used measure of inflation is the total **consumer price index** (CPI). It reflects changes in the average price of a representative “basket” of goods and services such as food, housing, transportation, furniture, clothing, recreation, and other items that Canadians typically buy.

The inflation rate is expressed as the year-over-year percentage increase in the CPI. For example, if the cost of the consumer basket rises, say, from \$100 in 2007 to \$102 in 2008, the average annual rate of inflation for 2008 is 2 per cent.

Canada’s annual rate of inflation, which had reached a high of 12.5 per cent in 1981, has averaged 2 per cent since 1991.

## High inflation has many costs

Inflation reduces the purchasing power of money over time.

High and unstable inflation can be costly. It undermines the economy’s ability to generate long-lasting gains in output, incomes, and employment. It creates uncertainty for consumers, businesses, and investors, and erodes the value of incomes and savings.

People on fixed incomes, including many elderly and less well-off Canadians, are particularly vulnerable to high inflation, since it erodes the value of their investment income or social benefits such as pensions.

High inflation and expectations of high inflation also encourage speculative activities rather than investments that increase production capacity and enable firms to stay competitive at home and abroad.

## Price stability

Price stability is a situation in which inflation is low enough that it no longer has a material effect on people’s economic decisions.

Canadian **monetary policy** is aimed at promoting price stability and harnessing the **benefits of low inflation**.





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## Commitment to low inflation

A credible commitment by the central bank to keeping inflation low and stable provides a climate conducive to sound economic decisions. It also leads to lower interest rates, supporting productive investments that allow the economy to grow at a sustainable, non-inflationary pace over time and to generate higher incomes and new jobs.

Thus, a focus on low inflation is the best contribution monetary policy can make to the economic and financial welfare of Canadians.

## Inflation-control target

Monetary policy in Canada is guided by an [inflation-control target](#). The target is the 2 per cent midpoint of a 1 to 3 per cent control range.

Inflation targeting has played an important role in reducing long-term inflation expectations and anchoring them around 2 per cent.

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