Economic growth not heating up Canadian inflation yet - but it's coming

By David Parkinson
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Canada's April consumer price index report shows that this country doesn't have inflation pressures to worry about yet. But looking at the strong retail sales figures released at the same time, the operative word is "yet."

Statistics Canada reported on Friday that CPI inflation was 1.6 per cent in April, unchanged from March and a tick below economists' consensus expectation of 1.7 per cent. What's more, the three measures the Bank of Canada uses to assess core inflation (CPI-common, CPI-median and CPI-trim) were also cool in the month, averaging just 1.4 per cent.

The whole point of core inflation measures is to gauge underlying inflation pressures across the economy by screening out the month-to-month noise in individual components that can cloud the broader trend. With the core measures not only firmly below the central bank's 2-per-cent inflation target but actually drifting downward in recent months, the signal to the Bank of Canada is that inflation remains benign – which means absolutely no need to raise interest rates at the bank's next rate decision on Wednesday.

In contrast, other economic indicators are giving off a considerably warmer signal. The latest instance was Statscan's March retail-sales report, also released Friday morning, which showed that sales rose a solid 0.7 per cent from February, well above economists' consensus estimate of 0.3 per cent. On a volume basis, sales were even better, up 1.2 per cent. Statscan also upgraded its April figures to a decline of 0.4 per cent from the originally reported 0.6 per cent. Between the revision and the better-than-expected March bounce, consumer spending looks considerably stronger than economists had thought.

Add that to other strong economic indicators for March – including impressive gains in trade and in manufacturing sales – and there's no question that Canada's economy shifted into a higher gear in the early months of this year. In light of the retail report, Bank of Nova Scotia economist Derek Holt estimated that first-quarter real GDP growth may come in at something approaching 4.7 per cent – which would be the strongest quarter in more than five years and well above the Bank of Canada's estimate of 3.8 per cent. And with an apparently impressive end to the first quarter, the economy looks to have carried momentum into the second.

So far, this economic momentum hasn't manifested itself in the inflation numbers. But if it continues, it inevitably will – it's only a matter of time.

For the Bank of Canada, the key to assessing the potential for a buildup in inflationary pressures is the output gap – the difference between how much the economy is capable of producing and how much it actually is producing. When that gap closes, the economy lacks capacity to meet new demand, and that tightness forces prices higher. Mr. Holt believes the economy's generally strong growth over the past several months has effectively closed the output gap under one of the two measures the Bank of Canada uses (the extended multivariate filter, a gauge the central bank has relied on for almost two decades), while the gap is narrowing by the other measure (the integrated framework, a relatively new innovation).

By the central bank's own admission, an output gap is a hard thing to measure, and both the gauges it looks at are, at best, rough estimates. For that reason, the bank also leans on indications from producers in the economy, via its quarterly Business Outlook Survey, to get feedback from the corporate trenches on capacity pressures that could add colour to the statistical models. But the next survey won’t be published until the end of June.

In the meantime, it might be useful to consider not those undeniably cool year-over-year inflation rates but the trend in consumer prices more recently, in the period in which economic acceleration has been evident. After a lull in the second half of last year in which the consumer price index actually declined, CPI has jumped 1.6 per cent in the first four months of 2017, the most inflationary four-month stretch in three years.

That’s probably too short a period to declare a “trend,” but it’s no coincidence that this has come during a stretch of particularly strong economic growth. As long as the growth story remains intact, inflation is going to move from a non-starter to an essential part of the economic conversation.