While the downward pull from lower gasoline prices was the key theme playing out on Canada’s inflation landscape in 2014, the emerging big story this year appears to be the meaningful upward pressure on prices due to the weak Canadian dollar. By our calculations, the lower loonie will boost overall CPI inflation by a hefty 0.8 percentage points in 2015. Indeed, without this currency impact, it is likely that overall headline inflation would be close to zero and core inflation would be running significantly below the Bank of Canada’s (BoC) 2% target.

A weaker currency makes imports more expensive. Historically, Canadian businesses have passed higher costs from a lower exchange rate onto consumers in the form of higher prices (see Chart 1). Since late 2012, the loonie has fallen by a dramatic 30% against the U.S. greenback and Chinese Renminbi. Over this two and half year period, retailers have been slower to raise consumer prices than they have been in the past. However, the January 2015 consumer price index (CPI) data revealed the clearest signs of pass-through yet. TD Economics estimates that currency weakness added 0.6 percentage points to the year-over-year increase in headline inflation.

Looking ahead to 2015 as a whole, the currency-related lift to Canadian CPI inflation is likely to increase further. Not only will Canadian retailers and wholesalers seek to restore margins that have been compressed from the past depreciation, but TD Economics still expects the loonie to lose some additional – albeit moderate – ground in the coming months, falling to around 77 US cents by year end. That said, impacts on the various key components of the consumer basket will vary widely primarily reflecting degree of import intensity.
Food prices most affected

As revealed in Chart 2, items accounting for about half of the CPI index will experience meaningful inflation due directly to the currency’s decline. Pass-through tends to be the largest for less discretionary items, such as food and beverages, and personal and health care. The exception is shelter costs, which accounts for a substantial one quarter of the overall weighting for the CPI and is shielded from currency movements. Dampened by low (and falling) interest rates and energy costs, we expect the shelter category to actually record outright price declines of 0.8% this year, helping to keep headline inflation muted at under 1%.

The 5% Y/Y jump in food prices in January certainly raised eyebrows. Up until January, food prices had been growing at roughly the same rate in Canada as in the United States (Chart 3). Prices in both countries were pushed up by drought and disease that cut global supply. This changed in January when food prices decelerated in the US, but accelerated in Canada. Global food price pressures are still the dominant force keeping food price gains elevated in Canada, but we estimate that a third of the increase in January can be attributed to the depreciation in the currency. The brunt of the impact has been felt on fruits and vegetables, which grew three and a half times faster in Canada than in the United States. Packaged food goods, which has high import content but where impacts tend to be more lagged than for fresh foods, is also likely to show visible price pressures as 2015 unfolds. Overall, the weaker Canadian dollar is likely to contribute about 1.5 percentage points to food price growth in Canada in 2015, bringing the overall expected increase this year to just over 3%.

The depreciation in the Canadian dollar is also expected to have a significant impact on prices for health care and personal items in 2015. The majority of household spending in this category occurs on services, ranging from doctors, dentists to hair stylists, of which prices are more tied to wage growth than currency movements. However, prices for personal items such as toilet paper and toothpaste are highly sensitive to changes in the Canadian dollar. The impact has been modest so far – prices for various personal items were up a still-muted 0.1%-2% Y/Y in January. However, based on past experience, prices for personal items could be 6% higher over the next year as a result of the falling currency. That said, these items only account for around 1% of overall consumer spending, so even a 6% gain will only contribute 0.1 percentage points to inflation.

Clothing and footwear and home furnishing prices take ride on loonie’s wings

Clothing and footwear is one of the most sensitive categories to currency movements (Chart 5). Unlike most other manufactured goods, which are impacted by the exchange rate with a lag of normally four to six quarters, the impact on clothing and footwear tends to be immediate. Clothing and footwear prices grew by 1.2% in 2014. While still seemingly tame, keep in mind that this was the fastest increase in prices in this category in 15 years and a turnaround from the secular price declines recorded between 2002 and 2010. For 2015, we expect clothing and footwear prices to grow even faster, by 2%, which in our estimates could be fully chalked up to Canadian dollar pass through.
Consumer spending on household operations, furniture and equipment includes many household services that are not affected by the value of the currency. For example, the dominant source of price pressures for this category in January was a sharp rise in internet, cable and phone bills. However, within this category, the majority of household furnishings are imported. Much like clothing and footwear, prices of household furnishings also move closely with the Canadian dollar over time, but there appears to be a lag of up to 2 to 4 quarters. As such, prices for furniture items, which have remained flat so far, will likely see upward pressure as 2015 unfolds. The Canadian dollar is expected to add two percentage points to household furnishing price growth over 2015, with prices for overall household operations, furniture and equipment expected to rise by a full 4% in the year ahead.

Auto prices may rise, but cost of driving to decline

The transportation category in the consumer basket includes items less affected by the currency – for example bus tickets, taxi rides, and mechanic services. Nonetheless, a number of items are currency sensitive, including gas prices, autos (both sales and rentals), and auto parts and supplies.

Within the transportation category, the purchase price of motor vehicles and auto parts are sensitive to movements in the Canadian dollar with a lag of four to six quarters, but the relationship is not as large as often thought. In the past, the impact on auto prices has been less noticeable, mostly because large scale depreciations usually occur during times of economic stress; times when dealers had to offer significant discounts to encourage households to purchase a car. Still, back in the 2001/2002 economic slowdown, the Canadian dollar depreciated significantly and Canadian car prices grew significantly faster than U.S. car prices (Chart 7). Given that the economy remains on a strong footing, the boosting effect of the currency may be particularly visible in the months ahead. Prices of autos and parts could rise by as much as 3 percentage points more in 2015, relative to what would have been the case absent of depreciation in the currency.

It must be noted that the inflationary impact of the exchange rate does not mean that overall transportation prices will increase over the next year. As a result of the recent (and likely some continued future decline) in energy prices, the category will likely record a decline in prices of close to 4%. However, a lower currency will likely dampen the negative impact of falling energy prices. This can be seen in gas prices themselves. The price of gasoline has fallen 38% in the U.S., but is down just 23% in Canada. Part of the difference reflects higher taxes on gasoline in Canada, but some of the lesser drop will reflect the weaker Canadian dollar.

Loonie drives prices for recreational items to break records

The recreation and reading material category includes a broad spectrum of items including computers, stereo systems, DVDs, books, magazines, and movie tickets. Of the major components in this category, only reading materials (books and magazines) and sporting goods are showing any significant pressure on prices due to the depreciation in the Canadian dollar (Chart 6). At a current pace of 7.7% Y/Y the prices for both books and magazines in Canada have risen almost four times faster than the comparable rate in the United States in January. While it is hard to pin down...
the historical relationship between reading materials and the Canadian dollar, the majority of books and magazines read in Canada are imported, so it is not surprising that prices have risen sharply over the second half of 2014. Still, reading materials account for a fairly small share of overall consumer spending and the sharp jump in prices for sports equipment and books and magazines are likely to contribute less than 0.2 percentage points to overall headline inflation in 2015.

Heading into 2015, the prices for many other recreational items will certainly be impacted by the depreciation in the Canadian dollar. Recreation is likely the one category that includes a number of services, for which prices will not remain immune to changes in the currency. For instance, travel accommodations are often priced in U.S. dollars and could move one for one with the currency. In addition, Canadian consumers are increasingly relying on US-based companies to deliver home entertainment, through such services as Netflix and iTunes, which may be more sensitive to currency movements. Apple, for instance, recently raised prices for its applications, citing the depreciation of the Canadian dollar as the key driver of the change.

The prices of most home entertainment equipment, electronics, computers and DVDs have been on a longer-term decline, largely unabated by the retreat in the Canadian dollar. This is somewhat counterintuitive given the majority of these items in Canada are imported. However, Canadian businesses have been increasingly importing these items from countries outside of the United States, where production costs are lower. For instance, the share of Canadian imports of computers, tablets and mobile devices coming from Asia reached 53% in 2014, up from 30% in 2002. Only 25% of these items were imported from the United States in 2014. In addition, many of these items have been replaced by easy access to TV shows, movies and music via the internet.

Still, there remains potential for pass-through to occur for these goods, especially as the Canadian dollar has fallen against most major global currencies. So far, the impact of the depreciation in the loonie has meant that electronic prices fell 2.8% on a Y/Y basis in January. If the currency had not fallen, they would have declined by an even greater 10%. However, with the loonie depreciating more broadly, 2015 could be the first year in over three decades that prices for computers and other electronics see positive, albeit modest, growth.

Overall prices for recreation, reading and education goods and services are expected to rise by 1.1% in 2015, with the currency depreciation accounting for half of the increase.
Summer patio evenings about to get a bit more expensive

At an average of 5.5% Y/Y since August 2014, alcohol and tobacco prices have been growing at twice their historical average. However, the gain has been led by tobacco prices (11.2%), which is likely unrelated to the currency. Most tobacco products are produced in Canada and taxes account for a large chunk of the price. The Federal Government increased taxes on tobacco in February 2014, boosting the price of these items. Beer prices have also been on the rise. Barley prices peaked in 2013, likely contributing to higher beer prices (4.8% Y/Y in January) in Canada. However, this is not the full story, as the same rise in beer prices is not evident in the U.S. market. Historically, beer prices have not been highly sensitive to currency movements. However, the beer industry has changed considerably over the last decade, with the purchase of Canadian big beer makers by foreign companies. As of 2012, the majority of the beer consumed in Canada was produced elsewhere, whereas in 2000 only 50% of Canadian beer consumption was supplied by foreign producers. Thankfully, wine prices have yet to show any upward pressure, likely because the majority of wine imported into Canada comes from Europe and South America. The Canadian dollar has not depreciated as much against the Euro or South American currencies over the last two years.

Overall impact

The sharp drop in the Canadian dollar over the past few years is beginning to exert a more visible upward impact on Canadian consumer prices. Since the Canadian dollar tends to impact most prices with a four to six quarter lag, the full effect of the weaker exchange rate is likely to be felt through the first half of 2015. The impact of the currency will be largest on items with high import content, which we estimate account for almost half of consumer spending. This year, the depreciation in the Canadian dollar will add 0.8 percentage points to the headline rate of Canadian inflation. Indeed, without this lift, the change in the total CPI would likely be slightly negative rather than our current forecast of a 0.4% change. In contrast, core CPI inflation – which excludes the dampening impact of lower energy prices – is likely to hold up at a hotter 1.8% in 2015 due in no small part to currency pass-through.

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