Economic funk or rising inflation – what should worry Poloz and Co. more?

By David Parkinson
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Friday's release of a couple of A-list economic indicators presents a bit of a quandary for the Bank of Canada. Should it be more worried about the funk the Canadian economy sank into in March, or the rising inflation tide in April?

Statistics Canada reported Friday morning that retail sales sank 1.0 per cent in March, slipping back more than expected after two months of strong gains. It was just the latest in a string of negative economic reports for March, suggesting that the economy may well have contracted for a second straight month, casting considerable doubt over the hope generated by January's booming start to the year.

But at exactly the same time, Statscan also released its April consumer price index, showing that Canada's inflation rate jumped to 1.7 per cent from March's 1.3 per cent. More importantly, the Bank of Canada's core inflation measure – which excludes the eight most volatile components of CPI, in order to get a clearer picture of the broader underlying inflation trend – unexpectedly rose to 2.2 per cent from 2.1 per cent in March, its highest reading in nine months.

For a central bank whose interest rate policy is expressly defined by pursuing a 2-per-cent inflation target, the CPI numbers – especially the above-target-and-rising core reading – are unquestionably an issue as the bank approaches its rate decision next Wednesday. Nevertheless, the Bank of Canada will probably need to see a lot more evidence than this before it moves inflation to the top of its list of worries, especially while the economic recovery remains halting, at best.

Under current governor Stephen Poloz, the Bank of Canada has been pretty consistently skeptical of inflation numbers in the absence of clear underlying capacity pressures from a growing economy. Core CPI ran above 2 per cent for 16 straight months from the summer of 2014 to the fall of 2015, and Mr. Poloz didn't get spooked. He shrugged it off as an aberration, distorted by a sinking currency. At the same time, the bank saw a sluggish economy that was a long way from absorbing its considerable spare capacity – the usual way that sustainable inflationary pressures build.

And despite what looks to have been a pretty strong first quarter for economic growth that likely nibbled away at some of that excess capacity, the March data have shown that "sluggish" was, if anything, an understatement by the end of the quarter. In addition to the pullback in retail sales, we have seen declines in wholesale and manufacturing sales, and a sharp drop in exports in the month.

Still, those economic data were for March, and the surprise rise in core inflation was for April. Could this be early evidence that the economy picked up speed in April, adding to price pressures? That's certainly something the Bank of Canada will consider.

The only other key data point for April that Statscan has already released was the monthly Labour Force Survey – an important indicator for the central bank, as tightening labour-market conditions are a key source of inflationary pressures. However, the LFS gave, at best, a mixed message. Employment was flat, but there was decent growth in hours and wages, and private-sector hiring was solid.

For a clearer picture of whether the economy has shaken its March malaise, the bulk of April's numbers won't roll out until next month. In the absence of that data, the Bank of Canada will probably stick with its position that inflation is being distorted by the effects of the steep decline of the Canadian dollar over much of the past year. And given that the currency has reversed that slide in the past four months (since mid-January, it is up 11 per cent against its U.S. counterpart), the bank can make a decent argument that the currency effects are due to wash out of those inflation numbers as the year progresses. Until and unless it has more compelling evidence otherwise, expect the stop-and-go economy to trump inflation in the bank's thinking.