Intelligence MEMOS

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To: Bank of Canada Watchers

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Re: **Taking Inflation Warnings Seriously**

Last week, the Bank of Canada left its target for the overnight rate at 0.25 percent, and kept its purchases of Government of Canada bonds at $3-billion per week. Forecasters and financial market participants expected these announcements, and took them in stride. Below the calm surface, though, a couple of key questions about Canadian monetary policy are causing concern.

One is about where inflation is going. The year-over-year increase in the consumer price index (CPI) hit 3.6 percent in May, its highest reading in a decade, and above the 1- to 3-percent acceptable range the central bank has for its 2-percent target. The Bank's statement emphasized that such above-target CPI increases are temporary. When demand for many goods fell off a cliff after March of last year, so did their prices. So recent comparisons with a year earlier exaggerated the trend in inflation – a base effect that will be with us for a while, but will eventually fade.

Some indicators, however, are less reassuring. Some of the Bank's own core inflation measures, which strip out volatile CPI components such as gasoline and food, are also running above 2 percent. The Bank highlights six on its **website**: CPI-trim, CPI-median, CPI-common, CPIX, CPI-XFET and CPIW. Each has its advantages and disadvantages, but is meant to get at inflation's underlying trend, discounting short-term volatility. These help the Bank better set monetary policy with an eye toward the medium-term horizon of six to eight quarters, at which point it expects inflation to be at the 2-percent target.

Five of the six core measures were above target in May, including CPI-trim and CPI-median, which are two of the three core measures (along with CPI-common) that the Bank introduced in 2017 and has since favoured.

While year-over-year changes get most attention, changes over shorter intervals can give clues about what is coming next. The Bank and Statistics Canada do not publish monthly values for these newer core indexes, but a recent National Bank **report** does this for us. It found an annualized rate of change at a three-month seasonally adjusted interval of 3.1 percent for CPI-median, and 3.5 percent for CPI-trim. This would suggest there is underlying momentum to inflation beyond simply volatility and base effects.

The reason for that momentum brings us to the other key question: how the Bank of Canada is dealing with the enormous increase in federal spending since last spring.

Federal income supports exceeded the income lost during the pandemic: the household saving rate in the second quarter a year ago was 27.4 percent, the highest on record, despite the largest quarterly fall in GDP since the Great Depression. Even as the economy began to recover in the third quarter, the savings rate remained elevated (13.5 percent), higher than any time since 1993. It was 13.1 percent in the first quarter of 2021. Chartered bank deposits as a share of the economy have never been higher. While there are groups disproportionately hurt by the pandemic, there is plenty of pent-up demand. With governments extending income supports, remaining slack in the economy may disappear faster than the Bank of Canada's announcement suggests.

The fact that the federal government is financing its spending by borrowing, and that the Bank of Canada is buying such large quantities of federal government bonds, naturally raises questions about the interaction of monetary and fiscal policy.

There is more to the federal government's deficit than bond-market borrowing, and there is more to the Bank's balance sheet than federal bonds – including the fact that it pays interest on the reserves it creates to pay for these bond purchases, thereby reducing the size of any surplus it can transfer back to the government. Still, it is a troubling coincidence that the Bank's $3-billion-a-week pace of purchases adds up, over 52 weeks, to almost exactly the $155-billion federal deficit projected for this fiscal year in the recent budget.

An increase in the overnight rate sooner than suggested in the Bank's announcement last week is a possibility. And further reductions in the pace of bond purchases would be a positive sign. We have no doubt the Bank has the tools to deal with inflationary pressures. The question is how soon, and how vigorously, the Bank should use them.

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