Bank of Canada needs to rethink its inflation strategy

By Jean-Paul Lam

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Inflation in Canada, and in many countries, continues to undershoot its target despite strong economic growth and low unemployment. The persistently low inflation – especially this year – has stumped many central bank leaders, including Janet Yellen at the U.S. Federal Reserve.

The Bank of Canada, on the other hand, does not seem to believe that low inflation is a mystery. The Bank's position is that inflation has been held down by temporary factors, including persistent excess capacity in the economy, and is just slow to come back.

Temporary factors and persistent slack in the economy may well be exerting downward pressure on inflation – even if it has been below 2 per cent since 2013. However, with energy prices back up, electricity rebates in Ontario being a one-time affair and measures of inflation (such as CPI-trim that excludes extreme price movements) remaining persistently below the 2-per-cent mark, temporary factors look less and less likely. With the economy currently operating close to full capacity and unemployment being low, conventional wisdom suggests that prices should start increasing, especially as firms start facing shortages of labour and have to pay higher wages to attract workers. The fact that inflation remains low despite these conditions is a puzzle and this suggests that there are other factors at play.

In its latest Monetary Policy report, the Bank indicated that factors such as globalization and digitization are not important drivers of low prices in Canada. As Governor Stephen Poloz has acknowledged, it is challenging to statistically quantify the effects of globalization on prices and wages, as these changes occur slowly and are fairly complex.

There are reasons, nevertheless, to believe that globalization is holding down the pricing power of firms and the bargaining power of workers even as the economy expands. Other structural factors, such as declining productivity growth and demographic and technological changes, are also contributing to lower prices and wages to varying degrees. These factors are likely to persist, and as long as wage growth is subdued, inflation will remain low.

Global competition has also contributed to low inflation in another way. As the share of imports has increased over time, total inflation in Canada has tracked more closely with tradable-goods inflation (the price of goods that are traded internationally). A decomposition of the CPI into tradable and non-tradable inflation reveals that while the latter has remained close to 2 per cent since 2012, tradable-goods inflation, on the other hand, has remained well below 1.5 per cent during that period. Traded-goods inflation has also been falling in numerous other countries, suggesting that globalization may be pulling down inflation everywhere.

The surprisingly low inflation makes it even more important to understand the dynamics of inflation, in particular the relationship between realized inflation, the unemployment gap (the difference between the actual unemployment and its equilibrium rate), and past and future expectations of inflation as embodied in the modern Phillips curve, which remains the primary framework for understanding and forecasting inflation at central banks. As the Bank gained credibility with the 2-per-cent inflation target in the 1990s, the weight on inflation expectations rose while the importance of the unemployment gap as a determinant of actual inflation fell.

While the latter remains true, there is evidence that inflation has become less forward-looking recently. Persistent low inflation may have caused inflation expectations to become less anchored around the 2-per-cent mark, explaining why inflation has become more backward-looking over time.

Indeed, the Business Outlook Survey published by the Bank shows that more and more firms are expecting inflation to remain in the 1-per-cent to 2-per-cent range in the foreseeable future. This does not necessarily mean the Bank has lost credibility, but it may imply a shift in inflation expectations and this is something that the BoC needs to pay close attention to. These apparent changes in the Phillips curve will make it more difficult for the Bank of Canada to understand the nature of inflation dynamics and make its work more difficult.

Inflation targeting is not an exact science by any means, and our understanding of the factors driving inflation is imperfect. The fact that the Bank did not raise rates in October and December after raising them twice earlier in the year despite a continued fall in economic slack and temporary factors waning suggests it may be grasping with the issue of low inflation after all.

Low inflation is a mystery in Canada and it may explain why the BoC has given no clear indication on the future path of interest rates. If the Bank truly believes that we are close to capacity and that temporary factors are holding down inflation – given that changes in interest rates take time to affect the economy – it should immediately resume increasing interest rates and avoid being behind the curve.

On the other hand, if structural factors are weighing on inflation in Canada, rates may have to stay low for a longer period of time. Doing so, however, leaves the Bank with very little room to fight a recession and also amplifies the downside risks coming from the household sector and housing market.

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