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e-brief

Food and Energy Prices: Why the Bank of Canada Should Remain Focused on the CPI

by David Laidler

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A lengthy upswing in energy prices, and now rising food prices, prompt questions about how central banks should fight a new inflationary threat. But central banks do not fight inflation. They cause it — or not — and the right question is how they can avoid inflationary or deflationary policy mistakes.

Answers are easier when all prices are rising at around the same rate, but more difficult when relative prices are changing and different sectors of the economy send different signals. Answers also differ across countries, depending on whether they are net exporters or importers of agricultural and energy products, and on their overall economic situations, so answers for Canada will not match the United States' needs, let alone India's or China's.

At present the Bank of Canada should pay close attention to overall inflation, as measured by rises in the Consumer Price Index (CPI), for which the Bank has set an annual target of 2 percent. The CPI measures the changes in the cost of living that ordinary Canadians experience. To avoid inflationary risks, it should downplay "core" inflation, which, among other things, takes no account of most food and energy prices. The latter are both volatile and, under certain conditions, the Bank can get a better reading of inflationary trends from month to month data by ignoring them. But that is not the case at present. The current upswing in their relative prices means that they need to be taken into account.

The relative price changes in food and energy are being driven by world market fundamentals — growth in India and China that is changing diets and increasing energy consumption; crop failures in some places, perhaps associated with climate change; misconceived energy policies; political uncertainties in oil producing regions, and so on. These price pressures are not soon to be reversed. If the Bank of Canada keeps CPI inflation on track, however, increases in food and energy prices within Canada will be offset by more slowly rising, or even falling prices for other items. If it pays too much attention to core prices, it will be misled into leaving room for food and energy to drag the overall inflation rate above

Figure 1: *Comparing Consumer Price Inflation Measures, Year-over-Year Growth Rates*

Figure 1a: *Canada*

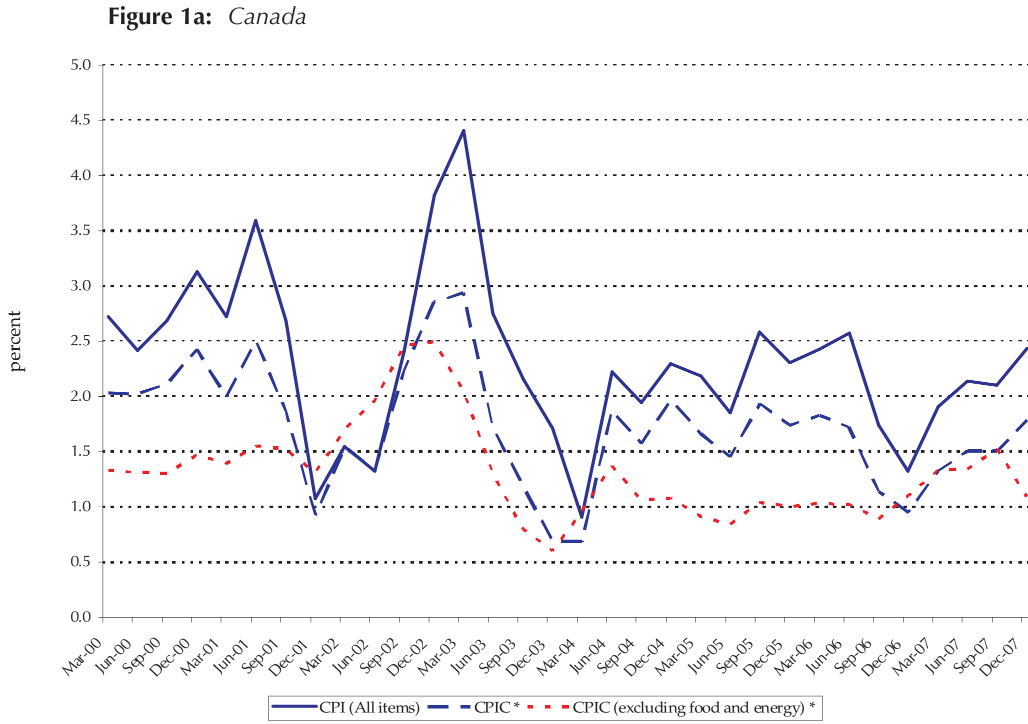
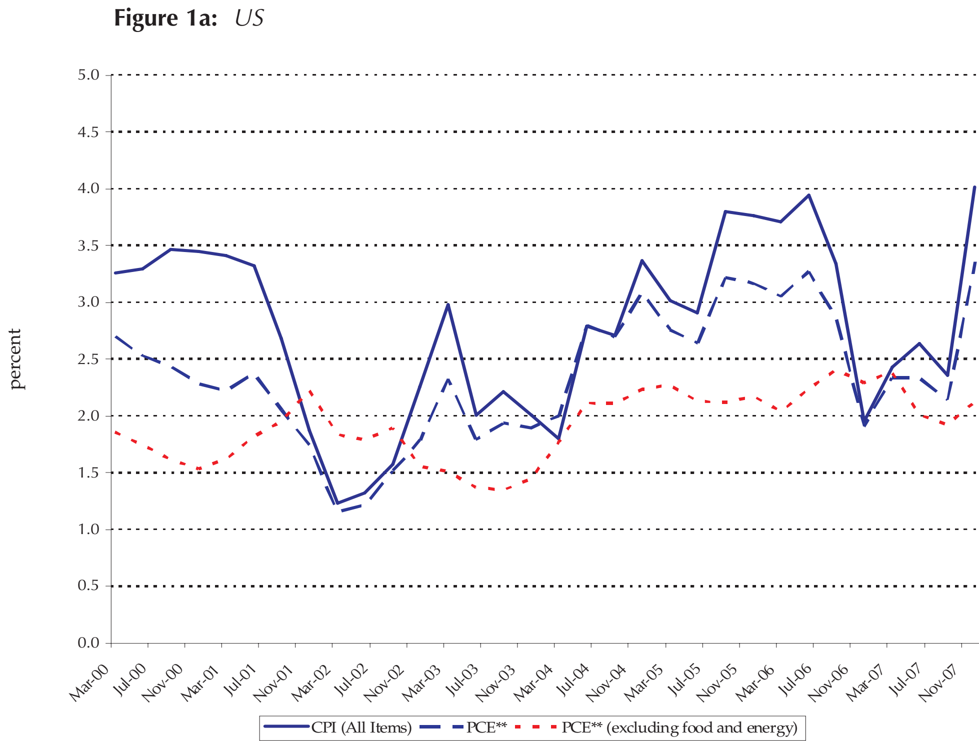


Figure 1a: *US*



Notes: * CPIC refers to the "Chain Price Index for Consumption." The Canadian CPIC is comparable to the American PCE.

** PCE refers to the "Personal Consumption Expenditures Price Index."

Sources: Bank of Canada, Bureau of Economic Analysis, Bureau of Labor Statistics, author's calculations.

target levels, which will begin to undermine the Bank's credibility. This is the inflationary risk in Canada's current situation, with which the Bank has coped well so far.

Not so the US Federal Reserve. Though the Fed does not have formal inflation targets and operates under a dual mandate that requires attention to growth and employment, it appears to have a 2 percent comfort zone for inflation. However, it monitors an index that ignores food and energy, called the "core personal consumption expenditure deflator," and this index has stayed in that zone since the bursting of the dot-com bubble.

The same cannot be said for the overall CPI: too-easy money in the US drove its inflation rate to around 4 percent, and helped turn a housing boom into a bubble. The Fed is now working hard to maintain its credibility as it copes with the consequences. In contrast, the Bank of Canada kept its eye more firmly on the CPI over the same period, generating a current policy environment that, though challenging, is nevertheless more benign than that south of the border. (See Figure 1, which shows the relevant indices for Canada in Figure 1a and the US in Figure 1b.)

Canada is a major exporter of commodities whose world prices have been rising. This would have created domestic inflation, had the Bank of Canada not stuck to its inflation targets and allowed the currency to appreciate. This has taken some of the edge off local food and energy prices, and driven price reductions for many other goods as importers, and the domestic producers who compete with them, respond to the exchange rate.

These effects are part of the relative price adjustments within Canada that international fundamentals call for. If they become strong enough to drag the overall inflation rate below 2 percent, despite continuing upward pressure on food and energy prices, it would signal that the Bank of Canada's policy needs to ease. The disinflationary risk in the current situation is that the behaviour of food and energy prices will cause an over-hesitant response to such a signal.

Local side-effects of the current US situation are further complicating Canada's policy choices. A slowdown there is creating extra problems for Canadian manufacturers already under pressure from a strong currency. In addition, the fragility of financial markets created by the collapse of the US housing bubble has destabilized the relationships between interest rates for various debt instruments and the Bank of Canada's setting of the overnight rate, a short-term money market rate that the Bank targets for monetary purposes.

These linkages remain sensitive to liquidity problems in financial markets, as well as to measures taken to combat them by central banks, including the Bank of Canada and the US Federal Reserve. Finally, though less obvious, worries about current US financial system problems are combining with deeper-seated doubts about the sustainability of the US fiscal position, and the potential for a shift of assets out of the US dollar into other currencies, and into commodities too, adding a speculative element to the current behaviour of food and energy prices.

Obviously, the US slowdown and widening interest-rate spreads between, for example, riskier corporate bonds and government-issued treasury bills, should push Canadian policy toward easing; and so should the speculative element in commodity prices, to the extent that it is causing them and the Canadian dollar to overshoot their long-run fundamentals.

The balance of risks at play is tipped towards an inflation-target undershoot — in the absence of further policy easing. World food and energy prices will need

continuous monitoring, of course, but so long as the Bank of Canada keeps it eye on the CPI, it will quickly catch any change in their significance for overall inflation in Canada. Sticking to this approach is what will matter for the Bank's future policy choices.

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