Intelligence MEMOS

From: Steve Ambler and Jeremy Kronick

To: Canadians Concerned About Inflation

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Re: **THE STRANGE ARITHMETIC OF HEADLINE INFLATION**

Canada's inflation numbers for July gave those of us who analyze the outlook for prices plenty to think about. The headline inflation number, which measures the increase in prices over the last 12 months, clocked in at an unruly 7.6 percent, while the month-to-month inflation figure came in at a much better-behaved 0.13 percent, which works out to an annualized 1.6 percent, which is below the Bank of Canada's 2-percent target.

The June-to-July change was mostly driven by a fall in energy prices, which may or may not be repeated and could easily be reversed if the Russo-Ukraine war or other international conditions worsen. People understand that energy prices go up and down. But the July result does underscore the importance of looking beyond the year-over-year headline inflation number, with its baked-in inertia.

The current inflation outbreak began in earnest in April 2021, when headline inflation came in above the top of the Bank of Canada's target range (one to three per cent) for the first time in this economic cycle. It has remained there ever since. This March, almost a full year later, the Bank began its tightening cycle to bring inflation back down, raising its policy rate (the "overnight rate") by 225 basis points in only five months. That rate now sits at 2.5 percent, smack in the middle of the Bank's estimated "neutral range" – i.e., what's appropriate for an economy operating at full potential output and with inflation securely on target.

The economy responds to monetary policy with, in its practitioners' usual terminology, a "long and variable lag." That the lag is variable raises many possibilities but it would be very surprising to us if the July month-to-month result persists. That would mean the much hoped-for soft landing has already been achieved – only six months after the Bank of Canada's first tightening measures.

But even if month-to-month inflation did stay within the Bank's target of 0.17 percent per month (or 2 percent per year), there's the problem that the year-over-year numbers that are the focus of headlines won't fully reflect it for another 12 months.

Suppose that in this month of August there is absolutely no change in prices from July. (StatsCan will let us know September 20.) If that's the case, the month-to-month inflation rate will be zero, which would be very good news: inflation will have been totally tamed. But the headline year-over-year increase in prices from last August would still be big. Why? It would include the 7.4 percent increase in prices between last August and this July.

Even if – which we don't expect to happen – the month-to-month inflation rate stayed at zero from now on, the year-over-year rate would not get back to 2 percent until May of next year. That would mean nine months of bad headlines about inflation being above the Bank of Canada's target even though inflation would have been stopped dead in its tracks as of this month.

Year-over-year inflation is not *ancient* history. But most of it is history nonetheless.

It's 11/12ths old news: price changes that took place up to a year ago and that we have known about for (on average) six months. What is new in the numbers is the month-to-month change.

Of course, month-to-month inflation can be highly volatile, so that projections of future inflation based on one month's number alone come with much uncertainty. In particular, as noted above, the July number is largely due to a fall in energy prices. Excluding energy, the month-over-month inflation number was 0.68 per cent, which works out to 8.5 percent annualized.

So, what are we left with?

First, one good month-to-month number does not yet mean monetary policy has started to bite in the Canadian economy. Slowdowns or reversals in prices will have to be broader than just in the energy sector. On the other hand, given all the inertia in headline inflation, and with the overnight rate now in the neutral range, focusing only on year-over-year price growth can be as misleading as looking only at one month's numbers.

More interest rate hikes are likely coming. How many more and how high they go will depend on when we start to see slower month-over-month increases in a broader range of prices.

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