Economics

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The truth about Canadian inflation

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Canadian inflation is as hot as it's been in years. As a result, it's become one of the hottest topics of conversation, second only of course to the pandemic itself. But are prices really all that high in Canada? That question can't be answered by the current inflation rate alone. To find the truth, we need to look at the level of consumer prices, not just the rate of change.

It's clear looking at the level of prices that Canadians are paying no more than they would have been if inflation had run at the Bank of Canada's 2% target since the pandemic began (Chart 1). So, yes inflation is high at the moment, but all it's done so far is make up for the weak inflation last year.

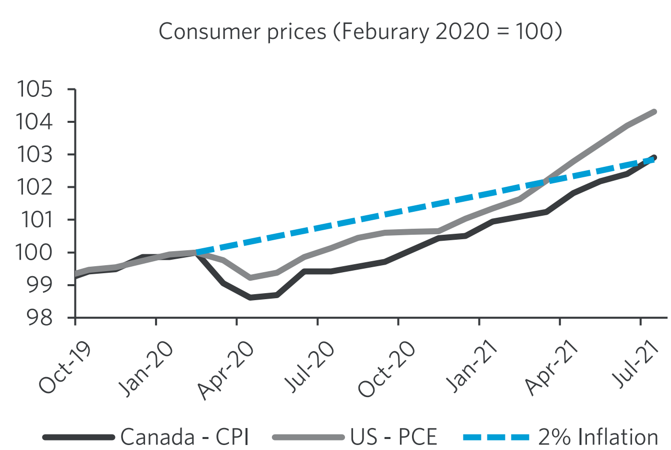
While a true inflation threat could emerge later in this expansion, current Canadian price pressures are largely transitory. They reflect base effects, the typical early-cycle rebound in commodity prices, supply chain bottlenecks and surging demand as services become available again. Transitory doesn't mean here today, gone tomorrow. Inflation could end up remaining in the vicinity of 3% until next year. But it's not the type of inflation the central bank should fight, particularly with unemployment still elevated and the Bank of Canada's core common component indicator of underlying inflationary pressures still running below 2%.

But wait, there's more

The experience north of the border is, however, in stark contrast to the movements in US prices. As of July, Americans were paying notably more for goods and services than in a counterfactual scenario where their central bank had been able to keep price growth running at its 2% PCE inflation target.

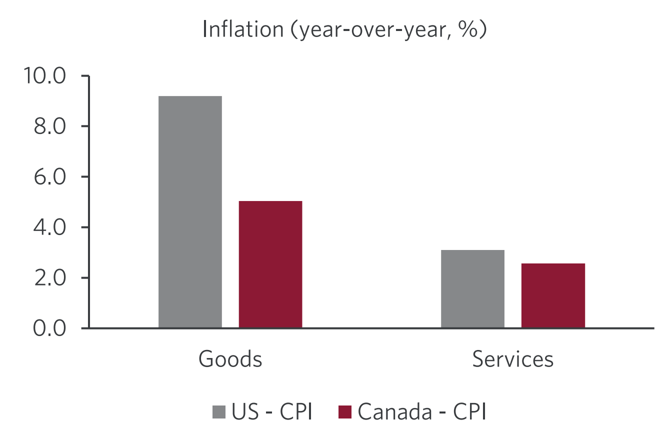
Even the elevated Canadian inflation rate isn't as hot as the pace of price growth in the US. The latest readings pegged Canadian inflation at 3.7% in July and US CPI inflation at 5.4%. According to the Fed's preferred gauge of inflation, PCE prices are running at an annual rate of 4.2%. Hotter inflation south of the border is true of both goods and services prices (Chart 2).

Chart 1: Current Canadian inflation has only just made up for weakness last year



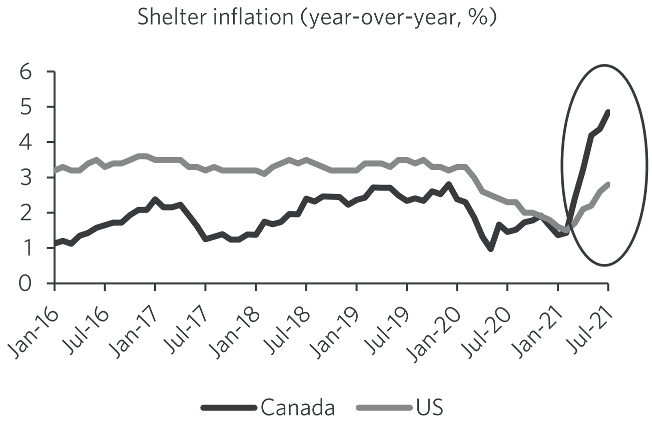
Source: Statistics Canada, Census Bureau, CIBC

Chart 2: Both goods and services inflation are running hotter in the US



Source: BLS, Statistics Canada

Chart 3: Rising shelter costs more prominent in Canada

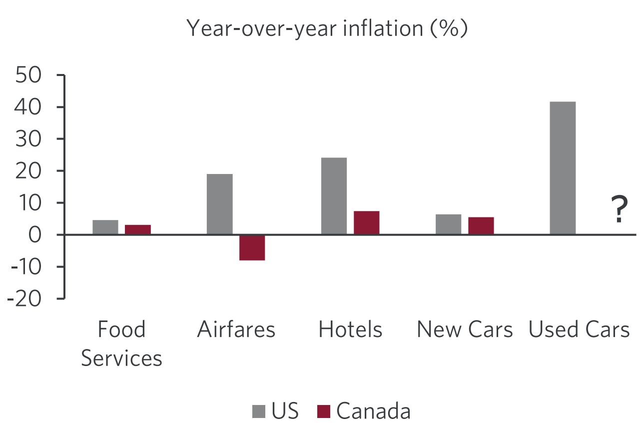


Source: Statistics Canada, BLS

That variation doesn't come down to any one category, and any differences in methodology likely come out in a wash. Indeed, Canadian data has better accounted for the rising costs of shelter recently (Chart 3), due to its more appropriate methodology.

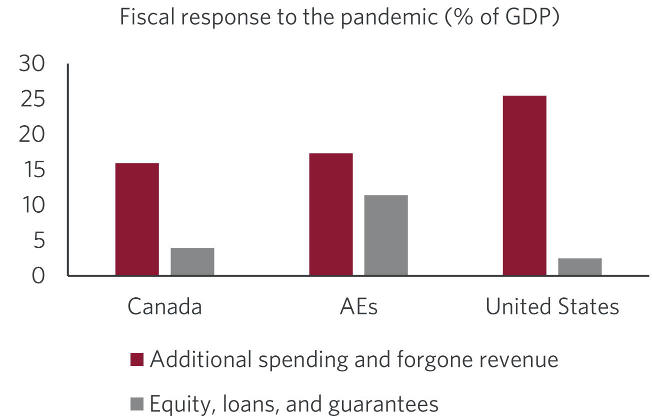
On the other hand, Statistics Canada doesn't gather prices of used cars (Chart 4), missing a key category that has surged in the US lately. But looking at alternative data sources suggests that used car inflation in Canada is nowhere near that in the US. Other categories that have seen rapidly rising prices during the reopening have also been more muted in Canada than in the US. As a result, we can't chalk up the gaps in inflation performance to measurement differences; US inflation is truly showing more heat.

Chart 4: Reopening inflation stronger in the US, but Canada doesn't count used cars



Source: BLS, Statistics Canada

Chart 5: The US has seen a greater fiscal response to the pandemic than Canada



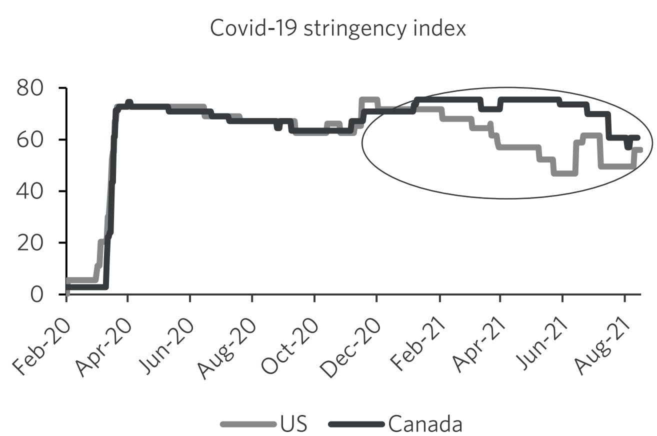
Source: IMF

Explaining the gap

Part of the story of the difference could come from the strength of the Canadian dollar earlier this year. The elevated value of the loonie versus the greenback has shielded Canadians from some price increases on imports. If so, that's a cushion that will begin to fade in the months ahead.

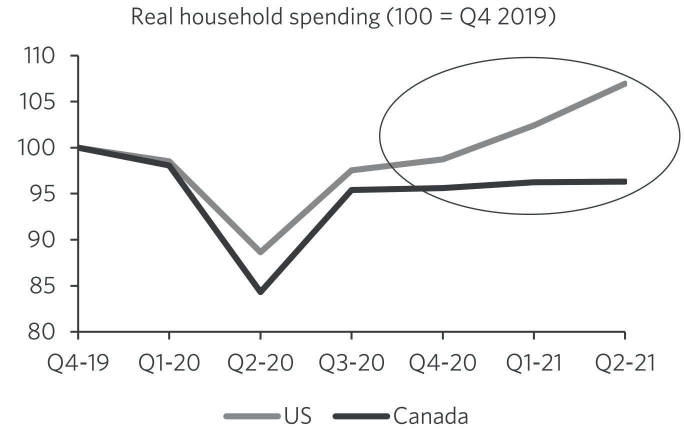
However, two more lasting factors seem more relevant to explaining the divergence and why it could persist. The US has seen far more fiscal support deployed than Canada (Chart 5), particularly in terms of putting money in consumers' pockets. US policymakers have also taken a more aggressive approach to reopening the economy since earlier this year (Chart 6). The latter has given households more time to spend some of that

Chart 6: The US relaxed Covid restrictions much earlier than Canada



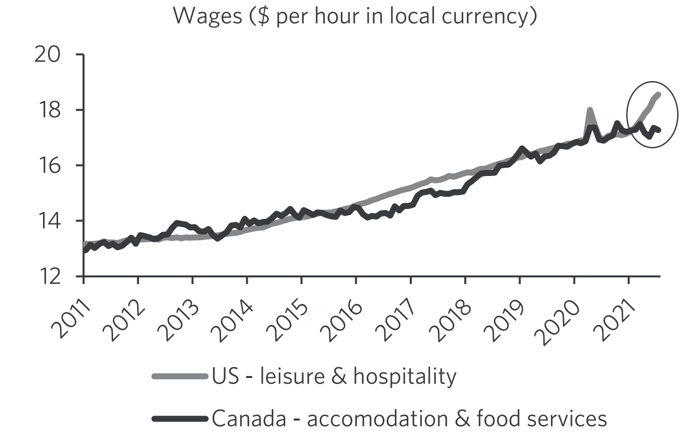
Source: OurWorldinData

Chart 7: Household spending has already surpassed pre-Covid levels in the US



Source: Census Bureau, Statistics Canada, CIBC

Chart 8: High contact services wages in the US have heated up, but Canada has not seen a similar increase



Source: BLS, Statistics Canada

greater fiscal stimulus, driving consumer prices higher in the process (Chart 7).

Labour shortages, as evidenced by high job vacancy rates in both Canada and the US, also seem to have had less of an effect on wages north of the border (Chart 8). It's unclear exactly why wages in high contact services industries haven't been as responsive in Canada. It could be that the longer reopening in the US has left more time and money being spent to drive up compensation. Other possible explanations include the greater use of masks and other containment measures in indoor settings making workers less fearful about returning to their jobs in Canada. Whatever the reasons, for now the calmer waters on the wage front are giving Canadian businesses fewer reasons to raise consumer prices.

While Canada was in the midst of relaxing restrictions earlier this summer, which could have spurred more household spending and driven wages and prices higher, a fourth wave now seems likely to take away at least some of Canadians' newfound freedoms, and temporarily slow the pace of consumer spending growth. That's going to make some businesses think twice about hiking prices this fall and winter, and should leave the gap between US and Canadian inflation intact. As a result, despite the recent pickup in inflation and the fact that some temporary factors might last for some time, we continue to see the Bank of Canada's commitment to keep rates on hold until the second half of next year as appropriate, particularly in light of the weak GDP data just released. That's of course, in contrast to market pricing which is suggesting there's a high probability of the Canadian central bank hiking before the midpoint of 2022, well ahead of its US counterpart.

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