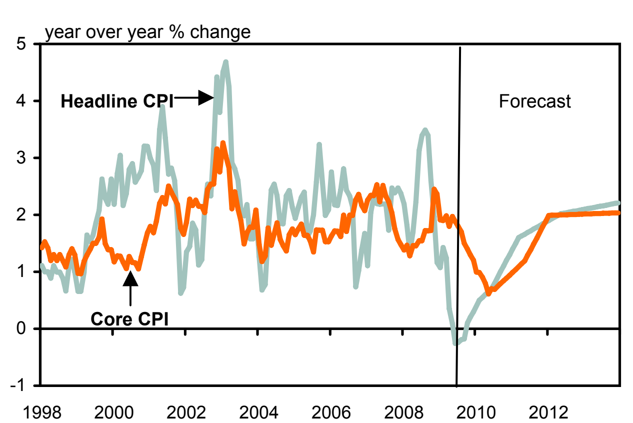
TD Bank Financial Group

# TD Economics
## Observation
July 23, 2009

# CANADIAN INFLATION TO REMAIN UNDER WRAPS BUT DEFLATION TALK IS UNWARRANTED

The recent Canadian inflation data has provided a very mixed picture. On the one hand, headline inflation, as measured by the year-over-year change in the Consumer Price Index (CPI), has plummeted, falling into negative territory in June for the first time in 15 years. This development led to many erroneous references to deflation. On the other hand, the Bank of Canada's core measure of inflation, which excludes the 8 most volatile items, has proven remarkably sticky hovering at close to 2% since the start of 2009. This gives the false impression that underlying inflation may not be dampened by the severe recession. While various factors are contributing to the current stickiness in core prices, there is good reason to believe that core inflation will dip to slightly below 1% by mid-2010. The moderation in core inflation will occur at the same time that the disinflationary impact from the past decline in energy prices gradually abates. Consequently, headline inflation and core inflation are expected to converge at around 0.7% in about twelve months time – a low rate that could once again spark undue worries about deflation. From mid-2010 onwards, both headline and core are projected to slowly trek higher towards 2% by the end of 2012.

CANADIAN CONSUMER PRICE INDEX




Source: Statistics Canada, Forecast by TD Economics as of July 22, 2009

**HIGHLIGHTS**

- **Canada is not experiencing deflation, but rather a relative price shock created by past plunge in energy prices**
- **Core inflation is poised to slow to below 1% by mid-2010, constraining the future rise in headline inflation after energy shock abates**
- **TD Economics anticipates a slower economic recovery and more economic slack than the Bank of Canada, justifying a lower profile for inflation over the forecast horizon**

### Canada experiences a relative price shock, not deflation

In June, the CPI recorded a year-over-year decline of 0.3%. This induced much chatter about deflation. However, the economic definition of deflation is a generalized decline in prices. The Canadian inflation experience fails to meet this requirement. The drop in the CPI was primarily a function of falling energy prices, which plunged 19% year-over-year in June. There were a couple of other non-energy items that have helped to temper headline inflation, such as a 5.1% decline in prices for the purchase and leasing of motor vehicles, as well as a 1.3% drop in clothing and footwear prices. Nevertheless, the vast majority of CPI components have continued to post gains.

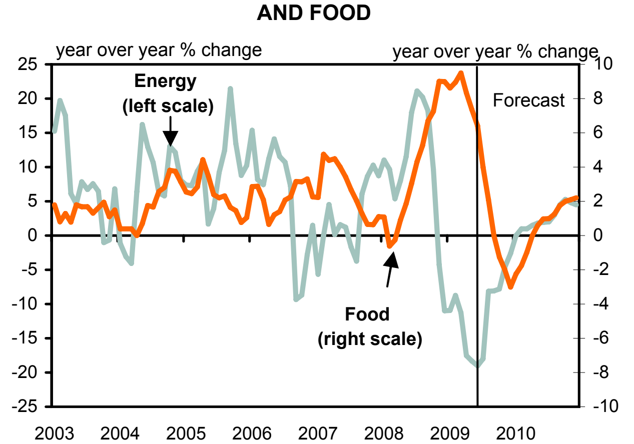
Indeed, the most remarkable development on the inflation front is not the drop in consumer prices for gasoline, home heating oil and natural gas (which simply reflects the deep correction in energy commodity prices), but rather the surprising resilience in non-energy consumer prices. In June, the non-energy CPI was up 2.1%. The Bank of Canada's measure of core inflation, which excludes the 8 most volatile items, has also proven quite sticky. Since the start of the year core inflation has averaged 1.9% and it has remained within a tight range of 1.8% to 2.0%.

Higher food prices have been a major part of the story and they have a substantial 19 per cent weight in the non-energy CPI index. The CPI food index averaged a 6.8% year-over-year rate of growth over the last 10 months – representing the fastest gain in 20 years. This increase was largely due to higher input costs for everything from feed for stock to fertilizer for crops that occurred more than a year prior but which took close to 12 months to impact the price of food products at stores.

This surge in food prices is having an influence on core inflation. The Bank of Canada only excludes fruits and vegetable prices from their core CPI index. The difference can be highlighted by the fact that the Statistics Canada CPI excluding all food and energy was up 1.3% year-over-year in June compared to 1.9% on the Bank's core measure.

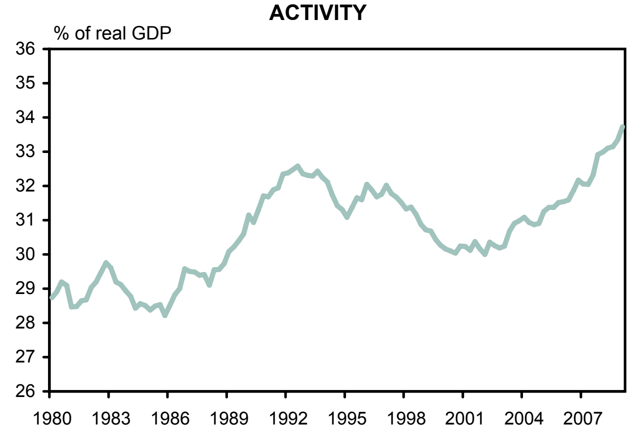
Digging further into the details, prices of goods excluding food and energy have been rising, largely owing to the depreciation of the Canadian dollar from above parity in May 2008 to temporarily below 80 cents in February 2009. This depreciation of the loonie has had the effect of raising prices for imported goods, such as recreational motor vehicles (boats, motorcycles, etc), home appliances, equipment and furniture, and books. And, the currency impact has been lagged because it takes time for foreign exchange movements to influence retail prices, which is why the recent rebound in the loonie from its lows has not yet been felt.

CANADIAN CONSUMER PRICE INDEX: ENERGY AND FOOD




Source: Statistics Canada, Forecast by TD Economics as of July 22,

CANADIAN SERVICE'S SHARE OF ECONOMIC ACTIVITY




Source: Statistics

Meanwhile, non-energy service costs have been quite sticky. This has occurred for a few reasons. First, some services (like health care, education, and personal care) tend to be less responsive to economic cycles than goods. Many other services are actually countercyclical. For example, homeowners and motor vehicle insurance costs, and property taxes tend to go up during recessions. And, services have been a rising share of the economy over time, increasing from 30% share of GDP during the early 90s recession to 34% at the moment. This means that the greater share and the reduced cyclicality are both tempering the disinflationary effect of the economic downturn.

So, Canada is clearly not experiencing deflation, but it is seeing a significant relative price shock, with prices for some goods falling sharply (e.g. energy) and other prices rising sharply (e.g. food). This explains the recent history, but the more important question is where inflation is headed?

### Impact of lower energy prices to abate

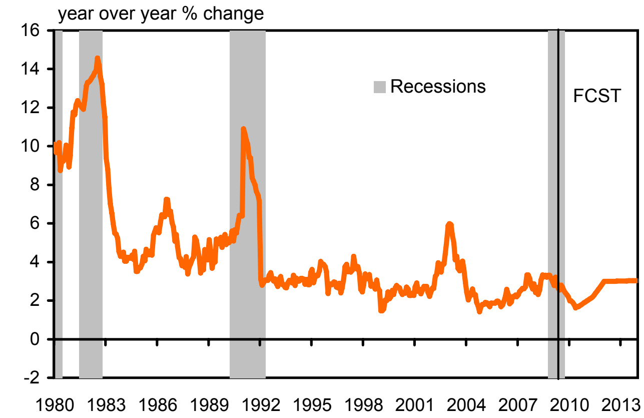
Not only is the talk of deflation inappropriate because it is really about a fall in energy prices, it is also inappropriate because the negative reading on inflation won't last for long. The disinflationary impact of lower energy prices is about to evaporate rapidly before our eyes. In

June and July last year, gasoline prices spiked to near $1.40/litre. This proved unsustainable, and gasoline fell to around $0.79/litre in December, before recovering to hover around the $0.90 to $1/litre mark. Meanwhile, the rally in crude oil in the Spring and Summer of 2009 has brought the price of West Texas Intermediate (WTI) crude back to roughly the level recorded in October 2008. The implication is that the year-over-year decline in gasoline and oil-related consumer energy products will disappear by the Fall. In contrast, natural gas will still be a headwind on CPI in the coming months, since its price will be well below the US$6-7 that prevailed late last year. But, the year-over-year change in natural gas prices will diminish from -70% in June to around -30% by year end, exerting a lesser dampening effect of the CPI. As this occurs, it will be developments in the components of the core CPI that will shape the inflation profile.

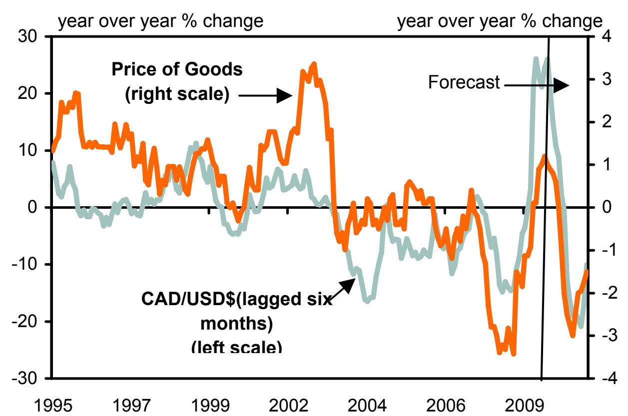
### Stickiness in core inflation won't last

As already mentioned core inflation has been hovering at close to the 2% mark in the first half of this year, but there is a number of factors that will increasingly exert a downward influence over the coming months.

First, the accumulation of significant slack (excess supply) in the Canadian economy during the downturn will start to have a greater impact on prices for many goods and services. Not only will the output gap continue to widen through the rest of 2009, but a slow economic recovery suggests that the slack will only be fully absorbed by the end of 2012. The lingering output gap will constrain, or outright reduce, the pricing power of firms and diminish input costs. This can be observed in the fact that wages and salaries fell for the first time on record in the first half of 2009. Since labour costs make up about 50% of input costs in Canada, this will mean lower production costs that should feed through to dampen growth in consumer prices over time.



Source: Statistics Canada, Forecast by TD Economics as of July 22, 2009



Source: Statistics Canada, Forecast by TD Economics as of July 22,

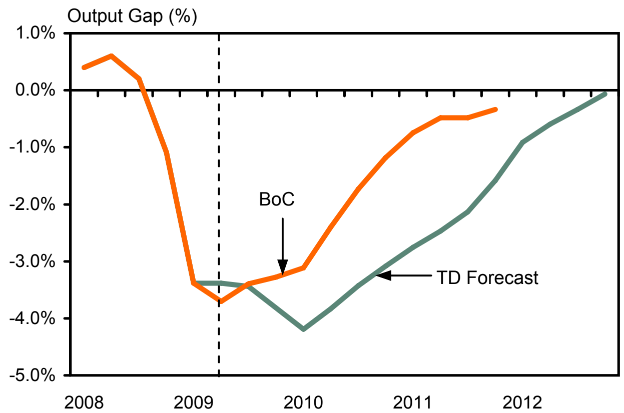
Second, while prices for services tend to be less cyclical than goods, history shows that the rise in service prices does traditionally slow in the later stages of economic recessions and the early stages of recoveries.

Third, the current record high inventory-to-sales ratio suggests that many firms will have an incentive to provide additional price discounting to draw in buyers and work down their stocks.

Fourth, the Canadian dollar has rebounded from a low of 79 cents in March to 90 cents in July. And we believe that further weakness in the U.S. dollar could propel the loonie even higher by the end of the year, putting downward pressure on the price of imported goods. Historical experience suggests that it takes up to 6 months for a currency appreciation/depreciation to pass through to the price of consumer goods, so the exchange rate could have a dampening impact on inflation until mid-2010. Moreover, the large amount of slack in the economy and the high level of inventories may encourage firms to pass currency savings onto consumers quicker than usual. In our opinion, the Canadian dollar appreciation could detract as much as 0.5 percentage points from headline inflation in 2010.

Fifth, non-labour producer input costs have fallen from

**FORECASTS OF CANADA'S OUTPUT GAP**




Source: Bank of Canada, Statistics Canada, TD Economics
* Assumed quarterly growth from semi-annual rates in MPR

year ago levels over the last three months. In particular, input costs for food products have come down significantly over the last 9 months, and we expect them to continue to contract through to mid- 2010. Since it takes about a year for the lower costs to show up in the final consumer price, we should also start to see consumer food price pressures ease over the next year and a half. Again, this would have a dampening impact on the non-fruits and vegetable food components in the core CPI. And, the decline in food prices could detract an average of 0.3 percentage points from headline inflation over the last quarter of 2009 to the first quarter of 2010.

Finally, the harmonization of sales taxes in Ontario is likely to have an impact on inflation in 2010. The HST could boost headline inflation by 0.4 percentage points in 2010. The core CPI excludes indirect taxes, so there won't be a corresponding lift in this measure. But, the harmonization will bring a reduction in producer prices that should be largely passed along to consumers. This could reduce core CPI by as much as 0.3 percentage points.

### Outlook for Consumer Prices

The conclusion is that we are likely to see a bit of a tug of war in the near term. The past decline in energy prices will have a disinflationary impact, likely keeping headline inflation in negative territory over the next couple of months. This impact will wane in the Autumn, but the future increase in headline inflation will then be constrained by a slowing in core inflation. As a result, we expect headline inflation to hover around the 0.5% market in last quarter of 2009 and the first quarter of 2010. This limited rise in headline inflation will reflect a slowing in core inflation from close to 2% to modestly below 1% over the next 12 months. Then, a modest-paced economic recovery should only support a rise in both core and headline inflation, with convergence in both measures at around 2% at the end of 2012 – which is when the output gap finally closes.

The TD Economics projection is consistent with the Bank of Canada's recent assessment that the overall risks to the inflation outlook are "tilted slightly to the downside." However, the TD Economics forecast does anticipate a lower trend and a later trough in core inflation than the Bank. This reflects the TD forecast for a modestly deeper contraction in 2009, but more importantly a much slower recovery next year, implying a greater and longer lasting output gap. TD also expects softer domestic demand growth and a stronger Canadian dollar ( TD average for 2010 is 93 cents versus the Bank's forecast for 87 cents). Consequently, the TD expectation is for core inflation to trough at 0.7% in the second quarter of 2010, while the Bank is anticipating a low of 1.4% in the second half of 2009. As the economy recovers, our forecast only gets back to 2% in late 2012, a year later than the Bank.

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