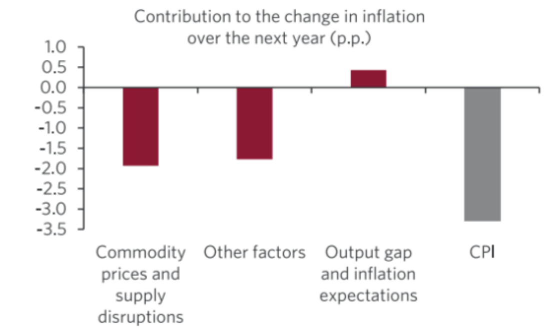
Good policy or good luck

by Karyne Charbonneau

Canada is blessed with skillful central bankers but they will also need luck on their side to bring inflation down.

Chart: Bank of Canada expects decline in inflation to be driven largely by outside factors



Source: Bank of Canada, CIBC

The Bank of Canada's rhetoric has emphasized the role of reducing excess demand to control inflation. But to fight inflationary pressures that are largely global, you need more than good policy. Over the next year, the Bank of Canada projects that inflation will decelerate by 3.3p.p., but a deeper look reveals that a large portion of this dynamic is attributable to factors outside of its control.

About 60% of the deceleration is coming from commodity prices and what they call supply-related disruptions (Chart). Those are the same factors that explain the majority of the Bank's inflation forecast errors over the past year, suggesting they are also the hardest to predict. While we believe that oil prices will not go back to their recent peaks, there is still a lot of uncertainty around their future evolution, which continues to be tied to geopolitical developments. As for supply disruptions, they are largely driven by excess goods demand from American consumers and lockdowns in China. Policies in these countries are therefore key to their resolution.

Then there are the mysterious "other factors". The Bank of Canada argues that parts of this category will respond to interest rate increases because it reflects excess demand not captured by the impact of the output gap. The main "other factor" that may fit the bill is shelter costs. We agree that the cooling of the housing market will help to reduce inflation, but according to the Bank's forecast, the deceleration in shelter inflation accounts for only 0.7p.p. over the next year. That would account for less than half of "other factors".

Overall, this suggests that most of the deceleration over the next year is due to drivers over which the Bank of Canada has little control.

Monetary policy does have a strong impact on two drivers in the Bank's forecast: the output gap and inflation expectations. The central bank wants to prevent an escalation in excess demand. It also wants to prevent the recent uptick in inflation expectations from worsening. In fact, this is the first time that the Bank of Canada has acknowledged above-target inflation expectations are playing a role in its outlook.

To this end, in the Bank's forecast, monetary policy is playing a crucial role in preventing the output gap and inflation expectations from exerting further upward pressure on inflation. This is essential to ensuring that inflation does not become entrenched. Good policy is therefore very important, but it is not sufficient to rein in inflation.

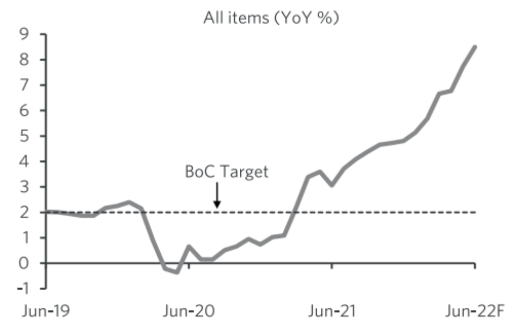
If we don't get a little help from our friends abroad and a healthy dose of luck, we will need a recession to bring down inflation. For now, we'll keep our fingers crossed.

Looking ahead

CPI inflation should have peaked in June at 8.5% year-over-year. While recent pull backs in the prices of oil and some agricultural commodities should provide relief in the future, it will not be apparent in the June CPI data. There was a further increase in gasoline prices in the month relative to May, and with the long lag between changes in agricultural prices and food prices in stores, we are still living through the impact of past increases. But recent developments mean that we should start to see some relief in the months ahead.

Outside of food and energy, we expect CPI inflation to have grown slower on the month and to be roughly stable at an annual rate. Prices linked to the housing market, though still increasing, are not exerting as much upward pressure on CPI as they were just a few months ago.

Chart: Canadian consumer price index



Source: Statistics Canada, Haver Analytics, CIBC

Forecast implications — The ongoing slowdown in the housing market should act to cool inflation in coming months and into next year, while recent declines in commodity prices should start to provide some relief, as early as July in the case of gasoline prices. With the rapid increase in mortgage rates however, expect mortgage interest costs to prop up inflation in the months ahead. Overall, while we see June as the peak, inflation should stay close to 8% through the summer months.

Canadian Forecast Table

Table: Canadian interest rates (end of period)

Variable	2022 28-Jul	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Overnight target rate	2.50	3.25	3.25	3.25	3.25	3.25	3.25
98-Day Treasury Bills	2.66	3.30	3.15	3.00	3.00	2.85	2.60
2-Year Government Bond	2.94	3.15	3.10	3.10	2.85	2.80	2.65
10-Year Government Bond	2.64	3.00	2.90	2.80	2.65	2.60	2.50
30-Year Government Bond	2.76	3.10	3.00	2.90	2.85	2.75	2.55
Canada - US T-Bill Spread	0.27	0.50	-0.23	-0.38	0.20	0.15	0.10
Canada - US 10-Year Bond Spread	-0.02	-0.20	-0.15	-0.15	-0.15	-0.05	0.20
Canada Yield Curve (10-year — 2-year)	-0.30	-0.15	-0.20	-0.30	-0.20	-0.20	-0.15

	Real GDP Y/Y % Chg				Nominal GDP Y/Y % Chg				Unemployment Rate %				Housing Starts 000s Units				Consumer Price Index Y/Y % Chg			
	2020E	2021F	2022F	2023F	2020A	2021F	2022F	2023F	2020A	2021A	2022F	2023F	2020A	2021A	2022F	2023F	2020A	2021A	2022F	2023F
BC	-3.4	5.9	3.2	1.4	-0.5	13.4	8.2	2.7	9.0	6.5	4.7	4.8	37.9	47.6	43.0	39.0	0.8	2.8	6.6	2.1
Alta	-7.9	5.1	4.8	2.5	-16.1	22.1	23.8	0.5	11.5	8.6	6.5	6.1	24.0	31.9	39.0	42.0	1.1	3.2	5.7	1.8
Sask	-4.9	0.0	4.1	2.5	-6.6	13.0	21.1	1.5	8.4	6.5	5.0	4.8	3.1	4.2	6.0	5.0	0.6	2.6	6.2	1.9
Man	-4.6	1.5	3.7	1.7	-1.4	7.5	9.0	3.0	8.0	6.4	4.8	5.0	7.3	8.0	9.0	8.0	0.5	3.2	7.0	2.0
Ont	-5.1	4.4	3.1	1.3	-2.8	10.9	9.1	2.6	9.6	8.0	5.4	5.6	80.8	99.6	85.0	77.0	0.6	3.5	6.6	2.0
Qué	-5.5	5.6	3.1	1.2	-2.4	12.1	9.1	2.6	8.9	6.1	4.6	4.9	53.4	67.8	57.0	49.0	0.8	3.8	6.2	1.9
NB	-3.2	5.3	2.3	1.2	-1.3	11.3	7.3	2.5	10.1	8.9	7.9	8.1	3.5	3.8	4.5	4.0	0.2	3.8	6.9	1.9
NS	-2.5	5.8	1.9	1.8	0.7	11.8	6.9	3.0	9.8	8.4	6.8	6.8	4.8	6.0	6.5	5.5	0.3	4.1	6.8	1.8
PEI	-1.7	6.6	1.8	2.1	0.9	12.6	6.8	3.5	10.6	9.3	8.6	8.3	1.2	1.3	1.0	1.5	0.0	5.1	8.1	2.1
N&L	-5.4	1.2	3.9	1.5	-10.7	14.2	20.9	-0.5	14.2	12.9	11.6	11.4	0.8	1.0	1.5	2.0	0.2	3.7	6.3	2.0
Canada	**-5.2**	**4.5**	**3.4**	**1.5**	**-4.5**	**13.0**	**11.6**	**2.2**	**9.5**	**7.4**	**5.4**	**5.5**	**217**	**271**	**253**	**233**	**0.7**	**3.4**	**6.4**	**1.9**

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Sources: Statistics Canada, Bank of Canada, CIBC World Markets Inc.