TD Bank Financial Group

TD Economics

Special Report

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DOES CANADA HAVE AN INFLATION PROBLEM?

Overview

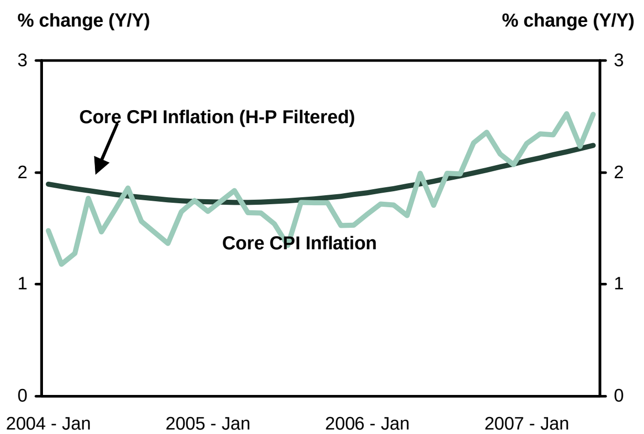
Since September 2006, the year-on-year (Y/Y) measure of core price inflation[1] in Canada has remained above the 2 percent target set by the Bank of Canada (BoC) for overall inflation - averaging close to 2.3 percent over the entire period. More ominously, since the beginning of 2007, Y/Y core CPI inflation has steadily increased from 2.1 percent in December 2006, to a more disconcerting 2.5 percent in June. The only exception to this upward trajectory was the slight retreat observed in May, when core inflation briefly fell to 2.2 percent as a result of favourable base effects, before rising again to 2.5 percent in June. In view of this troubling observation, the concern has been raised that the behaviour in core consumer prices may be a reflection of the current excess demand for goods and services in the Canadian economy – or more precisely, a result of the economy operating beyond its "full-employment" capacity. This recent up-tick has also brought impetus to the view that further monetary policy tightening by the BoC may be forthcoming – and indeed necessary – to reduce the current inflationary pressures that exist in the Canadian economy.

In this piece we argue that the persistent increase in core consumer prices over the past year has become broad-based, and driven in large part by the acceleration in the price inflation of most components in the core consumer basket, and not only inflation in the replacement cost of housing – as has been the case in the recent past. In particular, we will show that the upswing in core inflation has been due to the increase in the inflation rate in the price of core services. This persistence in core inflation is particularly worrying since it presents the danger that inflation in Canada, and consequently inflation expectations more generally, could conceivably loosen from the anchor set at 2 percent by the BoC.

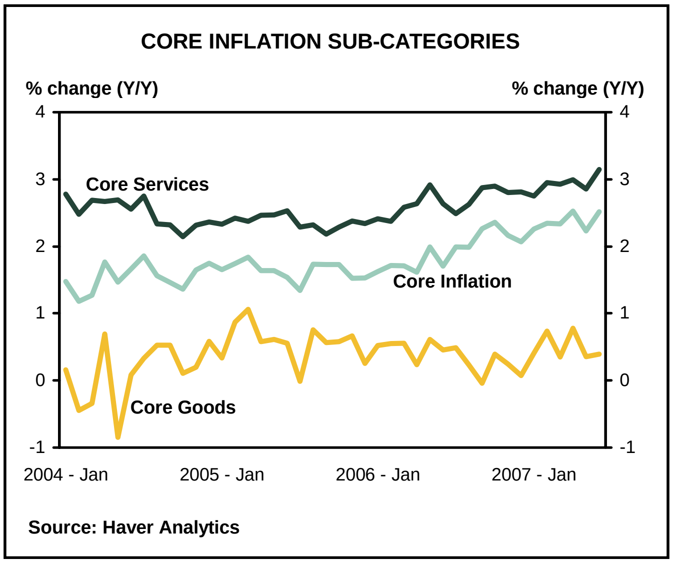
HIGHLIGHTS

- **Core inflation in Canada has not only been persistent, but it has also become somewhat broad-based.**
- **In recent months, the acceleration in core inflation has come from the upward movements in the inflation rate in the price of core services.**
- **Alberta continues to contribute disproportionately to core inflation in Canada, driven by its overheating housing sector.**
- **When the inflation in core shelter cost is excluded, the core measure of inflation in Alberta falls precipitously.**
- **With the main sources of inflationary pressures still in place, further action by the BoC will indeed be required to temper inflation in Canada.**

CORE INFLATION IN CANADA



Source: Haver Analytics



However, even though the recent trajectory in core inflation is decidedly upwards, an important consideration in assessing the dynamics is determining whether the observed behaviour is the result of secular (or the long-term) changes in consumer prices, or a reflection of more innocuous cyclical (or transitory) factors. This decomposition is particularly important to analysing the behaviour in core inflation since it disentangles the "noise" generated by temporary (or business-cycle) factors, from the more important secular or underlying trend. The importance of this distinction is borne out by the fact that transitory changes in the inflation rate may be a reflection of temporary shocks to the economy – which are generally discounted by policy-makers – while the more important trend component may be the result of underlying (or longer-term) changes in the behaviour of consumer prices, or the economy more generally, thereby requiring appropriate policy responses from the monetary authority to counter these factors.

To do this, the Hodrick-Prescott (HP) filter was applied to the Canadian inflation data for 1992 to June 2007. Using this decomposition, it becomes unequivocally clear that the recent trajectory for core inflation in Canada is decidedly upwards. In fact, the trend measure currently sits at 2.2 percent - above the BoC's target - and has been above the 2 percent target since December 2006. This must certainly be a major concern to policy makers at the BoC, since it suggests that the observed movements in the inflation rate for core goods and services are the result of more fundamental changes to prices in the Canadian economy.

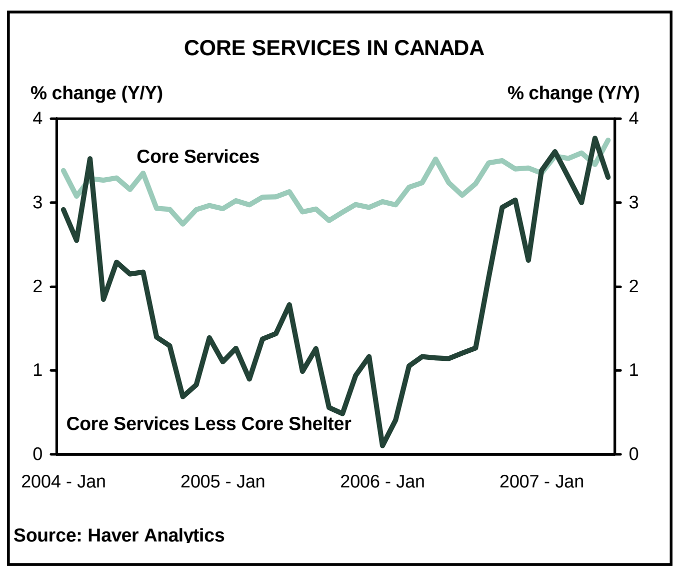
Its all Services!

A closer look at the 2.5 percent increase in core CPI reported in June points to the disproportionate contribution of core services to core inflation in Canada. Moreover, the upward trajectory in the price inflation of core services exhibits extreme persistence. This behaviour contrasts starkly to the lower price inflation rate for core consumer goods. Historically, the most important contributor to the consistently high levels of inflation in core services in recent times has been the inflation in the replacement cost of housing. However, the price inflation rate for this sub-component has shown signs of deceleration in the past few months, though it continues to grow at a strong pace – at well over 6 percent (Y/Y).

The conclusion that could clearly be drawn here from this evidence is that the elevated level of the inflation rate for core services is no longer the result of the accelerating inflation in housing cost. Indeed, while in the past the inflation rate for core shelter has been the main driver of inflation in the category, this is no longer the case. In fact, when core shelter is excluded from the core services measure, the upswing in the core services (less core shelter) becomes very pronounced, though it is lower in terms of levels – on account of the high rate of inflation in the excluded sub-component, as noted earlier.

Is Alberta to blame?

The popular line of argument that has emerged over the past year or so as a possible explanation for the behaviour of core inflation (and total inflation in Canada more generally) has been the undue influence coming from the booming Albertan economy. And not surprisingly, this is

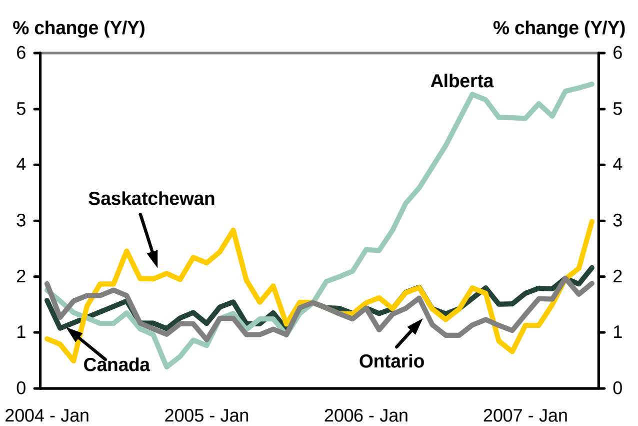


undoubtedly the case. The evidence unequivocally supports the view that Alberta has contributed disproportionationately to core inflation in Canada – which in this case is captured by the rate of inflation for all-items less food and energy. That is, of the 2.2 percent increase (Y-Y) in the price of the all-items basket less food and energy in June 2007, Alberta contributed 0.6 percentage points – or 27 percent of the total increase in prices. Note that Alberta's share of the national consumer basket is only 11.4 percent.

In fact, Alberta has consistently contributed more to core inflation in Canada than British Columbia and Quebec combined – which collectively accounts for approximately 35 percent of the overall Canadian core consumer basket, but contributes only 20 percent (or 0.5 percentage points) to the overall inflation in all-items less food and energy in June 2007. Without Alberta, the core inflation rate in Canada would have fallen to 1.7 percent, well below the 2.0 percent target. Suffice it to say, while this observation is interesting, it is unlikely to play any role in the policy decisions of the BoC. And why should it? After all, the target being monitored by the Bank of Canada is the national rate of core inflation, and not core inflation in Canada excluding Alberta, and as such, regional differences matter little for the Bank's decisions. Note also that the upswing in the core inflation rate for Saskatchewan over the past six months has also been pronounced. However, with a weighting of 2.64 percent for Saskatchewan in the Canadian composite (compare to 11.43 percent for Alberta), the inflation rate in Saskatchewan has had little impact on the overall core CPI inflation rate for Canada.

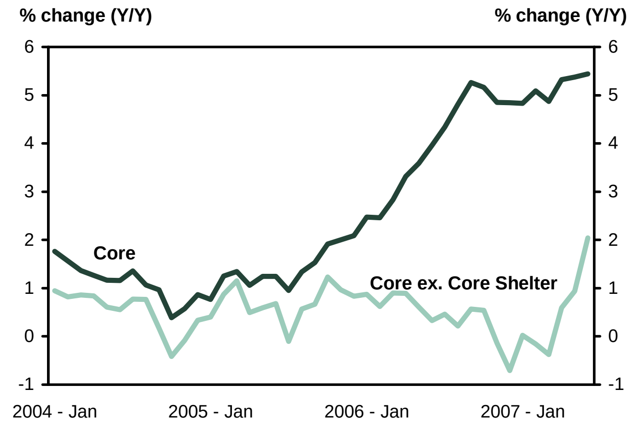
As such, the case can clearly be made that the "overheating" Albertan economy has been a major source of influence on the persistently high core inflation rate in Canada. Not surprisingly, the booming housing sector has been the main culprit for the surging rate of inflation in Alberta. Here again, the evidence is overwhelming. With the Y/Y rate of inflation in the shelter sub-category growing at an average rate of 13.7 percent in the first half of the year in Alberta – compared to 1.2 percent in Ontario and 3.1 percent nationally – the overheating housing market has undoubtedly been the key source of price inflation in Alberta. In fact, when the inflation in core shelter is excluded, the core measure of inflation in Alberta falls precipitously – closer to the 2 percent target set by the BoC.

CORE* INFLATION IN PROVINCES



Source: Haver Analytics
*All-items less Food and Energy

CORE* INFLATION IN ALBERTA



Source: Cansim II
*All-items less Food and Energy

What does this all mean?

From the discussion above, there are two key observations that emerge. In the first place, the recognition that the upswing in core inflation over the past four months has reflected the rise in inflation in the price of services - and the fact that this increase is broad-based - presents a troubling scenario for the BoC. Moreover, it reflects the fact that the dynamics in core inflation have moved beyond the cost of shelter – and more specifically beyond the inflation rate for the replacement cost of housing. We have also shown that core inflation has been consistently above the 2 percent target set by the BoC, pointing to the strong persistence in the behaviour of core inflation.

On both counts, the BoC will invariably be concerned, and as such, their bias towards further rate hikes - expressed in their last statement - is clearly justified. In fact, it could conceivably be argued that it is warranted. In terms of the future path for inflation, it would appear that as the economy continues to push against its production capacity, one can expect core inflation, particularly in services to accelerate. On the other hand, with the recent accelerating appreciation in the Canadian dollar, it would come as no surprise if the surge in inflation in core goods recedes somewhat, mirroring the pre-September 2006 decline.

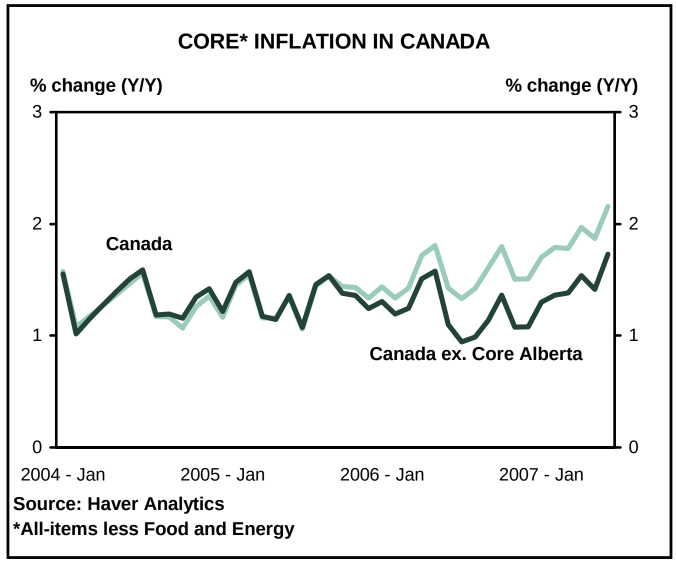
Where do we go from here?

Having analysed the recent behaviour of core CPI inflation, an important issue that will inevitably cross the mind is how core inflation will play out in the future. There are four key factors that will continue to be important in determining the future path of core inflation in Canada, namely: the output gap, energy prices, the Canadian dollar, and the US economy.

As always, in the short to medium-term, the excess demand for goods and services (positive output gap) in Canada will remain the key source of inflationary pressure for core services – and to a lesser extent, inflation in core goods prices. That is, if the Canadian economy continues to operate above its potential output level, the tight labour market will inevitably translate into higher wage demands – as the price commanded for the pool of available workers rises. As a result of this, if the higher cost of production, resulting from the increasing labour cost, is passed on to consumers in the form of higher price for services, accelerating inflation will be the unavoidable consequence. Indeed, this continues to be the main upside risk to core inflation in Canada – given the current excess demand in the Canadian economy, and the historically low unemployment rate.

In addition to a persistent output gap, further increases in the cost of energy (if it is passed on to consumers) could conceivably be another factor that would put upward pressure on the core CPI inflation in the medium term. Indeed, while the recent surge in the price of energy has not been reflected in the core consumer price inflation rate, further increases in fuel cost will clearly continue to pinch into the profit margin of producers, who will certainly be forced to push their prices higher.

In terms of downward pressures to core consumer price, the appreciating Canadian dollar, and the softening US economy will remain important factors. Over the past three months, the Canadian dollar has appreciated substantially, and this has invariably been translated into lower consumer goods prices. However, due to the low pass-through of persistent changes in the Canadian dollar to core consumer goods prices, estimated at about 20% of the percentage change in the Canadian dollar (Monetary policy Review – November 2000), the overall impact of any further appreciation in the Canadian dollar is likely to remain small.



Finally, the other important factor that could dampen core consumer price inflation in Canada would be a slowing U.S. economy. That is, with the U.S. being the main trading partner for Canada, any slowdown in the U.S. will inevitably be reflected in reduced demand for goods and services in Canada, putting downward pressure on core consumer prices – and consequently, core price inflation.

Conclusion:

In the analysis presented, we show that the increase in core inflation (Y/Y) over the past four month reflects a general increase in the price inflation in core services in Canada. Moreover, we show that this increase in the inflation rate for core services is broad-based – despite the deceleration in the inflation rate for shelter. Secondly, we confirm the view that the "overheating" Albertan economy has contributed disproportionately to inflation in Canada, and has been the main source of inflation in Canada. All told, there appears to be a very strong case that would support the view that further increase in the overnight rate by the BoC may remain in the cards.

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Endnotes

[1] Core CPI is a non-seasonally adjusted CPI measure excluding the 8 most volatile components (fruits, vegetables, gasoline, fuel oil, natural gas, mortgage interest, inter-city transportation and tobacco). Further adjustments are done to exclude the effect of changes in indirect taxes. This measure is generally used as the short-term operational guide for overall inflation pressures by the Bank of Canada