

HIGHLIGHTS

- Canadian core inflation accelerated more than expected in October, to 1.8% y/y, up from 1.5% in the previous month. More than half the acceleration can be explained by a 0.5% gain in the price of goods, excluding food and energy.
- We have estimated that on average a 1% appreciation/depreciation in the Canadian dollar leads to a 0.4% decrease/increase in the price of these goods with a six-to-nine month lag.
- However, the recession stripped retailers of their pricing powers, and as a result, they could not pass the sharp depreciation of the Canadian dollar, which increased import costs during 2008/2009 onto consumer prices. As a result, while the Canadian dollar remains 1.0% below its 2008 peak, the cost of goods excluding food and energy remain 0.5% below the price level at that time. As such, we believe that the sharp acceleration in this component of the CPI is a reflection of retailer prices picking up as demand has improved over the last year of economic recovery.
- Going forward, the cost of goods, excluding food and energy, are expected to take their cue from the slack in the Canadian economy in the near-term, rather than from Canadian dollar movements, giving the Bank of Canada the flexibility to keep rates on hold.

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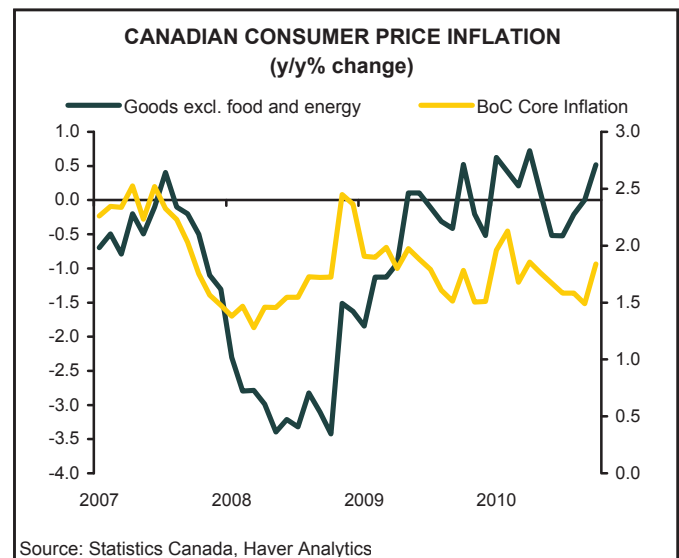
THE CANADIAN DOLLAR AND INFLATION - TALE OF A BUMPY RELATIONSHIP

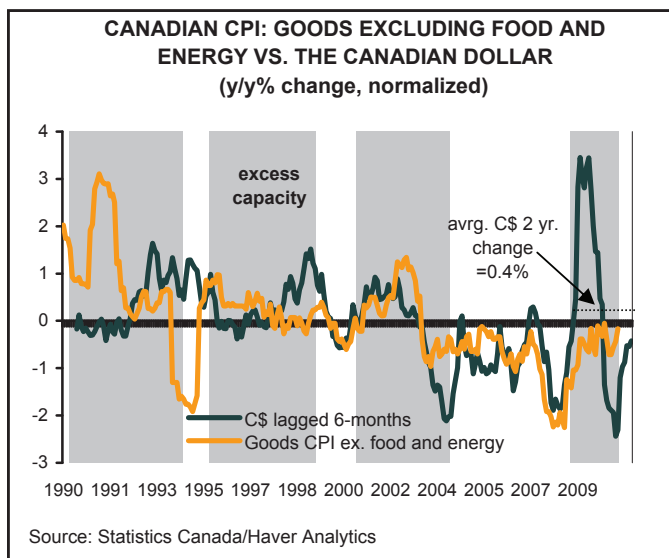
Yesterday's inflation report raised some eyebrows by showing that Canadian core inflation accelerated more than expected in October, reaching 1.8% year-over-year, up from a more moderate 1.5% in the previous month. As noted in TD Economics commentary, the acceleration in core inflation was at odds with the current economic backdrop – in particular, the large amount of economic slack that persists and a strong Canadian dollar. Even more surprising was that more than half the acceleration in core inflation can be explained by a 0.5% annual gain in the price of goods, excluding food and energy. Given that this component is the most sensitive to both the slack in the economy and the Canadian dollar, the upturn in October is very surprising.

Last week, the Bank of Canada's Review published research that indicated that the pass-through of the Canadian dollar to the price of imported goods was minute, and has been declining over time. On the surface, October's inflation report seems to support the Bank of Canada's findings – as that month's rise in goods inflation came despite a 3.5% appreciation in the Canadian dollar against the U.S. dollar from year-ago levels, and one would expect competition to lead importers to pass along savings to consumers. Normally, an appreciation in the Canadian dollar leads to lower inflation because a rising loonie makes imported goods cheaper on the international market.

This begs the question of whether the Canadian dollar matters for the inflation outlook? This matters because, if driven by strong economic fundamentals, an appreciating Canadian dollar can help offset inflationary pressures brewing on the domestic front, allowing the Bank of Canada to keep interest rates low amidst global economic uncertainty. But, if this type of upside surprise on inflation were to continue, the Bank of Canada could be pushed off the sidelines sooner than expected. Here, we present the case why we think that the pass-through might be more significant than the Bank of Canada research may suggest, and the upside surprises in inflation going forward are unlikely to continue.

In doing so, we look at the relationship between goods, excluding food and energy, and the Canadian dollar. Examples of these goods are furniture, electronic equipment, clothing and footwear, and automobiles. Many of these goods are





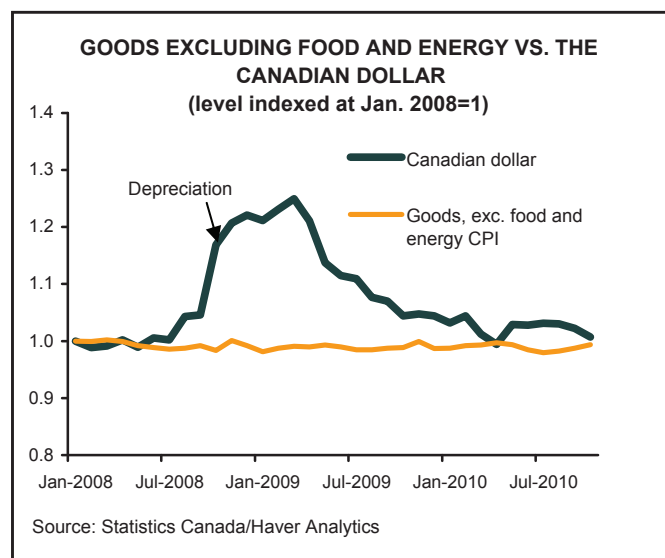
imported for consumption. As such, as economists, we call these goods tradable goods. If there were any pass-through of the Canadian dollar onto consumer prices, it would be most evident in this component of the consumer basket. We find that in general, there is a tight relationship between the price of goods excluding food and energy and the Canadian dollar. In fact, we have estimated that on average a 1% appreciation/depreciation in the Canadian dollar leads to a 0.4% decrease/increase in the price of these goods with a six-to-nine month lag. However, this relationship can vary, depending on the amount of economic slack in the economy. For example, prices of goods that are heavily imported moved very closely with the Canadian dollar over the time periods of October 1999 to June 2002, and May 2006 to December 2008 – periods when the Canadian economy was operating above or close to full-capacity. Meanwhile, the relationship is less clear in times of heavy economic slack, such the most recent recession. On a short-term basis, movements in the price of tradable goods and the Canadian dollar may deviate, particularly during weak economic times. Over time, however, the cost of tradable goods will ultimately be determined by the level of the Canadian dollar and eventually the price of tradable goods will adjust to reflect movements in the Canadian dollar.

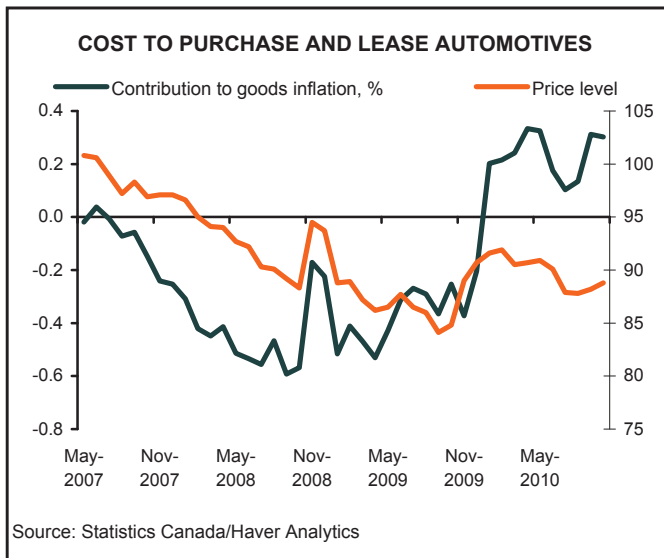
While anecdotal, we can think of a simple rationale for the changing relationship. During times of economic weakness in the past, interest rates were lowered, and the Canadian dollar weakened. Given the accumulation of slack in the economy, retailers are stripped of their pricing power during economic downturns and are unable to pass-through dollar depreciations onto consumer prices. As a result, during economic downturns, the price level of tradable goods is likely below what it should be given the level of the Ca-

nadian dollar. By the same token, as the economy begins to improve and the Canadian dollar strengthens, they also do not pass-through the Canadian dollar appreciations in the form of lower consumer prices as retailers make up for lost revenue.

This is consistent with the experience over the last two years. When the recession hit, retailers did not pass the full extent of the sharp Canadian dollar depreciation onto consumer prices. Annual inflation in goods went from a record low -3.42% in October 2008 to -0.31% in August 2009 (6-months after the Canadian dollar low) – but this was not as large a swing as could have happened if retailers had been willing or able to pass through the full extent of the Canadian dollar depreciation onto consumer prices. Since the low reached in April of 2009, the Canadian dollar has appreciated 20%, but the price of these goods has been accelerating through this year. Looking beyond the volatile movements over the last two years tells a different story. At its current level of 98 U.S. cents, the Canadian dollar is 1.0% below its peak level in 2008 – which should act as an inflationary pressure on good prices. However, the price of goods, excluding food and energy, is 0.5% below its value at the time the loonie peaked in 2008. The result being that retailers did not, or rather could not, pass along the depreciation of the Canadian dollar onto consumers in the form of higher prices during the depths of the recession. The acceleration in goods inflation in October likely reflected the fact that the price of goods are now playing catch-up to the Canadian dollar, as demand has improved over the last year.

The changing dynamics have been most evident in the Canadian auto sector, which also happens to be the sector contributing the most to goods inflation. During the depths of the recession, the auto sector implemented deep discount-





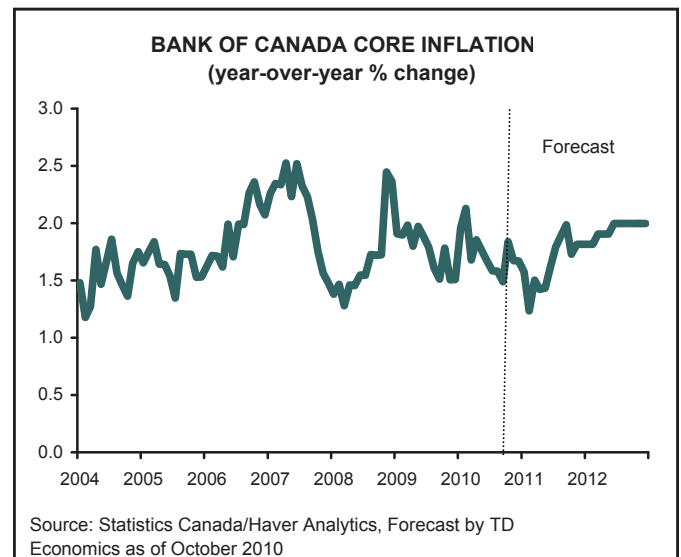
ing programs to attract buyers and clear high inventory levels – despite the upward cost pressures faced by this sector as the Canadian dollar depreciated sharply. Now, as auto sales have improved significantly over the last year, auto retailers have started to remove some of the discounts offered during 2009, leading to sharp gains in the purchase and leasing of automobiles component of the consumer price index. While the annual price inflation of motor vehicles has risen significantly over 2010, the consumer price of purchasing, or leasing, an automobile remains well below 2008 levels.

Conclusion

The bottom line is that the Canadian dollar matters significantly for the inflation outlook, particularly over the medium-term. And, should inflation pressures brew on the domestic front, a strong Canadian dollar could act as buffer giving the Bank of Canada some breathing room with monetary policy. For now, however, the Canadian dollar does not pose a risk to our inflation outlook. While we have seen some strength in the Canadian dollar recently, we simply don't see much further appreciation in the Canadian dollar in the near-term. It is our view that the Canadian dollar will

hold steady in a range of 98 U.S. cents through the first half of 2011 as concerns over the U.S. economic outlook weigh on the Canadian currency. More importantly, we expect the cost of goods, excluding food and energy, to take their cue from the slack in the Canadian economy. After delivering a V-shaped recovery in the early stages of the economic recovery, Canadian economic growth moderated to a 1-2.0% pace in the second half of this year – and economic slack is expected to be eaten-up at a much slower pace than was experienced over the first year of the economic recovery. In this environment, retailers may find it difficult to regain pricing power.

As such, the month's acceleration in goods, excluding food and energy, and overall inflation is likely to prove short-lived. We remain of the view that the Bank of Canada's core measure of inflation will continue to moderate through the first quarter of 2011 – reaching a trough of 1.5-1.6% - and then only gradually returning to 2.0% by mid-2012. This is consistent with our view that the Bank of Canada will remain on hold until July of next year.



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