

ECONOMIC VIEWPOINT



Will Inflation Eventually Pick Up in Canada?

Low inflation has persisted for the last few years in Canada. Structural factors have contributed to weak price growth, such as excess capacity in the Canadian economy, in addition to temporary considerations. The gradual absorption of excess capacity suggests that upside pressure on prices could sharpen. However, given the delayed reaction time between inflation and changes to production capacity, it will likely be several quarters before any real upside pressure on prices can be felt. That said, other disinflationary factors, which have also been observed in most industrialized countries, may continue to be felt in the coming quarters, which would hinder anticipated growth.

With the exception of a brief period of a few months, Canada's total annual inflation rate since spring 2012 has remained below the target median (2%) set by monetary authorities (graph 1). At first glance, this persistently weak price growth is surprising, since the Bank of Canada (BoC) has maintained a highly expansionary monetary policy with exceptionally low interest rates since the Great Recession of 2008–2009, while the federal government has implemented a budgetary stimulus policy. Therefore, there are clearly significant factors at work favouring modest price growth.

Temporary Factors Support Low Inflation

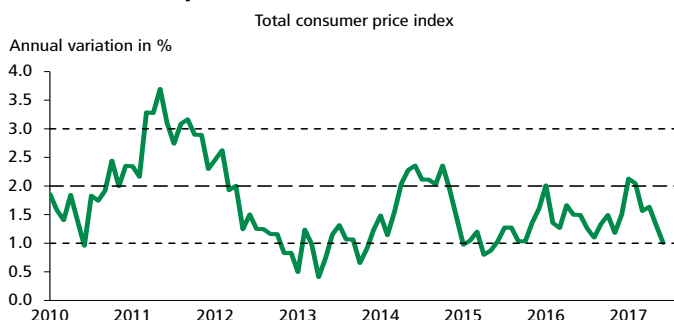
According to Statistics Canada, the annual change in the total consumer price index (CPI) fell to just 1.0% in June. As shown in graph 2, the three components that contributed the most to current low inflation were electricity, clothing and gasoline.

Electricity prices dropped due to a change in policy in Ontario that led to reduced electricity rates in January and May 2017. Another cut should be enacted over the summer, resulting in a total average decrease of 25% in electricity rates for Ontario's housing sector.

With regard to clothing, weak price growth is nothing new, but the phenomenon amplified in recent months. Stiff competition led retailers to resort to major markdowns. Merchants also appear to be diversifying the geographic location of their supply sources, with some leaving China for other Asian countries, which is helping keep costs down.

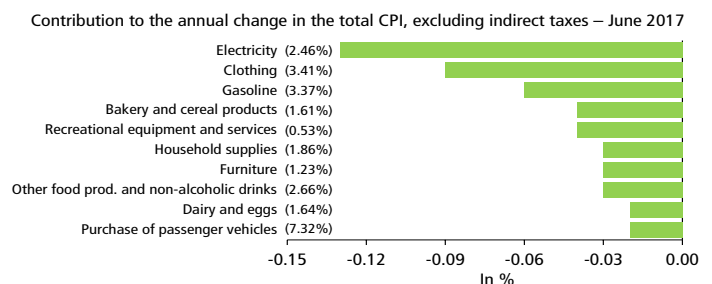
Lastly, gasoline prices have been subject to the fluctuations of crude oil prices on the international markets. After following a downward trend for most of 2015, oil and gas prices did an

GRAPH 1
Total inflation has remained at the lower end of the target range for an extended period



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 2
Top 10 negative contributors to the annual inflation rate



CPI: consumer price index
NOTE: Parenthesis indicate the weight in the CPI basket (excluding the effect of changes in indirect taxes) in June 2017.
Sources: Statistics Canada and Desjardins, Economic Studies

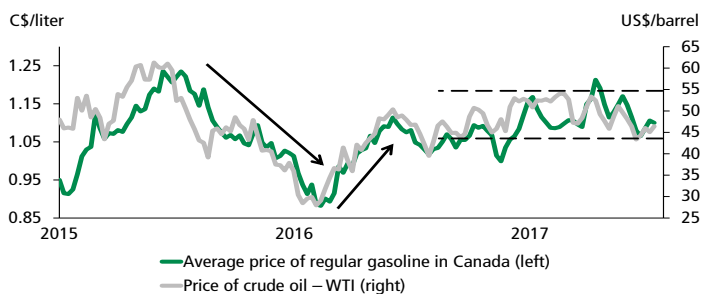
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about-face and rose sharply in early 2016. As a result, gasoline was a major contributor to the annual growth of the total CPI for this period. However, its impact has diminished in the last few months as oil prices have stabilized within a certain range (graph 3). Nevertheless, oil prices are currently hovering in the lower end of that range, whereas they were at the upper end a year ago. This difference was enough to cause a 1.4% drop in the annual change in gasoline prices in last June, which was echoed in the total annual inflation rate, given the relatively high weight of this component in the CPI basket. However, this negative contribution could easily become a positive one if future gas prices stay within the same range as in recent months.

GRAPH 3
Gasoline prices have been somewhat more stable for the last few months



These three components alone caused the annual change in the total CPI to drop to 0.3% in June. Temporary factors, such as sharply slower growth in car prices, also played a role. After significantly contributing to total inflation growth in 2016 due to the positive effects of the weaker Canadian dollar and strong demand, the annual change in new vehicle sales has slipped in recent months, even falling into negative territory in June 2017.

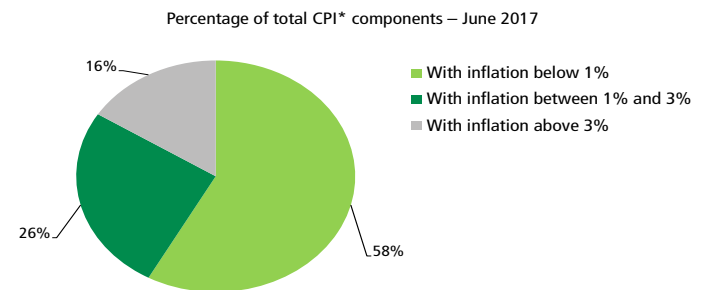
However, the effects of these factors are temporary. Their negative impact on total inflation is therefore expected to diminish in the next few months, and maybe even reverse itself. However, temporary factors are not solely responsible for the current low total inflation. Structural considerations are also at play.

Certain Structural Factors Also Impact Inflation

Beyond temporary factors, it should be noted that weak inflation growth is fairly widespread. In June 2017, nearly 58% of the CPI basket's components¹ posted annual price growth below the BoC's lower target of 1% (graph 4). In contrast, only 16% posted an annual change in prices above the upper target (3%). Therefore, just 26% of components were within the target range.

¹ The relative importance of each component in the CPI basket was taken into account.

GRAPH 4
A large proportion of the total CPI basket* posted annual growth below the target range



CPI: consumer price index; * Excluding the effect of changes in indirect taxes.
 Sources: Statistics Canada and Desjardins, Economic Studies

Among the components that posted an annual change of less than 1% were those we have already identified as having the largest negative contributions on the annual change in the total CPI in June: electricity, gasoline and clothing (table 1 on page 3). A slight decrease in car prices also played a critical role.

Other components also caught our attention. With an annual increase of close to nil, mortgage interest cost stood out. This weak growth was due to extremely low mortgage rates, which have hampered the growth of financing costs for the last few years. However, with hikes to Canadian key rates beginning, the situation could reverse itself in a few months as upward pressure on mortgage rates increases.

Price increases for rental units have also been very low for more than a year. A number of factors are undoubtedly behind this result. For example, supply appears to have significantly risen in recent years, with a growing number of condos available for rent. Very low mortgage rates have also reduced financing costs for owners of rental units. In addition, given the low total inflation of recent years, it is more difficult for landlords to justify significant rent increases to their tenants.

Lastly, growth in communications prices has remained very low for more than a year. This may be due to strong competition and regulatory changes in the wireless sector.

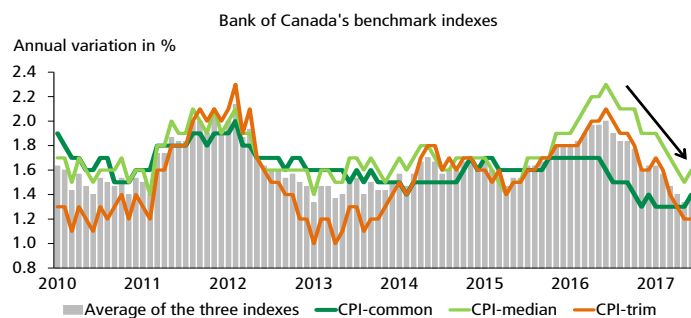
This picture shows fairly weak inflationary pressure on a number of components. This is clear in changes to the three new benchmark indexes used by the BoC to determine core inflation. The annual change in the three measures has decreased in recent months (graph 5 on page 3). With an average of only 1.4% in June 2017, these indexes show that the inflation trend on the whole is fairly low.

In addition to the factors already identified, widespread weak price growth is due in large part to excess capacity that has persisted in the Canadian economy since the Great Recession of 2008–2009. Excess capacity is measured by the output gap,

TABLE 1
Total CPI* components with an annual price change of less than 1% in June 2017

RANK	NAME	ANNUAL	WEIGHT OF
		VARIATION (%)	TOTAL CPI* (%)
		June 2017	
1	Purchase of passenger vehicles	-0.32	7.32
2	Rented housing	0.60	6.38
3	Other household goods and services	0.96	3.86
4	Mortgage interest cost	0.04	3.42
5	Clothing	-2.70	3.41
6	Communications	0.41	3.40
7	Gasoline	-1.87	3.37
8	Other food products and non-alcoholic drinks	-0.97	2.66
9	Electricity	-5.45	2.46
10	Meat	-0.16	2.19
11	Household supplies	-1.63	1.86
12	Health care goods	0.98	1.67
13	Dairy and eggs	-1.39	1.64
14	Bakery and cereal products (excluding infant and baby foods)	-2.31	1.61
15	Recreational equipment and services (excluding recreational vehicles)	-0.90	1.55
16	Homeowners' maintenance and repairs	0.72	1.47
17	Fruits, fruit preparations and nuts	-0.01	1.39
18	Personal care supplies and equipment	0.96	1.25
19	Furniture	-2.20	1.23
20	Shoes	0.20	1.10
21	Purchase of recreational vehicles and outboard motors	0.36	0.87
22	Leasing of passenger vehicles	-0.23	0.82
23	Clothing accessories, watches and jewellery	-1.91	0.69
24	Paper, plastic and foil supplies	-0.43	0.55
25	Home entertainment equipment, parts and services	-6.83	0.53
26	Use of recreational facilities and services	0.89	0.30
27	Services related to household furnishings and equipment	-0.86	0.28
28	Household textiles	-0.13	0.25
29	Rental of passenger vehicles	-1.30	0.10
Total			57.63

CPI: consumer price index; * Excluding changes in indirect taxes.
Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 5
Core inflation is down


CPI-common: common component; CPI-median: weighted median; CPI-trim: truncated average
Sources: Statistics Canada and Desjardins, Economic Studies

which, according to the BoC, has remained in negative territory on average² since late 2008.

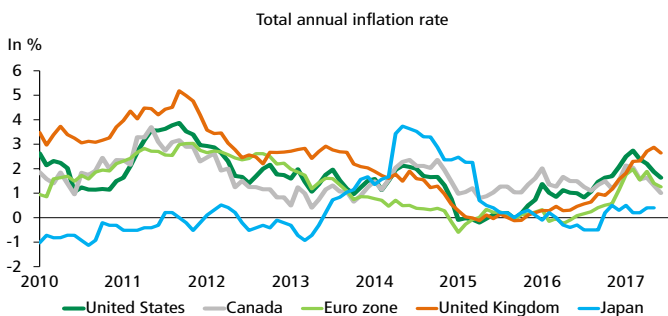
This concept of excess capacity has also been confirmed by other economic indicators. Until very recently, the industrial capacity utilization rate had hovered below its historical average. The unemployment rate also rose significantly in the wake of the Great Recession. Although unemployment has been on the decline in the last few months, wage growth remains fairly stunted, which indicates persistent excess capacity in the labour market.

² The BoC uses two measures to estimate the output gap: the integrated framework and the extended multivariate filter. For our analysis needs, we used an average of these two measures to obtain the estimated output gap for a given period.

Canada Is Not Alone

That said, the structural problem of weak price growth is not unique to Canada. Most industrialized countries have also posted very low inflation (graph 6), suggesting that common factors are affecting price increases. First, industrialized countries have all been impacted at varying levels by blips in energy prices. Secondly, the Great Recession had major worldwide repercussions, leaving most industrialized countries with excess production capacity. Other theories have also been suggested to explain widespread weak price growth. The BoC recently mentioned the effects of lower inflationary expectations as households and businesses have adapted to the extended period of low price growth in recent years. Booming e-commerce worldwide, which has sharpened competition, has also been pointed to, as has the impact of certain technological advances, which could improve productivity in ways that are difficult to measure. In all likelihood, these downward pressures could continue to impact price growth in most industrialized countries for some time to come. However, their true impact is difficult to assess.

GRAPH 6
Inflation has been low in several regions of the world



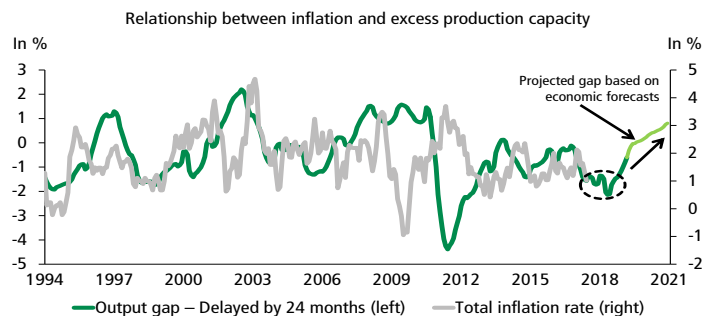
Sources: Datastream and Desjardins, Economic Studies

Is There a Possibility of Seeing Inflation Pick Up?

In light of these observations, there is reason to wonder whether inflation will eventually accelerate in Canada. It is clear that certain disinflationary factors will persist in the coming months. In particular, factors affecting global inflation could very well continue to be felt for several more years. However, the gradual dissipation of excess capacity in Canada could help turn the situation around in the next few quarters. As shown in graph 7, increased excess production capacity has a positive influence on inflation growth, with a delay of approximately 24 months.

This means that the persistent excess production capacity of the last two years will continue to put downside pressure on inflation in the coming months. However, given the gradual absorption of excess capacity seen recently, these deflationary pressures will become less and less significant. In addition, our economic projections for the next few quarters indicate that

GRAPH 7
Inflationary pressures will remain relatively weak for a few more months, but will pick up thereafter

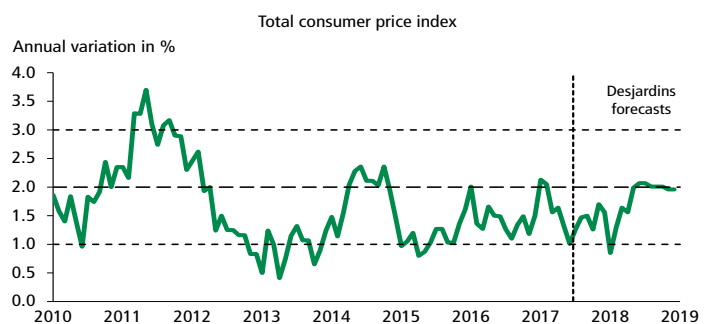


Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies

real GDP growth should continue to exceed its potential growth, which means that not only could excess production capacity completely disappear, but it could even lead to some shortages. Such situation could eventually put upside pressure on prices in Canada.

In these conditions, it is reasonable to believe that, in the next few months, the annual inflation rate could accelerate in Canada, closing in on the BoC's target median (2%). In the meantime, the delayed effects of excess capacity will continue to be felt and the total annual inflation rate could very well stay at the lower end of the target range for some time (graph 8).

GRAPH 8
Total inflation could approach the midpoint target within the next few months



Sources: Statistics Canada and Desjardins, Economic Studies

With these projections, nothing should prevent the monetary authorities from carrying out further hikes to their key interest rates in the coming quarters. It is worth noting that there is a delay between changes to the target for the overnight rate and their impact on inflation. Therefore, the BoC must consider the level inflation will reach in the next 18 to 24 months when the time comes to make a decision regarding its key rates.

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