



www.cdhowe.org

C.D. Howe Institute
Institut C.D. Howe

COMMUNIQUE

For Release at 10:00 a.m. EDT Thursday, April 23, 2009

How to Better Measure Inflation: C.D. Howe Institute

Toronto, April 23 – The Consumer Price Index offers an imperfect measure of changes in the cost of living, or inflation. What makes the issue important to the economy and to policymakers is that the Bank of Canada’s CPI inflation target guides monetary policy, and the fact that many employment and other contracts include inflation adjustments. Fortunately, improvements to the CPI are possible, and better measures of inflation expectations, which the Bank uses in making its policy decisions, are also feasible.

According to a study released today by the C.D. Howe Institute, *The Missing Links: Better Measures of Inflation and Inflation Expectations in Canada*, by Gregor Smith, the overall performance of monetary policy would be improved if new measures of inflation and inflation expectations were incorporated into the Bank of Canada’s inflation-targeting regime, when it comes up for review in 2011.

Professor Smith identifies two “missing links,” or information gaps, in the current methods used to measure inflation and inflation expectations.

The first relates to problems with the CPI, which is designed to measure changes in the price that Canadians pay for a basket of goods and services. The weightings that define the basket are infrequently revised and soon become outdated, so the index does not capture the effects of shifts in consumer spending away from items with rising prices to cheaper substitutes. As a result, the CPI usually overstates annual inflation by a significant amount (perhaps up to 1 percentage point) relative to the Bank’s 2 percent inflation target. For example, notes Smith, the CPI weights currently in use were last updated in May 2007, and are based on 2005 spending patterns. Smith goes on to argue that the Bank of Canada would do better to pursue targets for the behaviour of a new, chained, “superlative” price index, which would be created by Statistics Canada.

Smith identifies the lack of a robust measure of forecasted, or expected, inflation for the Canadian economy as a second gap in the Bank of Canada's current policy framework, and makes recommendations for filling it. These include making an array of inflation-indexed government bonds broadly available to the public, to improve the quality of market-generated information on their expectations about the likely future course of inflation, as well as a new survey of the inflation predictions of private sector forecasters. Smith argues that the conduct of monetary policy would be made easier, and its outcomes more certain, if it could be based on such information.

The study, *The Missing Links: Better Measures of Inflation and Inflation Expectations in Canada*, is available at www.cdhowe.org.

For more information, contact:

Gregor W. Smith.
Professor of Economics,
Queen's University,
613-533-6659

The Missing Links: Better Measures of Inflation and Inflation Expectations in Canada, C.D. Howe Institute Commentary No. 287, by Gregor W. Smith (April 2009). 21 pp; \$12.00 (prepaid, plus postage & handling and GST – please contact the Institute for details). ISBN 0-88806-755-0.

Copies are available from: Renouf Publishing Company Limited, 5369 Canotek Road, Ottawa, Ontario K1J 9J3; or directly from the C.D. Howe Institute, 67 Yonge St., Suite 300, Toronto, Ontario M5E 1J8. The full text of this publication is also available from the Institute's website at www.cdhowe.org.