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Parsing the Bank of Canada's Messaging

February headline inflation came in below expectations at 2.8%. Core inflation, captured by the Bank's preferred CPI-median and CPI-trim measures, also fell short of expectations, at 3.1% and 3.2% respectively. Some commentators have suggested that the Bank of Canada should declare victory and start cutting rates in April. They argue either that the Bank should look through the housing-related components of inflation or that core inflation measures overlook important aspects of the distribution of price changes.

Typically, the Bank doesn't explicitly indicate when its next policy move will be, particularly if that move involves a change in direction. Instead, it will offer insight into the key factors influencing its policy setting decision. These factors encompass corporate price setting, wage pressure, the relationship between housing and inflation, and inflation measurement.

LINK TO ARTICLE

The Bank of Canada is concerned about corporations leveraging their market power to boost profit margins during this inflationary period. However, current data paint a different picture: Corporate profits are under pressure and have fallen to below-normal levels relative to GDP as gains in the resources sector have waned. The Bank's research shows that businesses increased markups in 2020, but mainly because of rising costs. While there was some increase in markups in 2021, it contributed only marginally to inflation.

Business confidence remains downbeat. The Bank of Canada's Business Outlook Survey (BOS) indicator registered at -3.15 in Q4 of 2023, up slightly from the post-pandemic low of -3.45 in Q3 2023. Fewer firms reported feeling pressure to raise wages due to cost-of-living adjustments or retention concerns. The one negative note, from an inflationary perspective, is that businesses anticipate higher-than-average wage adjustments over the next 12 months, with roughly three-quarters of firms expecting wage growth to normalize by 2025. This pressure on wages initially stemmed from the challenge of filling the high number of job vacancies post-pandemic, followed by organized labor catching up on real wages as inflation surged.

The upcoming release of the Survey of Employment, Payrolls and Hours (SEPH) for January, scheduled for March 28, will provide valuable insight into the decline in job vacancies, which are currently running about 25% below year-ago levels. It will also indicate whether there is any sustained decline in wage growth. The Bank of Canada noted in its March policy statement that there are "some signs that wage pressures may be easing." It specifically highlighted that wage growth in the payroll employment data is about 2 percentage points below the 5% plus growth seen in the labour force survey data in Q4 of last year. If this differential continues, it will reassure the Bank that wage pressures are more in line with its target levels for inflation.

The mortgage interest cost in the February CPI rose by 26.3% year-over-year. Several commentators have suggested the Bank should look past this inflation component when setting policy, attributing increased mortgage costs to higher interest rates resulting from tighter monetary policy. The Bank's governing council acknowledged that "if mortgage interest costs were the only component holding up inflation, there could be some capacity to look through them, so as not to unduly restrain economic activity to get headline inflation back to 2%." However, the council concluded that this was not the current situation.

The Bank’s governing council discussions emphasize that underlying inflation isn’t gauged by a single statistic but by a collection of indicators. These indicators include core inflation measures, including the Bank’s preferred metrics—CPI-trim and CPI-median—as well as others that exclude volatile components, such as CPI excluding food and energy. Additionally, they consider the distribution of inflation rates across various components of the CPI basket.

Desjardins Financial believes that the current core inflation measures, CPI-trim and CPI-median, “have become biased, probably overestimating the actual underlying inflation rate.” They argue that the present distribution of price changes is imbalanced. Once this skew is adjusted, core inflation falls below 3 percent.

I expect that the Bank is aware of this concern. During the January Monetary Policy Report press conference, Governor Macklem remarked that underlying inflation “is more of a concept than a measure” and noted the Bank was also looking at CPIX (CPI excluding mortgage costs) and CPI excluding food and energy.

CPIX excludes the eight most volatile components of the Consumer Price Index (CPI) and adjusts the remaining components for the effects of indirect taxes. Among the excluded components are food, energy and mortgage interest costs. According to a recent report by CIBC, using a method developed at the Federal Reserve Bank of San Francisco, CPIX is “responding to the weakening in Canadian domestic demand of late, and not simply easing due to other forces that could dissipate.” Their view is that wage inflation remains a concern.

To predict the Bank’s next steps, pay attention to their commentary on wage pressures and their overall interpretation of core inflation. The upcoming April statement will feature a fresh economic forecast, including estimates of potential growth and the neutral rate of interest. If February’s inflation progress persists and indications of wage pressure relief emerge, the Bank may shift the tone of their discussion to signal a rate cut in June.

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Kevin has had a long career in capital markets, housing finance, and public policy. He has worked as an economist for Alberta Treasury, Saskatchewan Policy Secretariat, the Bank of Canada, and the Department of Finance Canada. His work has included tax policy, economic forecasting, as well as monetary policy and debt management. While at the Bank of Canada, he authored two Bank of Canada Review articles on monetary policy tactics. Kevin has worked on a variety of debt programs from treasury bills to domestic and foreign bond issues, and interest rate swaps. He worked on building and managing the federal real return bond program, the Canada Savings Bond program, and built out the bond buyback program and a synthetic foreign funding program - two programs which are still in use today by the federal government. While at CMHC, Kevin managed the market funding program for social housing, built and managed the Canada Mortgage Bonds program, and expanded the products offered under the NHA MBS program. He has worked for several mortgage insurers including CMHC, Canada Guaranty, Triad Guaranty and Genworth. This work encompassed product development and risk management across housing markets in North America, Europe, Asia, Australia, and New Zealand. More recently he has had senior management roles with residential lenders managing underwriting, risk, product development, capital markets, and strategic planning.

Independent Opinion

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