Is Slack Back?

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The Bank of Canada's three preferred core inflation metrics averaged 2.0% in March, back at the target after a four-month run below. South of the border, core CPI inflation inched down a tenth to 2.0% in March, indicating that the Fed's preferred measure, the core PCE price index, is likely to drift further below the 2% target, to 1.7% by March from 1.8% in January (the latest available data). Since June 2010 (a year after the end of the recession), both central banks have had a hard time hitting their targets *(Chart 1)*[1]. Allowing a one-tenth range around 2.0%, the Bank of Canada has achieved it 29% of the time and has come up short 71%. Average core CPI inflation has never exceeded 2.1% this cycle. The Fed has achieved the target 23% of the time and has come up short 77%. Core PCE inflation has, also, never exceeded 2.1% this cycle. Note the complete lack of symmetry within a very narrow range around the targets.

The fact that both central banks have had similar disappointing core inflation performances, despite differently-constructed price indices and differently-structured economies, emphasizes the common disinflationary forces they are facing. These include an aging population, automation and digitalization. These secular forces have effectively countered the cyclical inflation pressures that accumulated as economic slack was taken in and output gaps shrank. And, in the oscillating tug-of-war between cyclical inflation pressures and secular disinflation forces, it now seems that the cyclical side might not be as strong as originally posited. The output gap appears to be getting larger in Canada, as America's budding positive output gap is proving to lack net inflationary punch.

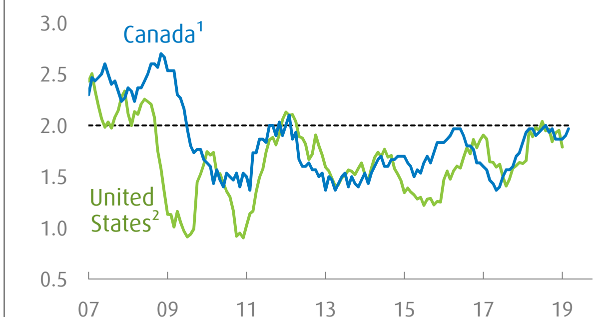
Back in January, the Bank of Canada judged the output gap was between -1% and 0% for Q4, representing an increase from the range-around-zero October estimate as real GDP growth was expected to be weak in the period (it turned out to be just 0.4% annualized) *(Chart 2)*.[2] However, most of the economy was deemed to be operating *"close to capacity"* with the increase in slack occurring in the oil-producing regions as that sector reacted to low prices. Not only has the latter slack escalated subsequently, but it appears to have spread to non-oil sectors.

One metric that factors into the Bank's output gap judgement is the quarterly Business Outlook Survey's assessment of capacity pressures. For Spring 2019, the share of firms perceiving difficultly in meeting unanticipated increases in demand dropped sharply to 31% from a cycle-high run of 56%-to-57% in the prior three periods. This was the largest quarterly decrease since the survey

Chart 1
Hard Time Hitting Target

(y/y % chng)

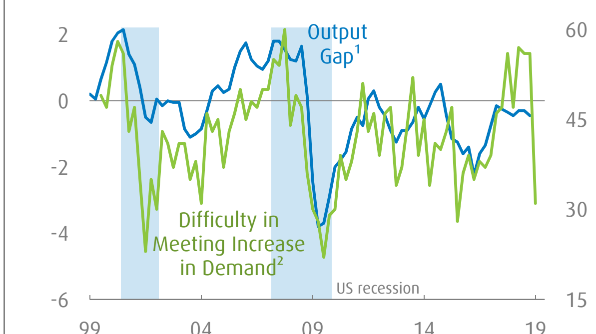
Core Inflation



1 avg. of BoC's 3 preferred core measures 2 core PCE price index
Sources: BMO Economics, Haver Analytics

Chart 2
Economic Slack Coming Back

Canada



1 avg. of two methodologies (ppts : lhs)
2 BoC BOS [capacity pressure proxy] (% of firms : rhs)
Sources: BMO Economics, Haver Analytics

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[1] Officially, the 2% target is meant for headline inflation but both central banks employ core inflation as an operational guide.

[2] This was consistent with the -0.5% average of the BoC's two point estimates, which is what we show in Chart 2.

commenced in 1999, with the share now hovering at a level last seen during the oil-led downturn in 2015 and, before then, the first quarters following the recession. We reckon the key culprit was the Alberta government's mandated oil production cuts, but the negative spending responses on both sides of the border to last year's plummet in equity prices and extreme winter weather (record precipitation across the U.S. and in parts of Canada, not to mention a polar vortex) were also factors.

We estimate real GDP expanded at a 0.7% annual rate in Q1, posting a second consecutive quarter well under the Bank's 1.8% estimate of potential economic growth, and increasing the output gap again. While we look for the economy to expand above potential during the middle quarters of this year (around 2.3%), this won't be sufficient to re-close the output gap.

The U.S. economy currently sports a positive output gap of 0.6%, according to the CBO *(Chart 3)*. It first emerged in 2018 Q2 as annualized real GDP growth topped 4% owing to fiscal stimulus. However, the emergence and persistence of a positive output gap has done little to visibly drive the inflation process. As recently as last July, core inflation was 2.0% with the shorter-term trends (3- and 6-month changes) pointing to some acceleration. The latest reading was 1.8% with the shorter-term trends pointing to further deceleration.

It may simply be too soon to expect an inflation reaction, or the reaction is being overwhelmed by the secular disinflation forces, but the positive output gap will probably get a bit smaller in Q1 anyway. In addition to the stock market and winter weather headwinds mentioned above, the government shutdown will act as a drag on economic growth. We estimate U.S. real GDP expanded at a 1.8% annual rate, slightly below the CBO's 2.2% estimate of (quarterly) potential economic growth. Like in Canada, the U.S. economy will probably rebound in Q2 but we doubt the positive output gap will get any bigger than what it has been, which has already proven, so far, to be ineffective in fuelling inflation.

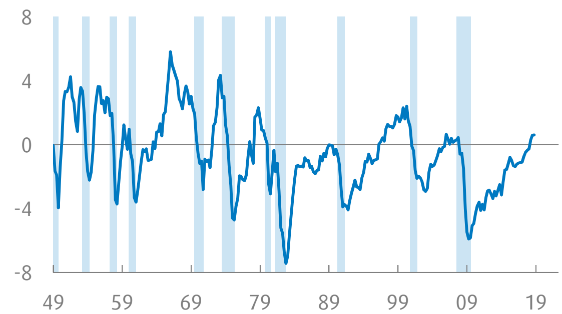
Capacity utilization rates provide another perspective on economic slack. The latest readings dipped below their medians on both sides of the border, and remain well below the levels attained in previous business cycles *(Chart 4)*. Whether seen in below-median and decreasing industrial capacity utilization rates, increasing output gaps or impotent positive output gaps, cyclical inflation pressures could be losing steam. For the Bank of Canada and Fed, this would be another reason to be "patient" in the period ahead.

Chart 3

America's Budding Positive Output Gap

United States (% of potential GDP)

Output Gap



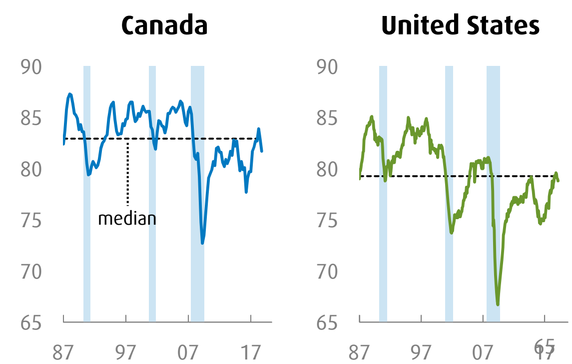
Shading marks periods of U.S. recession

Sources: BMO Economics, Haver Analytics

Chart 4

Cap U Capped

Capacity Utilization (% of capacity)



Shading marks periods of U.S. recession

Sources: BMO Economics, Haver Analytics