Weak inflation could persist several more months

The total annual inflation rate has fallen gradually over the last few months, reaching a fairly low point at the end of 2012. Weak price growth can be explained by several temporary factors, but it is clear that the excess production capacity seen for the last several quarters also plays a key role. Under these conditions, expect inflation to remain weak for several more months. This will give the Bank of Canada substantial leeway in conducting its monetary policy in 2013.

INFLATION BELOW THE BOTTOM OF THE TARGET RANGE
The total annual inflation rate, which is the year-over-year change in the all-items consumer price index (CPI), has slowed sharply in recent months. From its cyclical peak of 3.7% in May 2011, it has dropped gradually to just 0.8% in November and December 2012 (graph 1). This is exceptionally low, given that the Bank of Canada’s (BoC) monetary policy aims to keep total inflation within a range from 1% to 3%, with a midpoint target of 2%. What are the main causes of the drop in inflation and, more importantly, how much longer will this time of low price growth last?

Several components fostering low inflation
As shown in graph 2, the substantial slowdown by total inflation between May 2011 and the end of 2012 comes primarily from three components: transportation, housing and food.

Transportation
The bulk of the steep increase in transportation prices posted in May 2011 was due to rapidly rising gas prices. The end of the recession in most industrialized nations, combined with sustained demand from emerging nations, triggered a robust recovery by crude oil prices in fall 2010 (graph 3 on page 2). Therefore, the annual change in the CPI component associated with gasoline hit a peak of 29.5% in May 2011.

Contributions to the annual change in total CPI

Transportation, food and housing are behind much of the slowdown by inflation

Graph 1 – Annual price growth has declined substantially in the last few months

Graph 2 – Transportation, food and housing are behind much of the slowdown by inflation

Graph 3 – Transportation, food and housing are behind much of the slowdown by inflation

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Senior Director and Deputy Chief Economist

Benoit P. Durocher
Senior Economist

Copyright © 2013, Desjardins Group. All rights reserved.

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

IMPORTANT: This document is based on public information and may under no circumstances be used or construed as a commitment by Desjardins Group. While the information provided has been determined on the basis of data obtained from sources that are deemed to be reliable, Desjardins Group in no way warrants that the information is accurate or complete. The document is provided solely for information purposes and does not constitute an offer or solicitation for purchase or sale. Desjardins Group takes no responsibility for the consequences of any decision whatsoever made on the basis of the data contained herein and does not hereby undertake to provide any advice, notably in the area of investment services. The data on prices or margins are provided for information purposes and may be modified at any time, based on such factors as market conditions. The past performances and projections expressed herein are no guarantee of future performance. The opinions and forecasts contained herein are, unless otherwise indicated, those of the document's authors and do not represent the opinions of any other person or the official position of Desjardins Group.
Crude oil prices remained more stable as of spring 2011, however, as global economic outlooks were hampered by numerous uncertainties. As a result, the movement by oil prices stabilized and the contribution from gas prices to the total annual inflation rate has decreased markedly in recent months. Gas prices should also remain relatively stable in the coming quarters, without factoring in some volatility inherent to prices at the pump, and the contribution from gasoline to total inflation should remain limited.

Housing
The slowdown by housing prices can be largely explained by mortgage interest costs, which depend on two factors: the changing amount of mortgage debt, which is determined by growth in property prices, and changes to mortgage interest rates. One on hand, the slowdown observed in the real estate market in recent months comes with much slower growth by property prices. Over one year, the average price of existing homes went up only 2% Canada-wide in January 2013, compared with nearly 9% in summer 2011. On the other hand, mortgage rates have fallen in recent years. For example, the spread between the posted closed five-year mortgage rate and the same rate five years ago has been in negative territory for several years (graph 4). For some time now, borrowers renewing a mortgage with a maturity of five years have been getting lower interest rates upon renewal. As rate spreads on renewal have increased lately, the drop in mortgage interest costs has also intensified. According to our projections, this situation could continue until the end of 2014, with the negative impact of mortgage interest costs on housing prices likely persisting for several more quarters. Another element in housing is the more pronounced fall by natural gas prices. However, the relative weight of natural gas in the household consumption basket is fairly small, so its influence on total inflation is low.

Food
Annual growth by the food component has also decreased substantially in recent months. Fluctuations in food prices are much more volatile over time, however. Changes in vegetable prices, for example, are highly dependent on harvest quality (graph 5). Thus, we can detect no clear trend for food price movement for the next few months.

Other temporary factors
The BoC also identified a few temporary elements that favoured slower inflation in the latest Monetary Policy Report. Among other things, there was a change in the methodology used in estimating automobile prices, and a sharper slowdown than expected in some regulated prices, such as automobile insurance premiums.

EXCESS PRODUCTION CAPACITY ALSO FAVOURS A WIDESPREAD DOWNTREND
The weakness in inflation goes much further than the factors mentioned so far. Gasoline, natural gas, mortgage interest costs, and fruits and vegetables are all fairly volatile
components; as a result, they are excluded from the BoC’s core index (CPIX). Note that the core index is deemed to be a good indication of the general trend for price movement. The CPIX’s annual change has also fallen substantially over the last few months, reaching just 1.1% in December 2012.

The core CPI’s slowdown clearly reflects weaker pressure on prices overall as Canada’s economy has excess production capacity. For one thing, the industrial capacity utilization rate has been below its historic average for several quarters. For another, Canadian output remained below full potential at the end of 2012; the BoC put the output gap at -1.1%. Our forecasts therefore indicate that we may not see a return to full capacity until mid-2015 (graph 6), meaning that pressure on prices will remain subdued for several more quarters.

All in all, inflation will remain under some downside pressure in the coming months. The total CPI’s annual change could remain below the lower target (1%) until the spring, then stay between 1% and 2% for most of 2013. The change in CPIX will also remain very low in the coming months, with a return to the mid-point target (2%) not expected until early 2014.

**THE BoC HAS A LOT OF LEEWAY**

The low inflation anticipated for the coming quarters will again give the BoC a lot of leeway in conducting its monetary policy. Under these conditions, the current monetary policy stimulus could be left in place for an extended period without fears of accelerating price growth. Given the modest economic growth expected for the next few quarters and the many uncertainties that persist, the BoC should wait until mid-2014 before raising its key interest rates.

Conversely, even if total inflation is currently below its target range, it is unlikely that the BoC will order a key rate cut. Firstly, the annual change in total CPI should not drop much lower than where it is right now. Secondly, the projections call for inflation to tick up gradually in 2013. Thirdly, the degree of monetary policy stimulus is already considerable. It would therefore take a huge and unexpected shock for monetary authorities to decide to take key rates lower, especially in a context in which worries about overly high household debt have not yet dissipated.

**Benoit P. Durocher**

Senior Economist