



**Bank
Financial
Group**

TD Economics

Commentary

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MARCH INFLATION BENIGN, SETS STAGE FOR 50bps CUT

- All-items and core CPI inflation eased in March, both under 1.5%
- Canada one of few countries with such modest inflation
- Stage set for 50bps cut by BoC on April 22nd

After dipping below the 2.0% mark in February, all-items CPI inflation remained muted in March at 1.4%. This was the lowest inflation rate in 14 months, continuing a disinflation trend from a recent peak of 2.5% in November. Canada's dropping inflation thermometer readings runs counter to what almost every other economy is facing. Not only is Canada bucking the worldwide trend, but its inflation level is also strikingly lower. In February, 28 countries in the OECD – all but Japan and the Netherlands – recorded CPI inflation well above 2% and OECD total inflation was 3.4%. U.S. CPI inflation was 4.0% in March. Why is Canadian inflation so timid while other economies are experiencing head-on impacts of higher energy and food prices?

First off, gasoline prices are indeed pushing inflation higher than it would otherwise be. Absent gasoline, the CPI inflation was only 1.0% in March. Gasoline has added about half a percentage point to overall inflation in the last 6 months. Canadians have not been insulated from higher gasoline prices, as anyone driving a car can attest. Food inflation has, however, been on the wane, declining since early 2007, in part because of a high degree of competition. The GST cut is helping, but the impact of that measure on inflation will vanish by January 2009. Currencies also play a role. But currency appreciation – which tends to lower import prices of goods when expressed in the local currency – is not enough to explain say the stark 2.2 percentage points difference between Euro zone and Canadian inflation. In fact, the Euro has kept appreciating against the U.S. dollar since December while the Canadian dollar has been relatively flat. What matters for CPI is the amount of pass-through from currency changes to

CONSUMER PRICE INDEX - CANADA				
	Mar.08 % Chg. M/M	Feb.08 % Chg. M/M	Mar.08 % Chg. 12-mth.	Feb.08 % Chg. 12-mth.
All-items*	0.0	0.1	1.4	1.8
Core ex. indirect taxes*	0.0	0.3	1.3	1.5
Goods	0.7	0.1	-0.6	0.0
Services	0.2	0.6	3.3	3.5
Energy	2.7	0.3	5.4	9.7
Food*	0.0	0.1	0.4	0.2
Shelter*	0.4	0.3	4.1	4.1
Transportation*	0.7	-0.5	0.1	2.5
Clothing & Footwear*	-0.4	-0.1	-1.5	-1.4

*M/M uses seasonally adjusted data; Source: Statistics Canada

final goods prices. Here no other country is leveraged to the U.S. as much as Canada. Trade amongst Euro area countries dominates that area for example, whereas the U.S. still dominates Canada's import landscape. Parity with U.S. dollar also brought comparisons, widely reported in the media, with lower U.S. prices to the forefront. The threat of cross-border shopping jolted retailers, auto manufacturers and dealers in particular, into lowering their prices.

For the Bank of Canada (BoC), what matters most is the core inflation outlook, with policy anchored to the 2.0% target. Core inflation fell in March to 1.3% after holding steady at 1.5% for the previous 4 months. Peaking ahead, even assuming very little further currency pass-through, inflation is likely to remain under wraps for a while as the economy slows. The BoC's projection has core inflation running below 1.5% before creeping back close to 2.0% late next year. This gives it more leeway to cut interest rates than its counterparts in other countries. Add to that an economic and financial outlook which has deteriorated since January along with a correspondingly dovish tone emanating from Wellington Street headquarters in Ottawa, and you have a recipe for another 'super sized' 50 basis points cut in the overnight rate come Tuesday.

Pascal Gauthier, Economist, 416-944-5730

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