

November 21, 2008

## CANADA

### Energy prices dragging down inflation

#### HIGHLIGHTS

- The total consumer price index (CPI) fell by 1.0% in October.
- This decline is largely explained by the 13.4% drop in energy prices, a 6.1% decrease in natural gas prices and a 1.8% decline in prices for clothing and shoes.
- In contrast, few factors contributed positively to inflation. Property taxes nevertheless showed a monthly increase of 3.2%.
- The total annual inflation rate fell by 2.6% vs. 3.4% the previous month.
- The Bank of Canada's reference index (CPIX), which excludes the eight most volatile components, fell by 0.2% in October. Its year-over-year change was 1.7%, a level identical to that of the previous month.

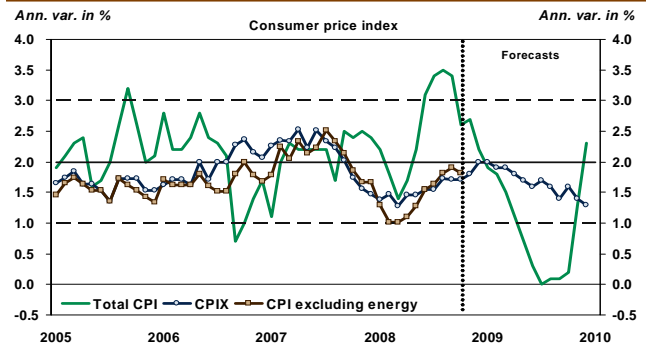
#### COMMENTS

This was expected: the drop in energy prices was a major contributor to the decline in inflation in October. However, the prices of other goods and services also fell significantly, such that total inflation posted a steeper-than-expected decline. As such, the price index for all non-energy goods and services also fell by 0.18%.

The price of clothing also declined sharply, partly as a result of a seasonal phenomenon (in 80% of cases, this component usually falls in October), but also probably due to the deterioration in household confidence. Clothing and several other durable or semi-durable goods are generally the first to go when economic conditions deteriorate. In fact, the price of all durable or semi-durable goods declined by 1.2% on average in October.

That said, the decline of the total inflation rate, which reached a cyclical peak of 3.5% a scant two months ago, should continue. The weekly surveys on gas prices already show a decline of more than 15% in November, and the declines sustained in the past few days have yet to be accounted for. With the financial crisis continuing to unravel, the drop in crude oil prices and the United States and other areas around the globe in recession, mounting pressures in the coming months will favour more price declines.

#### Inflation is falling rapidly



Sources: Statistics Canada and Desjardins, Economic Studies

The annual rate should therefore continue to decline until the summer of 2009, when a low point of 0% is expected. In these conditions, we cannot exclude the possibility of deflation (negative annual change in prices) over a period of a few months. The gradual improvement of economic conditions and especially the anticipated return of oil prices to their equilibrium (US\$77 a barrel at the end of 2009), should lead to upward pressures on prices as of next fall.

**Implications:** Inflation should shift under the Bank of Canada's target range (between 1% and 3%) in the next few months. The risks of deflation could be a growing concern for the monetary authorities. Therefore, the context remains favourable to other key interest rate cuts in the months ahead.

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