Economic Viewpoint

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Despite the recent increase in inflation, Canada is still dealing with disinflationary pressures

After a prolonged episode of weakness, the annual inflation rate climbed back slightly in recent months, reaching 1.5% in January 2014. A return closer to the lower target (1%) is likely in the near term, however, with the elimination of certain base effects and the lingering influence of disinflationary forces. As these forces are gradually absorbed, the total annual inflation rate should stay between 1% and 2% throughout 2014. However, significant downside risks remain and will continue to influence the Bank of Canada's monetary policy in the quarters ahead.

WEAK INFLATION PERSISTS

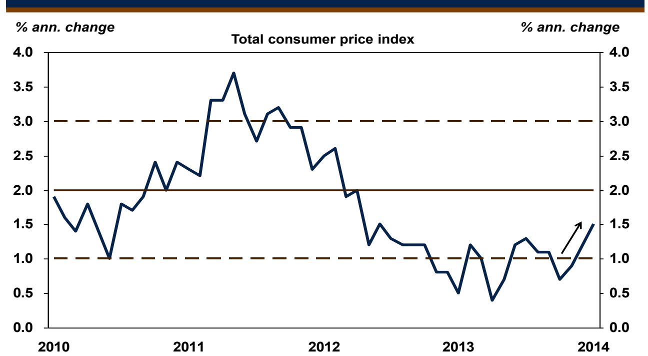
Inflation experienced an episode of extremely weak growth in the last few quarters. This problem was in fact addressed in a previous Economic Viewpoint[1] published about a year ago. At the time, we concluded that this was a temporary phenomenon and that a gradual acceleration of price growth would materialize some time in 2013.

In reality, price advances remained weak throughout 2013, requiring forecasters to revise their expectations downwards several times during the year. As a result, 2013 ended with total inflation at only 0.9 %, below the Bank of Canada's lower target.

Maintaining such a low level of inflation has raised some concerns in recent months. The Bank of Canada mentioned in its latest Monetary Policy Report that "the degree of uncertainty around the inflation forecast, and the range of weaker-than-projected outcomes in particular, are important considerations for policy in light of the low level of inflation and the recent series of downside surprises." We must remember that the primary objective of the Bank of Canada's monetary policy is to maintain inflation within a range of 1% to 3%, with a median inflation target of 2%.

That said, inflation has gone up recently, climbing from 0.9% in November to 1.2% in December and to 1.5% in January (graph 1). Does this mean that concerns about inflation that is too low are no longer valid? The answer is no. These types of jolts have often been observed in past quarters, and did not prevent inflation from averaging quite low levels in 2013. The base effects associated with brisk price growth in February 2013 will also subsided, this factor should contribute to pushing down the inflation rate closer to its lower band (1%) as of next month. In addition, downward pressures that have held back inflation for some time are likely to be felt in the months ahead.

Graph 1 – Total inflation up slightly in Canada since December



*Bank of Canada core index.
Sources: Statistics Canada and Desjardins, Economic Studies

[1] Desjardins, Economic Studies, Economic Viewpoint, "Weak inflation could persist several more months", February 19, 2013. http://www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv130219.pdf

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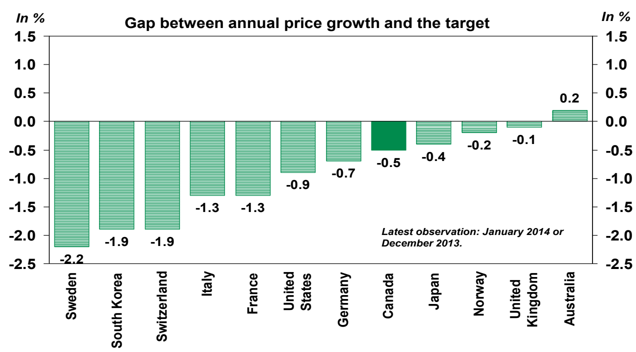
SEVERAL DOWNWARD PRESSURES REMAIN

Canada is not alone in dealing with persistent weak inflation. Price growth in several industrialized countries has recently come in below the targets set by different central banks (graph 2). Weaker price advances for food and energy in last months and the presence of surplus production capacity have helped slow down inflation in most industrialized countries. This phenomenon is far more widespread and compounded in Canada, where the price of several components in the consumption basket has also experienced very limited growth. As such, the core index, which excludes food and energy prices, edged up by only 0.8% in 2013 and all the other alternative indexes used to benchmark the movements in core inflation also converged towards this level (graph 3). A fairly high proportion of the CPI basket continues to show very weak growth while about 35% of components[2] recorded an annual change of less than 1% in January 2014. In contrast, only close to 12% of components showed an annual change in excess of 3%.

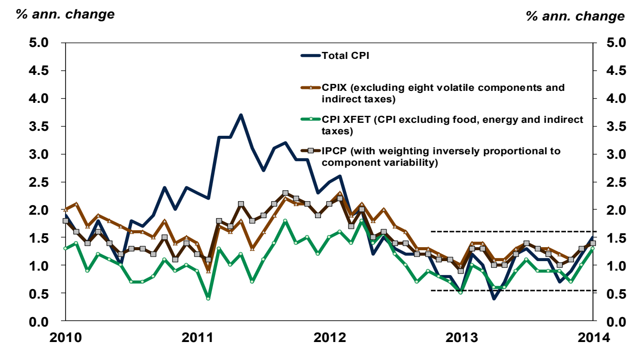
Graph 2 – Most industrialized countries are showing weak price growth



Sources: Bloomberg, Bank of Canada and Desjardins, Economic Studies

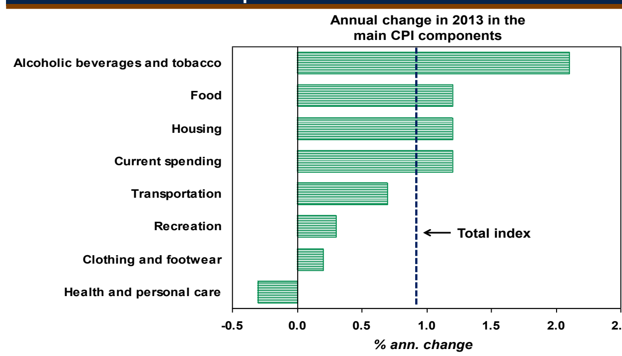
As we can see in graph 4, with the exception of alcoholic beverages and tobacco, which recorded price growth slightly above 2% in 2013, all of the other main components posted fairly weak advances last year. The price of durable goods fell by 0.2% in 2013 while prices for semi-durable goods were up by only 0.1%. Moreover, clothing prices were down by 0.7% in 2013. The price of non-durable goods and services posted respective increases of 0.9% and 1.4%.

Graph 3 – Alternative inflation benchmark indexes are converging



Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies

Graph 4 – Health and personal care, clothing, footwear, recreation and transportation reined in inflation



Sources: Statistics Canada and Desjardins, Economic Studies

This sheds light on an important factor that emphasizes the weakness of inflation seen in Canada for some time: fierce competition in retail trade. In fact, the retail sales deflator rose by only 0.3% for 2013 as a whole. It goes without saying that the arrival of major U.S. retailers on Canadian soil has shaken things up somewhat. This climate of strong competition could continue in the coming quarters while the average profit margin in retail trade was 3.4% in the fourth quarter of 2013, a level that is still higher than its historical average (2.8%). The popularity of online shopping and shopping in the U.S. has also fueled competition.

Much like what is seen in several other industrialized countries, the existence of surplus production capacity is another factor behind the slim price growth in Canada.

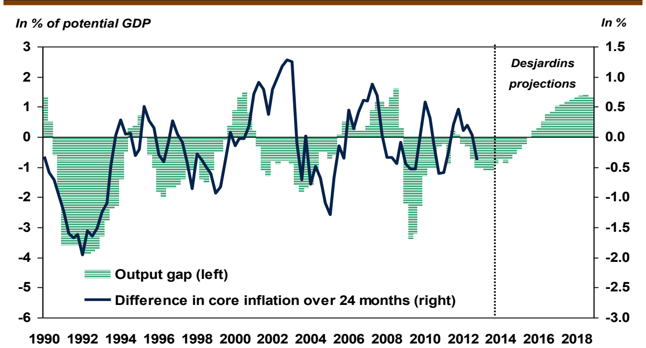
[2] Based on their respective weighting.

According to the Bank of Canada, total production's excess supply was approximately 1.0% in the fourth quarter of 2013. Canada has been grappling with surplus production capacity for five years now, and the return to full capacity is not expected until the end of 2015. In these circumstances, there is very weak upward pressure on prices.

WHAT DOES THE FUTURE HOLD?

In theory, there is a lag of several quarters between movements in excess supply and the inflation rate (graph 5). Maintaining a negative output gap until 2015 could rein in consumer price growth until 2016 or 2017. However, the effect will clearly diminish as the excess supply is absorbed. With regard to competition in retail trade, everything suggests that it will remain fierce for some time. In such conditions, we have to expect the total inflation rate in Canada to remain moderate for a few more months.

Graph 5 – The negative output gap will hold back the inflation rate for a few more quarters

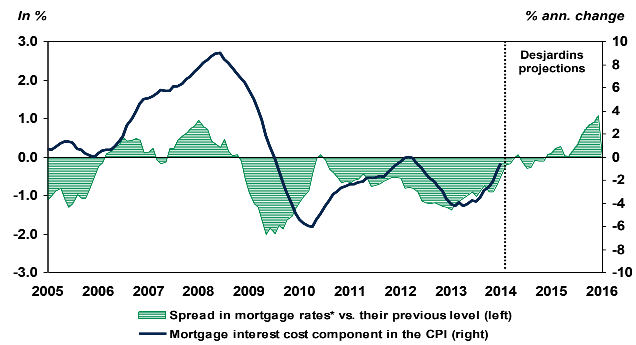


Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies

However, some factors should contribute to keeping inflation above the lower target (1%) in the next few quarters. Inflation expectations remain firmly rooted, since both the Bank of Canada Business Outlook and the consensus forecast are calling for a convergence of close to 2% in the medium and long term. Furthermore, the salary increases negotiated during major wage settlements have risen since the start of 2013. For most industries, the negotiated wage increase was set at 1.9% in the third quarter of 2013 vs. 0.6% at the start of the year.

Another important factor involves changes in mortgage rates. With the recent downtrend in rates in the past few years, Canadian households benefited from an effective reduction in mortgage interest costs at the time of renewal, which clearly contributed to containing advances in the total CPI. Interest rates have been steady for some time now and a slight uptrend is even expected in 2014 and 2015. In such conditions, the drop in the mortgage interest cost component of the total CPI should stabilize, or perhaps even reverse in the near term (graph 6).

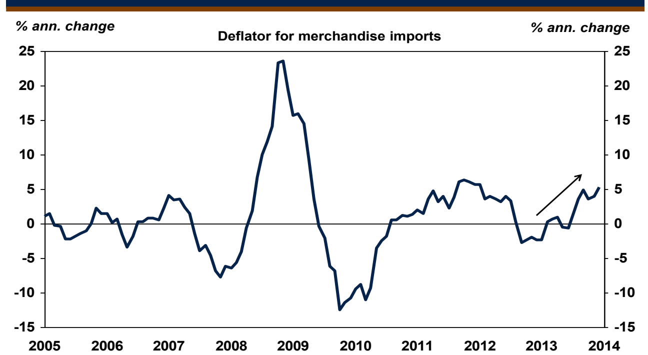
Graph 6 – The adverse effects of reduced mortgage rates will soon disappear



* Spread between the 5-year mortgage rate and the rate in effect 5 years before, combined with the spread in the 1-year mortgage rate and the rate in effect 1 year before.
Sources: Statistics Canada and Desjardins, Economic Studies

Moreover, the Canadian dollar's depreciation is likely to have an upside impact on consumer prices. The annual growth of the merchandise imports deflator has in fact risen in the past few months (graph 7).

Graph 7 – Price growth for imported goods is accelerating



Sources: Statistics Canada and Desjardins, Economic Studies

According to Bank of Canada[3] estimates, the core inflation rate should move closer to 1.6% given the current surplus production capacity. If we also take into account the temporary effects of fierce competition in retail trade, the theoretical core inflation rate could be slightly lower, or approximately 1.3%.

These projections are similar to our recent forecasts, which call for a total annual average inflation rate of 1.5% in 2014. We assume that disinflationary pressures will continue to be strong in the first months of the year, but their effects will diminish somewhat thereafter as excess supply is gradually absorbed and the effects of fierce competition in retail trade subside.

For the provinces, Quebec and British Columbia stood out in 2013 with the lowest total annual inflation rate in Canada (table 1). The re-introduction of the former provincial sales tax largely explains the slight pullback in prices seen in British Columbia last year. The effects of this change should dissipate in 2014. The weaker inflation in Quebec stems mainly from a decline in the price of food purchased in stores and the anemic growth of new automobile prices. These factors are temporary however, meaning that Quebec's inflation rate should move closer to the national average in 2014. The Prairies could see higher inflation in 2014 and 2015 due to more vigorous demand. Lastly, Ontario does not really stand out in terms of inflation since annual price growth has been in line with the national average for several years now.

Table 1 – Quebec and British Columbia recorded the weakest inflation in 2013

Total annual inflation rate (in %)				
	2012	2013	2014f	2015f
Atlantic	1.9	1.2	1.3	1.6
Quebec	2.1	0.7	1.5	1.9
Ontario	1.4	1.0	1.5	1.8
Manitoba	1.6	2.2	1.7	1.9
Saskatchewan	1.6	1.5	2.2	2.0
Alberta	1.1	1.4	2.0	2.2
British Columbia	1.1	-0.1	0.8	1.5
CANADA	**1.5**	**0.9**	**1.5**	**1.8**

f: forecasts
Sources: Statistics Canada and Desjardins, Economic Studies

THE RISKS REMAIN HIGH

Much like the results seen throughout 2013, we have to conclude that significant downside risks remain. The effects of stiff competition in retail trade could not only continue, they could also intensify. The expected acceleration in global demand and Canadian output in 2014 could be delayed, which would slow down the absorption of Canada's surplus capacity. Lastly, energy prices, one of the main factors that hold sway over changes in total inflation, could run into an unexpected episode of declining prices in response to an increase in the global supply. In contrast, upward risks also exist while the current disinflationary forces could disappear more rapidly than expected. This is, however, a less worrisome alternative, as it would only consolidate inflation's faster return towards the median target.

IMPLICATIONS FOR MONETARY POLICY

Keeping inflation at fairly weak levels—between 1% and 2%—in the next few quarters amid the significant downside risks that still exist requires greater prudence from Canada's monetary authorities. In these conditions, the Bank of Canada will undoubtedly leave its target for the overnight rate at 1.00% for several more quarters. In fact, we will likely have to wait until fall 2015 before key rates in Canada are increased. In the meantime, it is highly unlikely that the Bank of Canada will reduce the target for the overnight rate. Both total and core inflation would have to fall well below the lower target (1%) for a fairly extended period—and impact inflationary expectations—for this to occur.

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[3] "Flexible inflation targeting and 'good' and 'bad' disinflation", speech given by Tiff Macklem, Senior Deputy Governor of the Bank of Canada, on February 7, 2014.