Inflation

Inflation is the thief that steals from our pockets every day. Over the years, since this crook has been very greedy, the result has affected our living standards. The inflation rate measures the devaluation of the currency. In Canada, about 500 items are evaluated together in a basket with their average prices and values determined, and the total price is recorded and compared to previous prices. The Bank of Canada's continuing target range for inflation is one to three per cent—although last month's inflation was 4.3 per cent. This inflation measure is called the Consumer Price Index, or CPI, for short. The Bank of Canada also has another gauge called the core inflation rate. These indices are refined periodically and have been used to determine whether the Bank of Canada raises or lowers interest rates. The core inflation rate excludes eight volatile items such as food and energy, and the impact of changes in indirect taxes, since their prices fluctuate continually. CPI inflation, or "headline" inflation, includes all items and tends to fluctuate more than the core inflation rate. The core inflation rate is useful for short-term analysis, while CPI inflation is better for long-term assessments.

The core inflation rate excludes volatile items such as fruits and vegetables, gasoline, fuel and natural gas, intercity transportation, tobacco prices, mortgage interest costs and indirect taxes. In spite of the numerous exclusives, core inflation still includes 84 % of the value in the overall CPI basket, and is useful for assessing and predicting future inflation rates. It is less valuable to use CPI for adjusting interest rates. This is because changes in the CPI outside the desired range will not predict future inflation rates as effectively as core inflation rates do. If the Bank were to assess inflation according to volatile items, it would be constantly modifying their interest rates. As these volatile items fluctuate over short periods of time, the core inflation is able to measure a more stable inflation rate and it is much more useful for setting interest rates. Because it takes anywhere from 18 to 24 months for interest rate changes to affect total inflation, the Bank prefers to focus on a measure that has the best predictive power. There is nothing the Bank can do in the short term to turn around the total CPI, so it focuses on core inflation for information as to where total inflation will go.

The CPI inflation rate has historical precedence. It is the best measure of the value of our dollar over longer periods of time. Since it includes many volatile items, such as food and energy, it tends to fluctuate over short periods of time. In the long run, however, the fluctuations are evened out, and the rate reflects the total decline in purchasing power of the currency. It is the most accurate measure because it includes all the items.

According to the bank of Canada, CPI inflation tends to decline when it is above core inflation and tends to rise when it is below core inflation. In other works, when the volatile items' prices are high, they are bound to come down, and when they are low, they tend to go back up again. For example, if a volatile commodity is priced above the core inflation rate, there will be an economic incentive to increase the supply of that commodity. This will cause the price to be reduced, as the supply curve has shifted because of increased output capacity. Alternately, if this volatile commodity is below the core inflation rate, there is no incentive for suppliers to maintain the supply. Eventually, supply will shrink and prices will rise. This process continues over and over again, and this is why prices go up and back down again.

The overall inflation rate has been higher than the core rate for two years now, but rising energy prices accounted for about one-third of the rise. The average Canadian household paid 11.6 per cent more for energy, with natural gas prices up 50 per cent, and gasoline up 8.3 per cent. Many economists, along with the Bank of Canada, do not expect further increases in these energy prices, though. Total inflation figures were 2.7 per cent in 2000, 2.8 per cent in the first quarter, and 3.6 per cent in April. Comparable figures for core inflation were 1.3 per cent in 2000, 1.8 per cent in the first quarter, and 3.6 per cent in April. The central bank projects that total annual growth in the consumer price index will fall to about 2 per cent by the end of the year.

In conclusion, the CPI gauge is the total inflation rate and tends to fluctuate because of the many volatile items it includes. The core inflation rate, which is the Bank's measure for determining future interest rates, excludes volatile items and tends to be a more stable measure of inflation. CPI inflation is the true measure of inflation and is used for long-term evaluation, whereas core inflation is more practical for short-term assessments.