Three's a crowd

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A Bank of Canada report entitled "Renewal of the Inflation-Control Target. Background Information" doesn't sound like exciting reading, but buried within it was an important lesson for those trying to predict its next move.

That wasn't evident in its key conclusion, as the Bank had long ago telegraphed that it would retain its existing 2% inflation target for the next five years. Thought was given to aiming at a faster pace, to allow for higher peak nominal interest rates and more room to ease in subsequent recessions. In the end, policymakers decided that there was still enough firepower in monetary policy, using unconventional measures if need be, to address future slowdowns.

But there was a new twist, one that muddies the waters about what the Bank of Canada really tracks as it adjusts interest rates over time. As always, the official target is for the total CPI inflation rate over the forecast horizon. However, in monitoring underlying price momentum, the current core measure, CPIX which strips out eight volatile components, will be shelved in favour of not one, not two, but three new tracking indicators.

In this case, three's a crowd. Two are currently showing inflation running very close to 2%, with the one least understandable to non-specialists – which tracks the common component of inflation – sitting near 1½%. So is there room to ease or not?

The answer lies not in any of these three measures, but in a fourth, which investors should really think of as the tracking target for the Bank of Canada: the output gap. Note that in the Bank's staff research paper that evaluated the alternatives to core CPI, one of the key properties they sought was a good fit between the inflation measure and the output gap. The Bank always, always, shows a forecast that has a zero output gap consistent with headline inflation exactly at the 2% target over the medium term.

A focus on the output gap isn't new. Back in 2014, then Senior Deputy Governor Tiff Macklem explained that the BoC would ease to counter "bad" disinflation stemming from an output gap, but not "good" disinflation coming from other forces, such as increased competition. Tracking the output gap actually puts the BoC's behavior closer in line with the Fed, which has a dual mandate covering both inflation and full employment, the latter being a close analogy to a zero output gap.

So, for investors trying to predict the Bank of Canada's next move, forget about the crowded field of headline inflation and three new tracking measures. Simply keep an eye on the output gap and the progress being made to close it on schedule. For now, in line with our forecast, the Bank seems willing to stand pat if the economy tracks towards a zero gap by mid-2018. But any further slippage risks another ease, and the Bank will pick and choose among its multiple inflation indicators to make that case.