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From: Jeremy M. Kronick, Thorsten Koepl and Steve Ambler
To: Central Bank Watchers
Re: HOW TO REFINE THE BANK OF CANADA'S COMMUNICATION STRATEGY

The Bank of Canada should continue to seek improved measures of underlying or core inflation for its own internal use. However, it should reduce its reliance on these measures in communicating with the public, and, as we argue in a recent C.D. Howe Institute [paper](#), focus instead on providing a fuller explanation of how it intends to bring inflation back to – or keep it at – its target.

The Bank and the federal government renew their agreement concerning the monetary policy framework every five years. The next renewal will be announced later this year. Its mandate will likely remain focused on stabilizing “headline inflation,” defined as the year-over-year change in the Consumer Price Index (CPI). And it is very likely that the targeted rate of inflation will remain at 2 percent, with a goal of keeping headline inflation within a range of 1 to 3 percent.

Headline inflation is relatively easy for Canadians to understand. Statistics Canada publishes monthly data on it, and the media track these measures closely. But it has serious shortcomings as an indicator for monetary policy. It is often affected by narrow, temporary shocks unrelated to longer-term inflation trends.

For this reason, in a speech last year, then-deputy governor Rhys Mendes [suggested](#) that the Bank is looking to find better measures of underlying or core inflation to guide its monetary policy decisions and public communication. The Bank is re-examining its current core measures and examining new ones as part of a broad reassessment of underlying inflation.

Currently, the Bank relies on several different measures of core or underlying inflation. These measures remove the more volatile components of the CPI. They rely on complex statistical tools, which can be hard for non-experts to understand. And because they rely on historical data, some of these measures are also subject to revisions as more data become available. Over time, the relative emphasis the Bank has placed on different core measures has shifted.

This can be confusing for the public. Furthermore, when the Bank uses these measures to communicate its policy stance, it can give the impression that it is targeting the core measures themselves rather than headline inflation. Mendes made this point when he said: “We’ve long labelled one or more measures of core inflation as our ‘preferred’ measures. . . . At times, this language may have led markets to place more emphasis on the preferred core measures than we do.”

What should the Bank do instead?

It should focus on headline inflation in its communication, and provide more information about how it will ensure that headline inflation will be at 2 percent in six to eight quarters. This would include publishing the path for its main policy instrument (the overnight interest rate). Its communiqués should focus on how current and future interest rates will anchor this forecast around the 2-percent target. This would better communicate the fact that these two factors necessarily evolve together. The Bank’s internal inflation forecasts are by construction dependent on a path for its policy rate. Publishing the projected path would show more clearly how the Bank intends to reach its objective.

Other central banks in Norway and New Zealand already publish policy rate projections and have had some success with this strategy. The US Federal Reserve publishes the individual rate forecasts of its Federal Open Market Committee members. Other central banks – including the Bank of England, the European Central Bank, and the Swedish Riksbank – publish the market-implied interest paths used as an input for their published inflation forecasts. After adopting interest-rate projections, Norway’s central bank [found](#) reduced market volatility and a better alignment of expectations.

So far, the Bank of Canada has resisted the idea of publishing its projected policy rate on the grounds that doing so could be interpreted as an unconditional promise, something often equated with formal “forward guidance.” To counteract such concerns, the Bank’s new communication strategy will have to make clear that the projected policy rate path is highly uncertain and will change as circumstances evolve.

The upcoming renewal of the inflation target is a unique chance for the Bank of Canada to change its communication strategy, and bring renewed clarity to markets and ordinary people. What matters is headline inflation and the Bank’s strategy for setting interest rates over the next few quarters to bring inflation back to target. Done the right way, it will only strengthen belief in the Bank’s commitment to address inflationary pressures with the right tools in a timely manner.

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