Intelligence MEMOS

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To: The Bank of Canada

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Re: **On the Hunt for 2 percent Inflation**

Inflation went through a puzzling path after the financial crisis of 2008-09 and the reasons why warrant a closer look. In our recent C.D. Howe Institute **report,** we explore a link between the breadth of economic growth and inflation performance during the period following the financial crisis.

Economists have faced two strange puzzles in the inflation rate since the financial crisis: "missing disinflation" during a period of slumping major economies that lasted from 2009 to 2011, and "missing inflation" during much of the economic expansion that has occurred since then.

The missing disinflation puzzle was characterized by constant or even increasing inflation, despite significant economic slack from the global financial crisis.

The missing inflation puzzle has the exact opposite description: despite economic rebounds and closing output gaps, headline inflation remained below target for many inflation-targeting central banks.

In Canada's case, headline inflation, which includes commodities with volatile prices, has averaged 1.56 percent from January 2012 to the end of May this year, well below the Bank of Canada's 2 percent target.

We found that missing disinflation occurred when economic growth, though low, was spread across many industries. By contrast, missing inflation occurred when growth was higher but concentrated in a smaller set of industries.

One possible explanation for the link between breadth and inflation is different spending by different income quintiles. It is possible that the more widespread, or less concentrated, growth is, the more resources are spread across different income quintiles, rather than concentrated at the top.

This matters since lower income households tend to spend a higher percentage of their income, driving up inflation. For example, the sectors that grew the most, such as accommodation, fuel and other basic living needs, and propped up inflation during the missing disinflation period, were those where lower-income households spent a disproportionately larger proportion than higher-income households. Similarly, sectors that contracted the most, and dampened inflation during the missing inflation period, were those where lower-income households typically spent relatively more.

The robustness of this link across our different empirical tests suggests that the industry makeup of economic growth matters for inflation behaviour, and as a result, matters for monetary policy.

Despite some recent evidence of inflation at, or even above, target, understanding the monetary policy transmission mechanism continues to be a challenge in the post-crisis, low-inflation, low-interest-rate environment.

We show that broad-based growth, or the lack thereof, is an important factor in explaining inflation behaviour in Canada during the puzzle periods. The implication for the Bank of Canada is that the industrial composition of economic growth is important when considering the likely effect of a monetary policy shock.

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