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Canada Economic Perspectives

Inflation Trends Give the Green Light for Rate Cut(s)

As noted in previous commentaries, we think more rate cuts are on the way, despite stronger-than-expected economic trends over the past couple of months. Recent news on inflation reinforces our view.

Remarks from former Bank of Canada governor David Dodge this week suggest that a rate cut could come at this month's meeting. Dodge reiterated downside risks to the Canadian economy stemming from the US slowdown. These risks, coupled with a favorable inflation outlook, are enough to tilt the Bank of Canada toward further easing, in our view.

Our proprietary broad price index (BPI) is also signaling further rate cuts. The index combines prices for homes, industrial materials and stocks with consumer prices to provide a more comprehensive measure of the monetary picture. Through November, the BPI fell (**Display 1**), led by declining equity prices, easing producer-price increases and slowing home-price appreciation. We expect the downtrend in the BPI to be even more pronounced in December, given further weakness in the equity market.

The strong Canadian dollar is also lending a helping hand on the inflation front. In November, import prices fell more than 8% year over year, continuing the trend in October, when they dropped more than 5% (**Display 2**). Though further declines of this magnitude are unlikely if the currency stabilizes around parity with the US dollar as we expect, import prices should remain subdued for many more months.

Slowing broad-price inflation and the strong currency are allowing Canada to avoid the worst effects of soaring food and energy costs. These twin inflationary pressures have prompted central bankers around the globe to tighten rates or stop their easing cycles.

The story in Canada is quite different. As illustrated in **Display 3**, food-price inflation has slowed dramatically in Canada, while it continues to rise in the US. This suggests that surging global food inflation is having a much smaller impact on Canada than on other countries, eliminating yet another barrier to further monetary easing.

This does not mean that Canada is immune to all global price pressures. The raw materials price index for Canada jumped 15.7% in November, following a rise of more than 12% in October. Though farm-product inflation has receded in recent months, the latest reading showed it running at 5%.

All in all, the strong Canadian dollar and weakness in broad prices are creating a comfortable backdrop for the Bank of Canada's rate policy. If the US Federal Reserve signals that it is committed to a prolonged rate-cutting cycle, or if it becomes more aggressive in the face of weak markets, we will likely incorporate additional rate cuts into our Canadian economic outlook.

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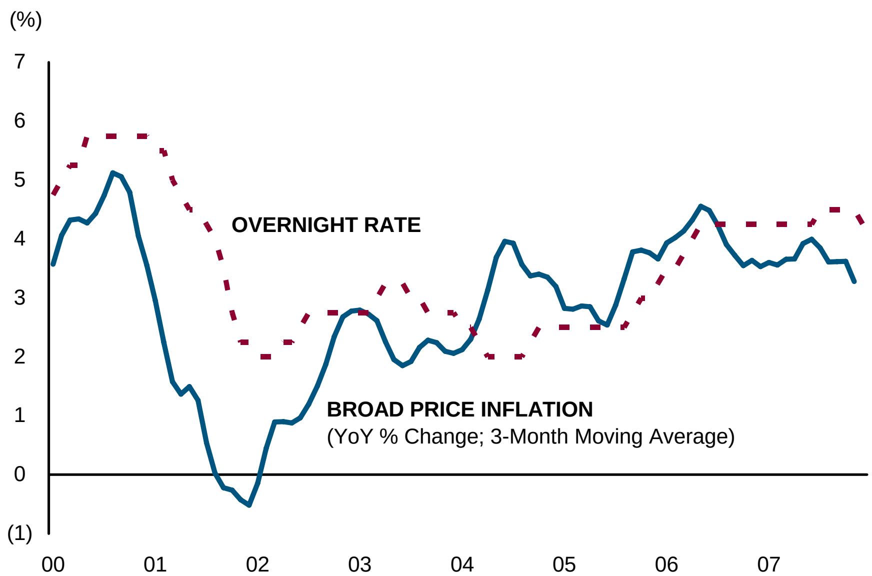
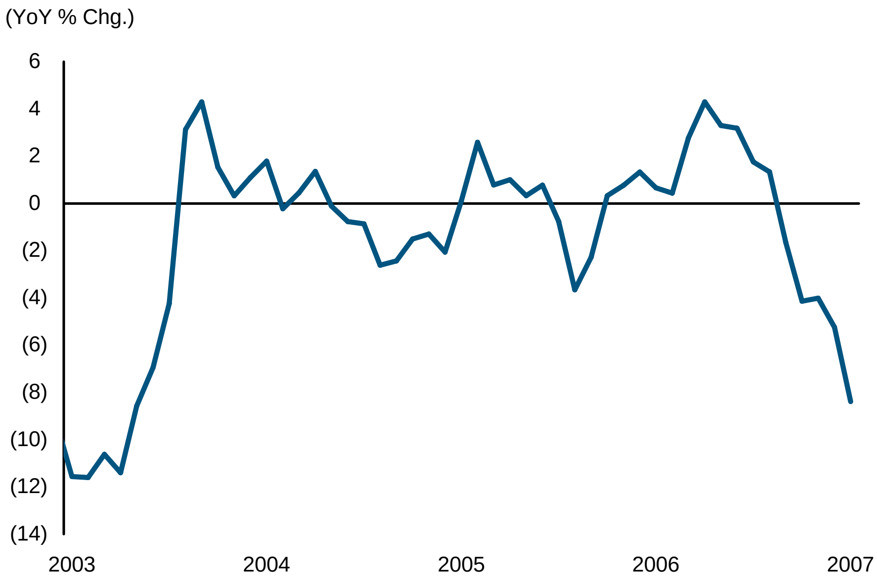
Display 1: Broad Prices Are Heading Lower
Inflation and Rates



Source: Bank of Canada, Haver Analytics and Statistics Canada

Our proprietary Canadian broad price index justifies further easing in official interest rates.

Display 2: Import Prices Plummet
Import Price Growth (Index)

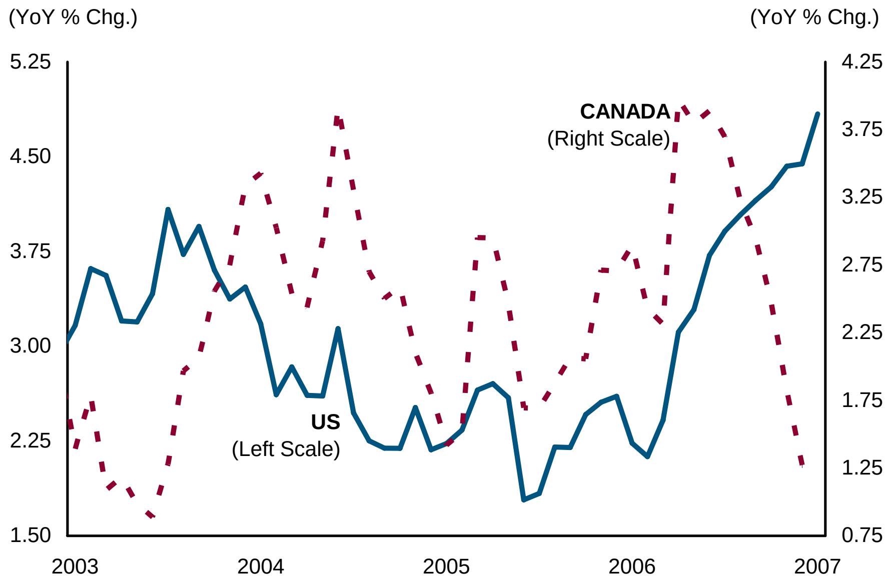


Source: Haver Analytics and Statistics Canada

The strong Canadian dollar is helping the inflation outlook by driving down import prices.

Display 3: Canadian and US Food Prices Diverge

Food Inflation in Consumer Price Indexes



Source: Bureau of Labor Statistics, Haver Analytics and Statistics Canada

The divergence in Canada's food-price trends from those in the US also augurs for rate cuts.