

## BoC Has Confidence In What It Doesn't Fully Know

- **This** is a speech about the BoC being (mostly) in control of its inflation target and a confident dismissal of the suggestion that “central banks may be losing the ability to understand the processes that drive inflation.” **It is not, however, a confident defense of the ability of central banks to fully understand and forecast those very same fundamental drivers of inflation and that remains an important distinction and therefore where most of the caution creeps in.** The broad speech tone should probably be characterized as dovish/neutral in the near-term, with mild hawkishness longer run in that I don't think one subjective label across all time horizons is appropriate. That's in keeping with our forecast for a pause until April, two hikes in 2018 (April, Sept) and three in 2019. The C\$ and rates markets largely shook off the speech because while it put a different spin on uncertainty, the broad messages of caution and uncertainty were not new.
- Before delving into his inflation perspectives, the cautious policy bias is summed up when Poloz states that “A lot of pieces need to fall into place before we can be certain that the economy has made it all the way home” with ‘home’ defined “as the intersection of full capacity and 2 per cent inflation.” **The BoC forecasts a return to 2% inflation over 2018H2 but it is in no rush to pre-judge such an achievement and hence to act accordingly through pre-emptive tightening.** That remains the most important message the BoC is delivering these days.
- **On inflation, the root cause of Poloz's uncertainty toward estimating future inflation risk is less about how he thinks there are factors beyond traditional fundamentals that have broken traditional inflation models and more about uncertainty surrounding forecasting those classic fundamental drivers of domestic inflation.** In this regard, he flags several factors that have led to repeated downsides:
  - ◇ the ‘surprising’ persistence of spare capacity in the economy and how it is difficult to measure.
  - ◇ that soft inflation can persist until all labour market slack has been absorbed as firms add capacity.
  - ◇ the role played by the wage Phillips curve and ongoing labour slack (see more below)
  - ◇ the role of repeatedly unexpected relative price shocks (electricity prices, food prices etc).
- On the theory there may be common international factors driving soft inflation, Poloz makes the following points in summing up BoC research:
  - Food and energy prices are a common global factor that “explain almost half of the movements in total inflation. This makes sense, as food and energy prices are driven by global commodity prices.” But he also dismisses paying much policy attention to this issue in that “we generally look through movements in food and energy prices....so, this common factor does not add much to our understanding.”
  - Poloz notes that BoC research references how “A further 15 per cent of the remaining variation in core inflation” may be explained by

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factors such as globalization or the digital economy. But he goes on to waffle on the role of such factors by perhaps wisely citing possible difficulty associated with empirically estimating the effects:

- ◇ “However, **Bank staff have yet to find rigorous empirical evidence to show that these factors add to our understanding of Canadian inflation** beyond what the basic drivers tell us. To be clear, **all I am saying is that the evidence does not pass the formal test for statistical significance. Common sense tells you that globalization and digitalization are affecting prices.** Over time, as we accumulate data, we may be more able to identify and statistically quantify these effects.”
- Poloz nevertheless goes on to say “Thee Amazon effect appears to be smaller than the....so-called Walmart effect’—and even that was not large enough to force a rethink of the inflation process for policy purposes.”
- Poloz’s final point of emphasis is upon the wage Phillips curve that relates unemployment to wage growth. His explanation for soft wage growth (curiously notwithstanding a sharp recent acceleration and what I think will be considerably further upside into 2018...) involves referencing labour market slack which is not a new point, the impact upon wages of transitory commodity shock effects, demographics as younger workers replace more highly paid older workers and the role of foreign competition.
- **To sum up, I’d say the message here is that the BoC has confidence in what to look for and consider as credible drivers of inflation risk, but much less confidence in its ability to forecast those drivers and hence being in no rush to pre-judge when the economy will have “made it all the way home.”**
- For the full speech, please go [here](#).

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