Bank of Canada moves toward new era of inflation

By David Parkinson
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The Bank of Canada's interest-rate announcement Wednesday was about as stand-pat as you're going to get. But it sent a signal that there is change afoot in the central bank's approach to inflation – a key issue that looks destined to take a prominent position on the central bank's agenda over the next 18 months.

In terms of news for the near term, the rate statement gave market watchers little more than a stifled yawn. No change in the key rate of 0.75 per cent; the economic outlook still broadly in line with what the bank said in its previous statement and Monetary Policy Report in mid-April. Anything moving the outlook forward even a sliver since April was largely covered in Bank of Canada Governor Stephen Poloz's speech and press conference in Charlottetown last week. He could have easily mailed this one in and spent a week touring Prince Edward Island's renowned golf courses.

Yet, there was a new element in the statement that caught the eye of keen central-bank watchers: A numerical estimate of "the underlying trend of inflation," which departs from the bank's so-called "core" inflation measure that for years has been its go-to benchmark for underlying price pressures.

The two figures aren't even close. The central bank estimated that the underlying inflation trend is 1.6 to 1.8 per cent, still considerably below the 2-per-cent target the bank uses as the basis for setting interest-rate policy.

The core rate – also known as CPIX, which is the consumer price index excluding eight of the most volatile components and the effects of indirect taxes – was at 2.3 per cent in April.

To be clear, this isn't really new. Internally, the Bank of Canada has long monitored a range of alternative inflation measures for years, and it has long published a table of alternative inflation measures on its website. Even the 1.6- to 1.8-per-cent range had previously been published, in the April Monetary Policy Report, and was repeated by Mr. Poloz in last week's speech.

But the elevation of this nugget of data to the text of the rate statement, the central bank's most closely watched public communication, represents a conspicuous step forward. It reflects the bank's increasing examination of, and even dissatisfaction with, the CPIX as its main guide to underlying inflationary trends.

The issue is setting up to be front and centre as the bank gears up for a public re-examination of its approach to inflation, ahead of the November, 2016, renewal of its five-year agreement with the federal government that maintains the 2-per-cent inflation target as the bank's basis for setting interest rates.

Since the fall of 2013, when the bank began providing a chart of these alternative measures in its Monetary Policy Report, they have become gradually more public. Around the same time, senior bank officials, starting with Deputy Governor Agathe Côté (the bank's key official overseeing the inflation file), began talking in speeches about a re-examination of inflation measures. Mr. Poloz brought the issue up again in his Charlottetown speech.

In the most recent MPR, in April, the bank added another layer of public detail: It estimated how much the "pass-through" effects from the depreciation of the Canadian dollar are adding to the range of alternative measures (none of which factor for currency swings), applied this to the range, and came up with the 1.6- to 1.8-per-cent estimate. And now those figures have made the leap into the rate statement.

They aren’t the only part of the conversation leading up to the inflation-target renewal. At the heart of the agreement is, of course, the 2-per-cent target itself; the Bank of Canada acknowledges that there is merit in considering whether the target should be lowered to 1 per cent. But the reality is that a change in the target is an extreme long shot, and that the bank has as much as said so (“the bar for change is high,” in the bank’s words). The key to inflation targeting is that it locks consumer, business and market expectations into the target over time; change the target and you face a long, uphill battle to re-establish those expectations, not to mention potentially undermining the credibility of your inflation stance. Not a choice any central banker would make without extremely compelling reasons.

On the other hand, the bank is more than ready to change the way it gauges inflation. And why not? CPIX, which has been the central bank’s “operational guide” for assessing underlying inflation since 2001, has looked less than reliable in the post-recession era.

For the past nine months in a row, it has given off readings above the 2-per-cent target – despite some pretty compelling evidence that the Canadian economy has been operating well below full capacity and isn’t, in a meaningful sense, particularly inflationary at all.

The central bank has found itself routinely listing off and attempting to quantify the myriad factors (currency, oil, retail competition, meat and telecommunications prices) imposing “transitory” distortions on the inflation numbers, to a skeptical public that wonders why it’s being told the inflation numbers aren’t really the inflation numbers any more. When the supposed “core” inflation reading needs this many qualifiers, maybe it’s time to give it a decent burial.