

**Report from** Financial Management Services**Date of Report:** May 3, 2017**Date of Meeting:** May 31, 2017**Report Number:** FMS-B024-2017**File:** 10.57.10**Subject:** Inflationary Measures and Explanations

## Recommendation

That the Budget Standing Committee (BSC) approve 2018 overall expenditure budget guidance increase of 1.5%, which is based on the CPI-common rolling 12 month average; and

That the BSC approve an increase of 2.5% for 2019 to 2021 multi-year operating budget expenditure guidance; and

That staff be directed to return to BSC at the beginning of each annual operating budget cycle with an update on the rolling 12 month average of CPI-common in order for the BSC to set the annual overall expenditure budget guidance.

## Background

At its meeting of April 12, 2017, BSC moved the following motion.

That the overall expenditure increase from prior year be no higher than inflation; and further

That staff report back on how inflation is measured and why.

At its meeting of September 19, 2016, Council approved the following motion.

That annual rate and fee increases be set at a minimum, at the rate of inflation (core CPI), which is 2.1% for 2017;

In addition, Council's 2015 Strategic Plan, under Economic Sustainability pillar has a goal to be an affordable city for young people, families and retired older adults by working towards achieving a budgetary tax rate increase at or below the rate of inflation by 2018.

The Bank of Canada's (BoC) Core Consumer Price Index (CPIX) is one commonly used inflation measure for municipalities. The CPIX is the Consumer Price Index (CPI) excluding eight of the most volatile components (fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, inter-city transportation and tobacco products as well as the effect of changes in indirect taxes on the remaining components. The BoC utilizes

this index to “look through” such transitory movement in total CPI inflation, by focusing on core inflation such as the CPIX, that are considered to reflect better the underlying trend in inflation. In June 2016 the previous twelve month published CPIX average was 2.1%. This is the percentage increase that was used to set the inflationary increase for 2017 Schedule of Rates and Fees.

## Report

The Consumer Price Index (CPI) provides a broad measure of the cost of living in Canada. While there are other ways to measure price changes, the CPI is the most important indicator because of its widespread use. Through the CPI, Statistics Canada tracks on a monthly basis, the retail price of a representative shopping basket of about 600 goods and services from an average household’s expenditure on food, housing, transportation, furniture, clothing and recreation.

In October 2016, the BoC published “Renewal of the Inflation-Control Target” document. This review resulted in the BoC deciding to replace its current measure of core inflation (CPIX) with three new measures. Since 2001, the BoC’s main measure of core inflation has been CPIX. The introduction of new measures of inflation were the result of some components that have shown particularly high volatility while others have moved countercyclically. This made it increasingly challenging to describe the extent of movement in CPIX due to sector-specific factors.<sup>1</sup> Therefore, BoC has decided to cease using CPIX inflation as its preferred measure of core inflation and to replace it with three new measures – CPI-common, CPI-trim, and CPI-median. These new measures of core inflation better capture persistent price movements with one that tracks common price changes across categories in the CPI basket (CPI-common), a measure of inflation excluding upside and downside outliers (CPI-trim), and the median inflation rate across CPI components (CPI-median). Having a set of measures assists BoC in managing risks associated with relying on a single focal measure. Details of core inflation measures is in Appendix 1.

In February 2017, staff began the preparation for the 2018 Rates and Fees. Based on the available information at that time, the inflationary measure used was 1.9%. As a result of the Bank of Canada’s change in core inflation measures, data from the last quarter of 2016 was not yet available. This resulted in a higher 12-month rolling average. For that reason, the rate and fee percentage increase for 2018 will be slightly higher than the percentage increase recommended by staff for the annual operating budget expenditure guidance. Depending on timing of staff beginning their work on the annual review of Rates and Fees and the Committee’s guidance setting for the annual operating budget, each year there may be small difference between the inflationary

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<sup>1</sup> Bank of Canada – Renewal of the Inflation-Control Target – Background Information – October 2016, page 19

increases used for these items. This will largely be dependent on the inflationary indices information available from BoC.

The City's current financial institution, Scotiabank has provided an outlook on the Canada's economic performance. "Scotiabank expects growth to continue to accelerate into 2017, but the sources of this strengthening performance are proving somewhat different than we anticipated a quarter ago. Despite our previous expectations that housing and auto sales would begin to provide a mild drag on Canadian growth in 2017, both sectors continue to add to Canada's improving outlook. Investment in oil and gas drilling is showing renewed strength, but long-awaited improvements in economy-wide investment and non-energy exports have yet to gain traction, and execution on public-infrastructure spending is ongoing, but at a more moderate pace than planned. Investment will continue to be inhibited by uncertainty surrounding NAFTA and the prospect of US business-tax reform, but a widening US-Canada policy-rate differential and weaker CAD should help cushion any hit to Canadian competitiveness. On balance, the prospects for Canada look even sunnier than at the beginning of 2017."<sup>2</sup>

Considering Scotiabank's economic forecast and BoC recent review of core inflation measures and its continued commitment to monetary policy aimed at keeping inflation at 2 percent and within a control range of 1 to 3 percent around this target.<sup>3</sup> It is reasonable to predict inflationary estimates not likely to exceed this range. This information and the CPI-common inflationary measure has been used to determine the appropriate guidance for consideration by the BSC for the current and multi-year operating budget increases.

### **Current year guidance**

Considering the changes made by the BoC related to core inflation measures, staff recommend the use of CPI-common 12 month rolling average for 2018 and onward for operating budget expenditure guidance. Although the BoC has moved to a set of measures to assess inflation, CPI-common tracks common price changes across categories in the CPI basket. As such, the CPI-common 12 month rolling average (April 2016 to March 2017) is 1.5% and a reasonable measure to use for annual operating budget guidance. Details of past 12 month CPI inflationary measures are in Appendix 2. It is recommended that 1.5% be used as the overall operating expenditure budget guidance increase for 2018.

### **Multi-year budget guidance**

The City of St. Catharines has been developing multi-year operating budget forecasts for the past couple of years. While staff is recommending operating expenditure budget guidance increase for 2018 of 1.5%, there is also the need to determine the appropriate

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<sup>2</sup> Scotiabank – Global Economics – Economic Commentary – Canada and the Provinces, April 7, 2017, pages 1 and 5.

<sup>3</sup> Bank of Canada – Renewal of the Inflation-Control Target – Background Information – October 2016, page 2

increase for future budget years (2019 to 2021). Keeping annual operating budget increases at or below inflation provides little room for flexibility with one-time expenditure or special projects. For that reason, staff is recommending an additional 1.0% to be added to CPI-common 12 month rolling average for future budgets for forecasting purposes.

Allowing for the additional 1% forecast will still leave final budgetary decisions with the Committee, however this additional percentage will provide Staff with the opportunity to bring forward new initiatives and demonstrate their full priorities to the BSC. This guidance would help both staff and the Committee as it allows for departments to present a complete depiction of their needs for consideration by the BSC. Therefore, the guidance for the 2019 to 2021 operating expenditure budget increase would be 2.5%.

Staff will come back each year with a recalculation of the 12-month rolling average of CPI-common to receive annual operating budget expenditure guidance from the BSC.

## **Financial Implications**

Are contained within the body of this report.

Relationship to Strategic Plan

The Economic Sustainability pillar has goal of being an affordable city for young people, families and retired older adults is reinforced with annual operating budget expenditure guidance at inflation

## **Conclusion**

The use of CPI-common 12 month rolling average as the inflationary measure for annual operating budget expenditure guidance supports Council's Strategic Plan action item of working towards achieving a budgetary tax rate increase at or below the rate of inflation by 2018.

Approving the multi-year (2019-2021) operating budget expenditure guidance at a 2.5% provides staff with the opportunity to present their full budgetary and forecasting needs to the Committee while still leaving final budgetary decisions under the discretion of the BSC.

## **Notification**

Dave Sherlock, St. Catharines Transit Commission

Jack Foster, St. Catharines Public Library

## **Prepared and Submitted by:**

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## **Approved by:**

Shelley Chemnitz, Commissioner of Corporate Services

### **Pre January 2017 Consumer Price Indices**

<b>Index</b>	<b>Description</b>
Total Consumer Price Index (CPI)	The Consumer Price Index is an indicator of changes consumer prices experienced by Canadians. It is obtained by comparing, over time, the cost of a fixed basket of goods and services that Canadians typically buy. The CPI is widely used as an indicator of the change in the general level of consumer prices or the rate of inflation.
Core Consumer Price Index (CPIX)	Core Consumer Price Index is calculated using a price index that excludes the eight most volatile components (fruits, vegetables, gasoline, fuel oil, natural gas, mortgage interest, inter-city transportation and tobacco products) as well as the effect of change of indirect taxes on the remaining components.
CPI-XFET	Consumer Price Index is calculated using the CPI excluding food, energy and the effect of changes in indirect taxes.
CPIW	Consumer Price Index is a volatility-weighted measure of core inflation that assigns a weight to each CPI component that is inversely proportional to the component's historical volatility.

## **Post January 2017 Consumer Price Indices**

<b><u>Index</u></b>	<b><u>Description</u></b>
Total Consumer Price Index (CPI)	The Consumer Price Index is an indicator of changes consumer prices experienced by Canadians. It is obtained by comparing, over time, the cost of a fixed basket of goods and services that Canadians typically buy. The CPI is widely used as an indicator of the change in the general level of consumer prices or the rate of inflation.
Consumer Price Index Trim (CPI-trim) (trimmed mean)	Consumer Price Index Trim is a measure of core inflation that excludes CPI components whose rates of change in a given month are located in the tails of the distribution of price changes.
Consumer Price Index Median (CPI-median) (weighted median)	Consumer Price Index Median is a measure of core inflation corresponding to the price change located at the 50 <sup>th</sup> percentile (in terms of CPI basket weights) of the distribution of price changes in a given month.
Consumer Price Index Common (CPI-common) (common component)	Consumer Price Index Common is a measure of core inflation that tracks common price changes across categories in the CPI basket.
Core Consumer Price Index (CPIX) <sup>4</sup>	Core Consumer Price Index is calculated using a price index that excludes the eight most volatile components (fruits, vegetables, gasoline, fuel oil, natural gas, mortgage interest, inter-city transportation and tobacco products) as well as the effect of change of indirect taxes on the remaining components.
CPI-XFET <sup>5</sup>	Consumer Price Index is calculated using the CPI excluding food, energy and the effect of changes in indirect taxes.
CPIW <sup>6</sup>	Consumer Price Index adjusts each CPI basket weight by a factor that is inversely proportional to the component's historical volatility.

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<sup>4</sup> Not known at this time if Bank of Canada will continue to publish this index over the long due to the introduction of the three new inflationary measures.

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

## Rolling 12 month CPI Average

Month	CPI- trim%	CPI- median%	CPI- common%	Core CPI (CPIX)%
2017-03	1.4	1.7	1.3	1.3
2017-02	1.5	1.8	1.3	1.7
2017-01	1.6	1.8	1.3	1.7
2016-12	1.6	1.8	1.4	1.6
2016-11	1.5	1.8	1.3	1.5
2016-10	1.8	2.0	1.4	1.7
2016-09	1.8	2.0	1.5	1.8
2016-08	1.8	2.0	1.5	1.8
2016-07	1.9	2.1	1.5	2.1
2016-06	2.0	2.2	1.6	2.1
2016-05	2.0	2.1	1.7	2.1
2016-04	2.0	2.1	1.7	2.2
<b>Average</b>	<b>1.7</b>	<b>2.0</b>	<b>1.5</b>	<b>1.8</b>