Canadian Inflation: Talk About Losing The Plot!

- **Inflation rates may be distorted…**
- **…because of the way that revised weights are incorporated…**
- **…which leaves us with poor ability to track true inflation**
- **How this could have been avoided**
- **The BoC has added reason to be more circumspect toward what is happening with inflation**

Canadian CPI, m/m / y/y %, June:
Actual: 0.3 / 3.1
Scotia: 0.6 / 3.5
Consensus: 0.4 / 3.2
Prior: 0.5 / 3.6

Canadian core CPI, y/y % change, June:
Average: 2.2 (prior 2.3%)
Weighted median: 2.4 (prior 2.4%)
Common component: 1.7 (prior 1.8%)
Trimmed mean: 2.6 (prior 2.7%)

While headline and core inflation appeared to land softer than expected, there is strong cause to counsel treating the results with caution. The year-over-year and month-over-month rates of inflation may have unfortunately lost their usefulness at an important transition point for monetary policy given the way Statistics Canada (and other global agencies) incorporate basket weight changes into CPI, given the chosen timing of that transition and given the absence of other simultaneous attempts the agency could have provided in an effort to offer a fuller picture of true inflation.

This frankly means that for policy purposes we're left flying blind on true underlying inflation and that markets may have over-reacted somewhat to the perceived miss relative to expectations. Note that the Canadian dollar initially depreciated by about a quarter cent to the USD and shorter-term yields rallied before these effects stabilized.

THEY LOST THE PLOT TO THE INFLATION STORY

At issue is Statistics Canada's choice of the chain-link reference month for incorporating new basket weights. Up to May 2021 the basket weights are still set at 2017 levels and nothing gets revised for changed pandemic-era spending patterns. Starting in June 2021 onward those weights are set at the revised 2020 basket weights that were updated last Wednesday.

That means that when we are looking at year-over-year headline and core inflation rates we are comparing amoebas to blue whales in that June 2020 price index levels are still set at 2017 weights. Ditto for every other month during the pandemic to date except for starting with June 2021. When StatsCan says that the

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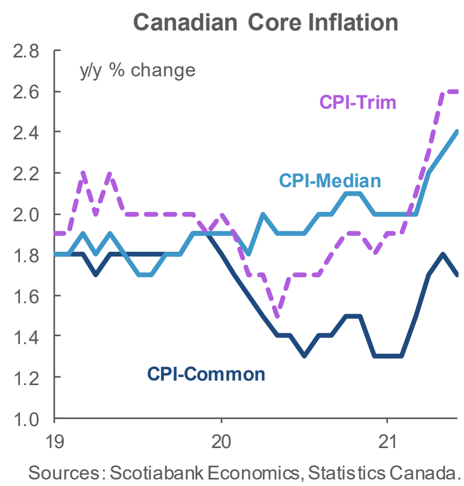
Chart 1

Chart 2



year-over-year CPI inflation rate would have been 3.1% regardless of whether 2017 or 2020 weights are used they are arriving at this conclusion only because they are *not* adjusting June 2020 for the revised 2020 weights in addition to the June 2021 index levels at 2020 weights. They are only saying that June/June would be the same if they were still using 2017 basket weights, or if June 2021 used 2020 weights compared to June 2020 at 2017 weights which isn't a useful comparison. What we needed was June 2021 at 2020 spending weights compared to June 2020 at 2020 spending weights and the same thing for each historical month during the pandemic in order to assess the evolution of inflationary pressures.

It's standard practice for global statistical agencies to transition from one set of basket weights to a revised set at a particular month without revising history and this point is called the chain-link reference month. That part is understood and the agency is doing so competently in keeping with global and historical practices.

It's just unfortunate that in the midst of the pandemic we've lost the continuity of the spending basket's influences upon inflation to reflect changes in spending behaviour that are only being incorporated from June 2021 onward. That makes the year-over-year rates an unreliable depiction of what is truly happening to inflation. It's a case of doing the right thing in a data nerd sense by keeping with standard data practices over time and internationally while missing the whole plot of the story from a market and policy standpoint in terms of the need to provide reliable inflation estimates that reflect pandemic-era realities.

HOW THIS COULD HAVE BEEN AVOIDED

StatsCan could have addressed this in one of at least a couple of ways, or it could now be incumbent upon the BoC to do so. One way would have been to provide shadow CPI figures using a chain-link reference month set for the beginning of the pandemic or, say, the end of 2019. That would have allowed us to track a constant basket of spending behaviour and the price implications throughout 2020–21.

Alternatively they could have simultaneously published an updated version of their adjusted CPI measure (last one here) that dynamically adjusts spending weights each month throughout the pandemic and which was tracking about 0.4% higher than official CPI on a year-over-year basis the last time they published it. Instead, the agency will publish a revised methodology and estimates for the adjusted CPI measure 'later in the Fall' and hasn't reported on the measure with estimates fresher than January 2021 when it was tracking about 0.4% higher than the official headline y/y CPI rate. They teased us with inflation estimates that were tracking higher than the official CPI estimates but then subsequently lost the whole point of the efforts.

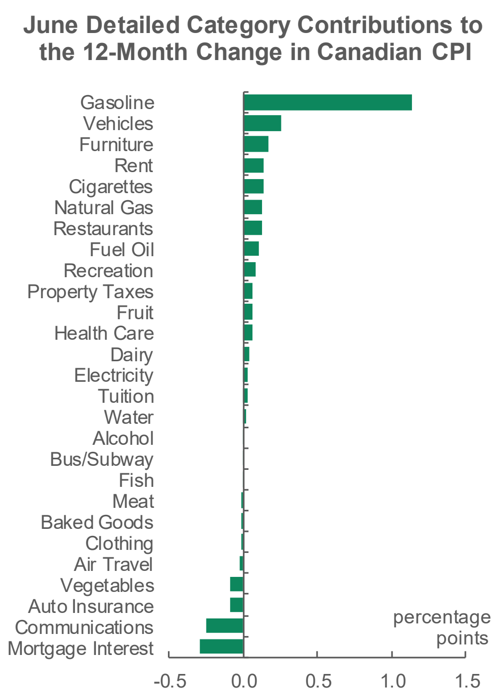
BoC IMPLICATIONS

Former Governor Dodge was on the mark yesterday when he indicated that the BoC should be more circumspect toward inflation risk. He's even more correct today in that if we don't have a good handle on true inflation at a vulnerable transition point then the BoC has even less reason to sound so strident with its exaggerated conviction that everything is all just transitory and driven solely by base effects that now can't even really be judged. There is also the residual issues stemming from the earlier flap over seasonality adjustments to components of the basket and wherever that now stands.

DETAILS, FWIW!!

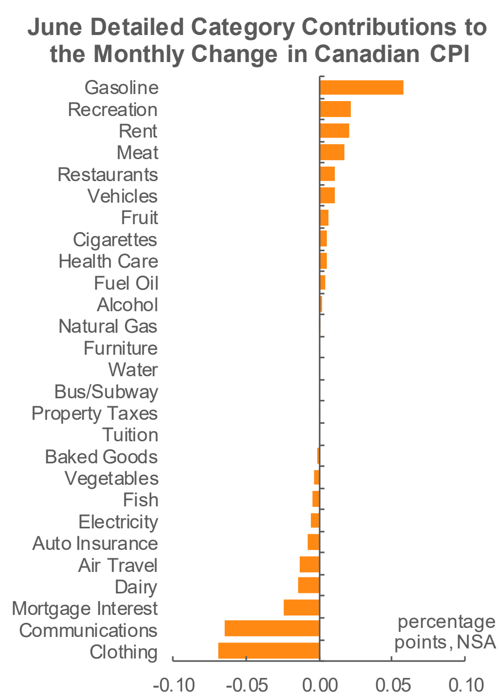
Because of the comparability issue at a transition point for the spending basket it's largely pointless to delve too deeply

Chart 3



Source: Scotiabank Economics, Statistics Canada.

Chart 4



Source: Scotiabank Economics, Statistics Canada.

into the composition of changes to inflation tracking. That will therefore be kept brief by referring the reader to charts 1–5. They show unchanged average core inflation at 2.2% y/y, the breakdown of the core measures, the breakdown of the weighted contributions to the year-over-year headline inflation rate, the same thing for the month-ago inflation rate and a breakdown of the trimmed mean CPI basket on the next page.

Chart 5

Sources: Scotiabank Economics, Statistics Canada.