Quiet Counsel

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Investment Outlook

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Inflation Mandate Renewal

The Bank of Canada is responsible for setting the Overnight Lending Rate, which influences all other borrowing rates in Canada.

Inflation is defined as the overall rate at which the prices of goods and services increase over time and is one of the key determinants of the Overnight Rate. This has traditionally been measured by the Consumer Price Index (CPI), which tracks the weighted average price changes of a basket of consumer goods and services, including food and transportation.

In 1991, Canada became one of the first countries to explicitly target a sustainable rate of inflation through the **Bank of Canada's Overnight Rate**, which represented a move away from simply controlling the supply of money. The early years saw inflation reduction targets aimed at bringing inflation down from the 4.0 – 5.0% range seen through much of the 1980s toward 2.0%. In 1995, the 2.0% midpoint target of a 1.0 – 3.0% range was established, and the Bank of Canada has been using this guide ever since.

Every five years, the inflation target is renewed, with the Federal Government and the Bank of Canada sitting down to agree on an updated framework. At the renewal this November, the agreed upon changes to the framework represent the biggest shift to the Bank of Canada's mandate since they began targeting inflation in 1991. The changes afford the Bank more flexibility in setting their policy, which may make predicting the direction of their policy more difficult for market participants going forward. The changes also clearly define the Bank of Canada as responsible for controlling inflation and price stability, while leaving the Minister of Finance responsible for the stability of the financial system in Canada.

In making this decision, the following three aspects of the Bank's mandate received careful consideration:

1. Should the 2.0% inflation target be increased?

In considering whether to increase the inflation target, the Bank ultimately decided that the 2.0% level has been successful and should remain. A higher inflation target would give the Bank of Canada more room to cut rates, once they have theoretically risen in the future, but the costs of transitioning to and operating in a higher inflation environment were deemed to outweigh its uncertain benefits. It's noteworthy to mention that the Bank's current 2.0% target is in line with most of the inflation targets used by advanced economies around the world.

2. How should core inflation be measured and used?

The second topic focused on how inflation should be measured and tracked. Although the pace of total inflation, measured by Total CPI*, is the target for the Bank of Canada, it can be influenced by short term factors that introduce volatility into the reading. The Bank has historically endeavored to look-through this temporary noise by using Core CPI, defined as CPIX**, as its operational inflation metric since 2001.

***Total CPI** – Measures the changes in consumer prices of a fixed basket of goods. The weightings of this basket are revisited every two years based on household spending patterns. Total CPI is currently measured at 1.3%.[1]

****CPIX** – Excludes the eight most volatile components of Total CPI (fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, intercity transportation, and tobacco products) and adjusts for the impacts of indirect taxes. CPIX is currently measured at 1.8%.[1]

The research published by the Bank of Canada in conjunction with the recent renewal of its inflation mandate noted a decline in the usefulness of CPIX as the measure of Core CPI. As a result, the Bank indicated it will cease using CPIX going forward in favour of the following three new Core CPI metrics:

CPI-trim – Excludes the components of Total CPI that showed the most volatility in the past month. CPI-trim is currently measured at 2.0%.[1]

CPI-median – Illustrates the median price change in Total CPI's weighted basket of goods and services each month. CPI-median is currently measured at 2.1%.[1]

CPI-common – Extracts the component of inflation that is common across the individual data series that make up Total CPI. This method attempts to minimize the impact of sector-specific disturbances to Total CPI. CPI-common is currently measured at 1.5%.[1]

As noted above, the first two of these new metrics are currently running at or above the Bank of Canada's 2.0% target and above its old operational metric of Core CPI (CPIX). However, a Bank of Canada paper released a year ago, established that CPI-common tracked key macro-economic variables very well, appeared to give insight into shifts in aggregate demand, and as a result would be the Bank's preferred Core CPI metric moving forward.[2] This is important because at 1.5%, CPI-common is running measurably lower than the previously used CPIX and the other measures of CPI.

1: Bank of Canada - http://www.bankofcanada.ca/rates/price-indexes/cpi/

2: Bank of Canada - http://www.bankofcanada.ca/core-functions/monetary-policy/renewing-canadas-inflation-control-agreement/

3. To what extent should monetary policy consider financial stability?

The third topic examined the extent to which the Bank of Canada should incorporate financial stability concerns into monetary policy decisions. In the past the Bank has identified vulnerabilities to the financial system and incorporated them into their decisions. Its latest research however, concluded that the Bank of Canada should focus on its inflation mandate and let Bill Morneau, the Mister of Finance, address financial stability. In a speech following the renewal of the Bank of Canada's inflation mandate, Mr. Morneau stated that he held the ultimate responsibility for the security and stability of the financial system and the Bank of Canada could support his efforts by continuing to focus on inflation and price stability.

The above changes mark a move away from a rigid, rules-based approach to one that provides much more flexibility for the Bank to adjust policy. However, these changes have the potential to create communication challenges for the Bank as the public attempts to discern which measures it utilizes to make important policy decisions.

Presently, we interpret the combination of less pressure to consider financial stability in their policy decisions and a new preferred operational inflation metric (CPI-common) that is tracking lower than the previously utilized Core CPI measure (CPIX), as putting the Bank of Canada closer to stimulating financial conditions than it had been under its old mandate.

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