The inflation target is renewed, but the measurement of underlying inflation has changed

The Canadian government and the Bank of Canada have agreed to renew the 2% median inflation target and its operating range of ±1%. This decision will be in effect for a further five-year period. The next decision on renewing the inflation target is expected in 2021.

The BoC had suggested that the target could be raised, particularly to offset the impact of the cut to the neutral interest rate. The BoC had indicated, however, that the bar was high to make such a change.

The neutral interest rate is the overnight rate that we should see when economic activity is humming at full potential and inflation is at its target, once all the cyclical shocks have settled. The BoC estimates that this rate is now about 3.25%, a decline of about 1.5% over the past 10 years or so. The decline in the average economic growth is one explanation for the neutral interest rate cut.

The reduction in the neutral interest rate is restrictive for the BoC, as it limits the Bank’s capacity to reduce the overnight rate to kick-start the economy. Nevertheless, for the past few years, several new tools such as mass asset purchases and negative interest rates have been used by the central banks, suggesting that the BoC still has considerable capacity to intervene despite the neutral interest rate cut. Several analyses have shown the upsides and downsides of these new tools. In the end, it appears as though the Canadian government and the BoC deemed that the benefits of these tools outweigh the drawbacks.

Changing the target could have increased uncertainty in the short term. How would the markets have responded? Would long-term interest rates be adjusted higher to reflect the lofter inflation expectations? On the contrary, the expectations could have remained the same, forcing the BoC to ease its monetary policy further. The long-term credibility of the inflation target could also have been threatened.

In addition to the renewal announced this morning, the BoC indicated that it will stop using the CPIX as the preferred metric to measure core inflation. The CPIX is the price indicator that excludes the effect of eight volatile components, such as the price of gas and certain foods. The CPIX will be replaced by three new measurements: the CPI-common, the CPI-trim and the CPI-median. The CPI-common measures core inflation that tracks common price movements between categories in the CPI basket. The CPI-trim is a measure that excludes the components whose rates of change are located in the tails of the distribution of price changes. Lastly, the CPI-median is a measure that corresponds to price changes located at the 50th percentile of the distribution of price changes in a given month, weighted based on the components in the CPI basket.

Despite this change, we have to understand that the inflation target is still based on the total CPI. However, new tools to measure core inflation will be used to help the BoC track these dominant price development trends to provide insights on its monetary policy decisions.

Implications: Today’s announcement brings an end to the suspense surrounding the possibility of increasing the inflation target. However, the change made to core inflation monitoring could have certain repercussions. The new indexes are far more difficult to communicate and understand than the CPIX. They could also shift in divergent directions, as is currently the case, which sends contradictory signals on future monetary policy decisions.