Is the Bank of Canada's tame inflation outlook correct?

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The Bank of Canada is not worried about Canada's surging inflation. But it felt a certain urgency to make sure you're not worried about inflation, either – especially if you're a currency or bond trader.

That may be the key takeaway from the central bank's interest-rate decision Wednesday, in which it summed up its views on the Canadian economy and held its key rate unchanged at 0.5 per cent. Conspicuously, the bank's rate announcement led with a discussion on inflation – which has been much lower down in the rate statements of the past six months. Anyone familiar with central bank communications will tell you that this is no accident.

Last week's January inflation report showed total consumer price index (CPI) inflation had surged to 2.1 per cent. Given that the bank uses a long-standing inflation target of 2 per cent as its key guide for setting interest rates, an inflation number surpassing that target is bound to start conversations about whether a certain central bank might need to raise interest rates sooner than expected.

So the bank was eager to send the "move along, nothing to see here" message. The Canadian economy still has loads of excess capacity, it said; the inflation number is a mirage created by a spike in gasoline prices, due in part to new carbon-pricing levies in Ontario and Alberta. Measures of core inflation – the stuff underneath the short-term gyrations and special circumstances affecting prices of a few outliers in the CPI basket – remain tame, comfortably below the Bank of Canada's target.

Which is all fair enough. Statistics Canada's inflation report did, indeed, show that sharply higher year-over-year gasoline prices were the main contributor to the surge in CPI inflation.

The three new measures the Bank of Canada now uses to gauge core inflation are all, to varying degrees, below the 2-per-cent target – although the range among them (1.3 per cent to 1.9 per cent) leaves plenty of room for interpretation.

The Bank of Canada only recently began using this new three-pronged gauge of core inflation, after the November renewal of its five-year agreement with the federal government on the inflation target. It's still unclear exactly how to interpret the three measures and their relative importance in the central bank's thinking. But in the lead-up to the renewal of the inflation-targeting agreement, it seemed the bank was particularly fond of the "common components" measure, a complicated statistical construct that attempts to gauge the price movements that are common to all categories in the CPI basket (i.e. screening out the portion of price changes that are idiosyncratic to individual items or sectors).

The common component clocked in at a thin 1.3 per cent in January. If, indeed, the central bank's governing council still puts a lot of stock in the common component, then the Bank of Canada has reason to think the country's true underlying inflationary pressures are still stubbornly low, and that the economy still has oodles of unused capacity to absorb before underlying inflation starts building in earnest. Which is pretty much the position the central bank took in its rate decision.

Whether the bank's distinctly tame leaning on inflation is the correct one, only time will tell. But it has its reasons for stressing that message

at the top of its rate statement, where market participants can't miss it.

The Bank of Canada is intent on cooling market expectations about any possibility that it will be raising its key interest rate any time soon (and by "soon," in this context, we probably mean in the second half of 2017). The surprisingly strong inflation numbers raised some questions about that stand; the central bank felt compelled to shoot them down, and fast.

Significantly, this rate announcement once again contains the phrase "in contrast to the United States" in the bank's assessment of the Canadian economy. The implication is that as the United States raises its rates this year – which it might do as soon as this month, and quite possibly several times before the year is done – Canada has no intention of going along for the ride.

Strategically, there are good reasons for the Bank of Canada to dwell on the negatives, and contrast them with the United States' positives. To some degree, global bond and currency markets have been lumping Canada in with the U.S. economic story, and bidding up the Canadian dollar and bond yields accordingly. Canada's still uneven economic recovery would, frankly, be better supported by a softer currency and lower bond-market interest rates. Persuading the markets to better recognize the economic gap between Canada and the United States, and the widening interest-rate policy divergence that's on the way, would deliver just that.

One question, though, is how long the Bank of Canada can make a convincing case. On Thursday morning, Statscan releases quarterly gross-domestic-product numbers, and they are all but certain to show that Canada's economy grew considerably faster in the fourth quarter than the central bank had estimated. Employment surged by nearly 100,000 in December and January. If this keeps up much longer, either the Bank of Canada's position on "material excess capacity" in the economy will need some rethinking, or its sales pitch to the currency and bond markets will become less than convincing.