



TD Economics

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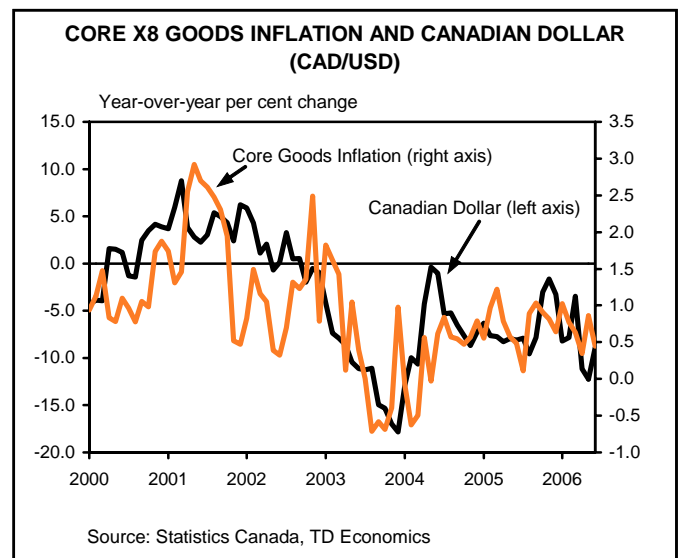
GETTING THE GOODS ON THE RISK TO THE BANK OF CANADA'S INFLATION OUTLOOK

Despite the Bank of Canada's expectation that the economy will continue to operate above its productive capacity until the end of 2008, they forecast that core inflation will remain grounded near the 2% target. Underpinning this assumption is that falling prices for manufactured goods will provide the necessary offset to the inflationary pressure generated by an economy in a position of excess demand. While prices for manufacturing products have fallen around the globe as the emerging economies of China and India have increasingly become the world's factory, the elevated level of the Canadian dollar has also helped restrain price increases of imported manufactured goods.

Going forward, a strong Canadian dollar will continue to play an important role in restraining inflation. Indeed, the Bank acknowledged in their update to the Monetary Policy Report that the dollar has recently traded in a higher range than initially forecast in April and is assumed to remain between 88.5 and 91.5 U.S. cents over the next two years. The dampening effect that the currency is anticipated to have on Canadian inflation highlights a key risk to the Bank's outlook – if either the dollar displays any weakness or if the momentum in the domestic economy is greater than expected, inflation may top the Bank's expectation, raising the odds of a further rate hike.

Goods inflation restrained by the dollar...

The effect that the appreciation in the Canadian dollar has had on core inflation can be demonstrated by breaking out the goods portion of the core inflation measure. Since early 2002 the Canadian dollar has appreciated by over 40% while the year-over-year rate of core goods inflation



has fallen to an average of 0.7% over this period. This is nearly half the rate of increase observed in the previous four years, a period during which the Canadian dollar depreciated by nearly 13%. Moreover, the year-over-year increase in the goods component of core inflation has remained below the increase in core in every month since August 2001.

Recently, the rate at which the dollar has appreciated has slowed considerably as the dollar has treaded water between 89 and 91 U.S. cents over most of May and June and has actually fallen towards 88 U.S. cents over the first half of this month. As a result, goods inflation may begin to see some signs of edging higher in the near term as the lagged effects of the past appreciation of the dollar wane. Looking further ahead, TD Economics expects that a global correction in commodity prices corresponding to an

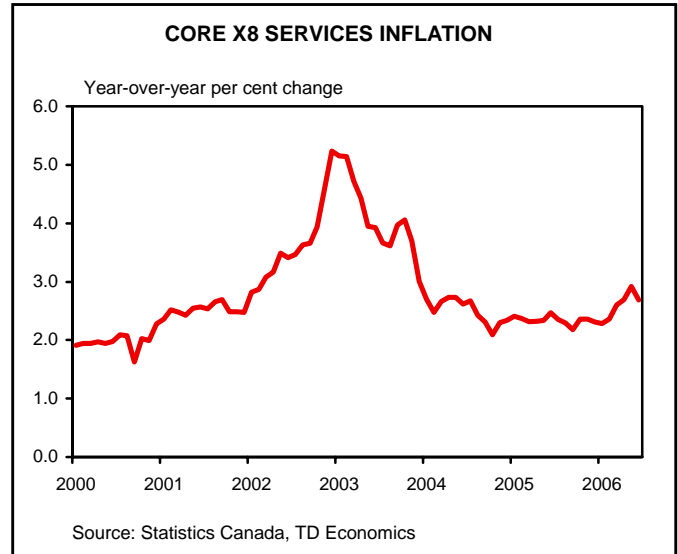
easing in global demand will pull the dollar down to 87 U.S. cents by year-end, with a trough of 85 U.S. cents in the middle of 2007. So, with a forecast below the Bank of Canada's expected trading range there is a risk, on the margin, of greater inflationary pressure.

... While core services inflation reflects the strength of domestic demand

In contrast to the lower trend observed in goods inflation, core services inflation has remained elevated over the last four years, averaging a year-over-year increase of over 3%. What is especially worrisome is the upwards trend observed since the start of the year where core services inflation has risen by four tenths of a percentage point since January. Much of this momentum is due to the strength of the domestic economy, which measured by the Bank of Canada's output gap, has outstripped its potential growth rate by 0.4% in the second quarter of 2006. A generational low in the unemployment rate and a modest up-tick in wage pressure in the last two months also reinforce the view that the Canadian economy is pushing beyond its capacity. Looking forward, a moderation of growth in the United States is expected to slow growth in Canada, but given the significant momentum in the domestic economy, it is likely that services inflation will continue to rise in the months to come.

Conclusion

The fundamental forces of enhanced competition reshaping the global manufacturing industry will continue to put downward pressure on prices as the world's supply curve continues to shift outwards. But a weakening in the loonie will likely limit the effect on Canadian inflation. The momentum shown by core services inflation has also



to be of concern and will likely continue as long as the economy operates above its productive capacity. While the Bank expects that these two forces will remain balanced, there is a risk that the scale may tip towards more inflation moving forward. However, consideration must also be given to the forward-looking nature of monetary policy. Indeed, the U.S. economy is showing signs of slowing, a trend that will likely intensify over the remainder of the year and into 2007. The TD Economics forecast for U.S. real GDP growth is somewhat weaker than the very similar views of the Bank of Canada and the Federal Open Market Committee in the United States. With the expectation of softening growth, the Bank's decision to move to the sidelines at this stage is prudent. But it is certainly not without risks.

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