The Bank of Canada and the uncertain outlook for inflation

By Steve Ambler and Jeremy Kronick

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The Bank of Canada announced on Wednesday that it was holding its overnight rate target constant at 1.75 per cent. Many analysts had been predicting a lowering of the rate since at least Oct. 30, when the bank also held the rate steady and the U.S. Federal Funds Rate dropped a quarter percentage point.

A recent Reuters poll reports that a majority of forecasters now expect the Canadian central bank to hold its rate constant right through the end of 2020. That will, of course, depend on the course of inflation.

In 2018, the bank was engaged in a tightening cycle and seemed to be on a course toward its long-run "neutral" rate in the range of 2.25 per cent to 3.25 per cent (compatible with an economy at full capacity and inflation steady at 2 per cent), having raised the overnight rate five times between June, 2017, and October, 2018.

However, earlier this year, with persistent economic uncertainty, it appeared the bank would join a host of other developed world central banks in cutting rates. Yet, we now seem to be in a holding pattern. Why? And, what might we expect as we look ahead?

The main reason the bank has remained on hold is that inflation has been at or close to the bank's 2-per-cent target for the past two years (both headline inflation and the bank's three measures of core inflation). And, as noted in Thursday's remarks by Deputy Governor Timothy Lane, the overall resilience of the Canadian economy has allowed the bank to chart its own course.

Moreover, it is challenging to assess where the balance of pressures lie – up or down.

In terms of upward pressures, the latest reading for the unemployment rate was 5.9 per cent, which is very low by historic standards. The Bank of Canada's labour-market indicator, which historically has shown greater labour-market slack than the unemployment rate, stands at 5.5 per cent.

Wages are accelerating, while productivity growth has been relatively weak. Average hourly earnings (as measured by the Labour Force Survey) grew by 4.2 per cent year-on-year in the third quarter of 2019, and 4.3 per cent in September, up from 2.2 per cent in the first quarter of this year.

This combination of more rapid wage growth and slow productivity growth indicates that nominal wage increases have less to do with rewarding workers for being more productive, and more to do with labour-market tightness. High productivity tends to result in lower prices as it becomes more efficient for businesses to produce goods or supply services. Therefore, if productivity has been weak, this wage growth is more likely to feed through to increases in headline inflation.

If headline inflation does go up beyond the 2-per-cent target, should the bank increase the overnight rate?

Perhaps, but there is room for the bank to remain sanguine in the face of modest increases in inflation above the 2-per-cent target. A period of above-target inflation will make up for inflation that has more often than not undershot the bank's target over the past several years.

Since 2012, inflation has averaged 1.6 per cent. There are also no signs that inflation is set to spike up above 3 per cent, the upper limit of the bank's target range. Moreover, the current strength of the Canadian dollar (the strongest performer of industrialized-economy currencies against the U.S. dollar in 2019, largely because the bank's policy rate is now

higher than its counterparts') will relieve some of the upward pressure on inflation by making imports cheaper.

In terms of downward pressure, a series of economic uncertainties exist both at home and abroad.

Trade continues to be a huge source of preoccupation. Indeed, the lowering of policy rates by many central banks is largely to take out insurance against this uncertainty.

The United States is now threatening to increase tariffs on French wine and other goods and the European Union is threatening to retaliate. Trade talks between China and the U.S. seem headed toward either a peaceful resolution or a major deterioration.

Domestically, personal insolvencies have climbed, reaching the highest point in more than a decade and up 13.4 per cent year-over-year. If this has negative knock-on effects on the demand for housing and consumer durables, all bets may be off.

There are always many variables that are used by the Bank of Canada's governing council to make a call on the overnight rate. As they look ahead they will have to deal with indicators that are pushing inflation in both directions.

But, as the bank has made clear in its announcements, incoming data will play a major role. As it should.

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