What does an inflation-fighting central bank do when there's no inflation?

By Barrie McKenna
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The self-declared raison d'être of Canada's central bank is to keep inflation at or near 2 per cent.

Indeed, after an exhaustive review, the Bank of Canada concluded last year that sticking with the target is the best way to deliver "sustained economic growth, rising levels of employment and improved living standards."

So it's a bit a of head-scratcher that bank Governor Stephen Poloz and top deputy Carolyn Wilkins have been prepping financial markets in recent weeks for possible interest-rate hikes, even though inflation is well below that level – and falling. Higher rates would typically act as a break on rising prices. So the bank risks pushing inflation further away from its own target.

The annual inflation rate slipped to 1.3 per cent in May from April's 1.6 per cent, Statistics Canada reported Friday. It was the weakest reading since November, 2016. Among the factors driving prices lower in May: cars, gasoline and Ontario electricity rebates.

This raises the intriguing possibility that a proudly inflation-fighting central bank may be poised to raise interest rates when inflation is in retreat.

The chance of a rate hike at the bank's next rate-setting date on July 12 stood at 33 per cent on Friday, according to markets. That's down from more than 50 per cent before the latest inflation numbers. But there is now a 66-per-cent probability of an increase in the Bank of Canada's key rate by late October.

There has been a radical shift in sentiment in recent months. In January, Mr. Poloz was still talking about possible rate cuts to deal with economic weakness. And as recently as a few weeks ago, most economists were not expecting a rate hike until next year.

And why would they? The central bank has mostly failed to meet to its inflation target in recent years. For most of the past five years the bank's three benchmark inflation indicators have remained stubbornly below 2 per cent. And core inflation, which strips out volatile food and energy prices, is now at its lowest point since 1999.

"It's very hard to make the case that underlying inflation is accelerating or is significantly close to the 2-per-cent target," RBC Dominion Securities strategist Mark Chandler pointed out.

That was echoed by Scotiabank economist Derek Holt. "It is going to be optically and substantively difficult for the [Bank of Canada] to hike in July with inflation continuing to decline," he said in a research note.

But scratch a little deeper and there is a lot happening beneath the weak headline inflation numbers.

In a speech last week, Ms. Wilkins played down recent weak inflation, suggesting that much of it is temporary. She blamed intense competition in the grocery industry for lower food prices and the "lagged effect of excess supply" elsewhere in the economy.

There is also a dichotomy between goods and services. In May, prices of goods were up a mere 0.1 per cent annualized. But prices in the service sector rose a healthy 2.3 per cent.

At the end of the day, services inflation is "a better indicator of domestic slack" in the economy, argued Canadian Imperial Bank of Commerce economist Nick Exarhos.

Other experts argue that official inflation measures, such as the consumer price index (CPI), may be miscalculating the strength of food prices.

“This year, with food inflation, the CPI seems way off,” said Sylvain Charlebois, dean of the management faculty at Dalhousie University. “Food inflation may be underestimated in Canada.”

Prof. Charlebois said there are “unexplainable differences” between the CPI and Dalhousie’s own food price report, which is based on random price spot checks of 100 food items across the country. Among the anomalies: the CPI suggests meat prices have fallen 2.1 per cent from a year ago (April, 2016, to April, 2017. Dalhousie found an 11-per-cent increase in meat prices, just since January of this year.)

Then there is crude oil. It has fallen by more than $10 (U.S.) per barrel to less than $43 since April, dragging down gasoline prices. But many analysts expect that drop to reverse itself in the months ahead.

More broadly, there is a disconnect between weak inflation and the generally strong performance elsewhere in the economy, including GDP growth, retail sales, job creation and housing. GDP surged ahead at a 3.7-per-cent annual pace in the first quarter. That, combined with strong job gains and retail sales, suggest an economy that’s gaining traction.

The time is fast approaching when the Bank of Canada will have to sort out these conflicting signals.