Out of step: Low inflation poses hurdle for Bank of Canada

By David Parkinson
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Friday's economic releases from Statistics Canada illustrate precisely the conundrum that the Bank of Canada faces as it inches interest rates off their floor. Pretty much everything about the economy is looking up – except, crucially, inflation.

Statistics Canada reported that the country's 12-month inflation rate sank to its lowest level in nearly two years in June, clocking in at a thin 1.0 per cent, amid weaker gasoline prices. That matches the bottom of the Bank of Canada's inflation range of 1 per cent to 3 per cent, basically its official band of comfort as it pursues its long-standing target of 2-per-cent inflation.

But the tepid inflation numbers landed at precisely the same time as yet another indicator that Canada's economic resurgence is continuing apace. Statscan's retail report showed that the value of sales rose 0.6 per cent in May from April, their third-straight month of solid gains. On a volume basis, retail sales were up an even more impressive 1.1 per cent.

The retail results added to the mounting evidence that the second quarter was another strong one for the Canadian economy. Economists are now talking about an annualized growth pace north of 3 per cent for a second-straight quarter.

But this is not the way it is supposed to work. Smoking-hot economies are supposed to generate inflation, as swelling demand squeezes finite supplies and scarcity of labour forces wages upward. Yet, inflation is defying the laws of economic physics.

This is at the root of the dilemma the Bank of Canada faced last week, when it was deciding its next move on interest-rate policy. Strong growth dictated that it start raising its key rate from its historically low level of 0.5 per cent. Weakening inflation argued for at least holding the rate steady, as low rates generally stimulate inflation. The bank had to choose one over the other.

As we now know, the central bank opted for the growth story. That is a deeply difficult and potentially even problematic choice for a central bank that, by agreement with the federal government, has an inflation-targeting mandate that serves as the central core of its interest-rate policy.

But the bank made its choice, and now, it seems, the financial markets are following suit. The Canadian dollar rose one-third of a cent against its U.S. counterpart on Friday, closing in on 80 cents (U.S.) for the first time in more than two years. The reaction is a pretty clear indication that the markets believe the central bank has all but dismissed the weak inflation, and will forge ahead with more interest-rate hikes in response to the hot economy.

This is an oversimplification of the Bank of Canada's position. The bank is not ignoring inflation, and, indeed, it will remain crucial to its rate decision in the coming months. But the bank believes the inflation numbers reflect some temporary distortions that will come out in the wash.

It would not be the first time. In 2013, inflation dipped as low as 0.4 per cent; the bank's core CPI measure spent several months hovering barely above 1.0 per cent. The bank stuck to its policy course – which, at the time, was tilted gently yet unmistakably toward eventual rate increases – while attributing inflation's depressed state to a confluence of temporary factors. Within a year, the inflation rate had topped 2 per cent.

Similarly, the bank cut its key rate in mid-2015 even though core inflation had been above 2 per cent for nearly a year, insisting it was a transitory mirage caused by "past depreciation of the Canadian dollar and some sector-specific factors." Again, a little over a year later, core inflation had slid well below the 2-per-cent target.

As Bank of Canada Governor Stephen Poloz reminded us in announcing last week's rate increase, a central bank's job is to target inflation not where it is today, but where it will be more than a year from now (since it takes 18 to 24 months for an interest-rate change to have its full impact on the economy). In the past few years of inflation inconsistency, keeping its gaze on the distant horizon proved prescient.

Hints of a coming turnaround may already be emerging in the details of the inflation report.

Despite the decline in the overall inflation rate, two of the Bank of Canada's three preferred measures for core inflation – which replaced its previous single gauge of core late last year – posted increases in June, the first time in more than a year that the core readings trended upward.

It's also notable that a major contributor to the inflation slowdown – energy prices – peaked at this time last year. That means that future inflation reports will have more favourable year-earlier comparisons for their year-over-year price change. Similarly, the food component is also approaching some more generous year-earlier comparisons.

That alone should lift the inflation numbers over the next six months, even without price increases from current levels. It doesn't exactly solve the inflation paradox, but at least we may soon see year-over-year inflation begin to head in the same direction as the rest of the economy.