Special Report

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HIGHLIGHTS

- **In this report, we answer a few of the more common questions we receive from clients on Canadian inflation.**
- **Why is the reported inflation rate by Statistics Canada so low when prices for everything appear to be going up?**
- **Why does the central bank tend to focus on a core measure of inflation that strips away some of the most important prices like gasoline?**
- **If the Canadian dollar is at parity, why are we still paying more for identical goods than Americans?**
- **Is the Canadian dollar providing any benefits in the form of lower prices?**
- **What impact has the harmonized sales tax (HST) in Ontario and B.C. had on retail prices?**
- **Why have gas prices been so high recently?**
- **What's the outlook for inflation? Will gas and food prices continue to rise?**

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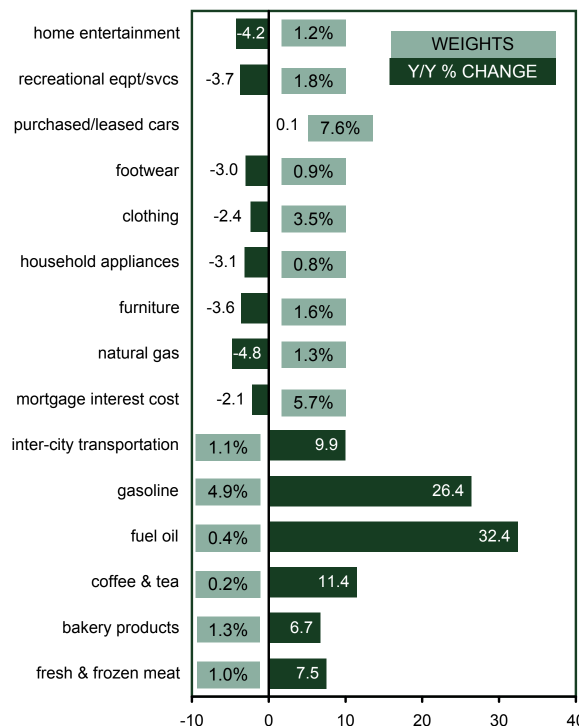
ANSWERS TO COMMON QUESTIONS ON CANADIAN INFLATION

When we speak to clients, few economic indicators generate the same number of questions as inflation. Why does the central bank strip away gasoline prices from its chosen measure of consumer price inflation? How is it that Canadian prices are higher than U.S. prices when the currency is at parity with the U.S. dollar? In particular, we find there is often skepticism that the measured inflation rate – currently 3.3% on a year-over-year basis – accurately captures the true increases in the cost of living. In this report, we attempt to provide answers to some of the most frequent questions pertaining to trends in consumer prices.

Why is the reported inflation rate by Statistics Canada so low when prices for everything appear to be going up?

The consumption basket used by Statistics Canada to derive the Consumer Price Index (CPI) reflects the aggregate spending mix of Canadians. As such, it is unlikely that a household's inflation rate will match that of the nation as whole, and depending on how an individual's consumption patterns differ from this "average", the variation in inflation can be significant. For example, rented and owned accommodation account for 5% and 17% of the national CPI, respectively. However, if a household rents, then it likely does not own, and vice-versa, so few Canadians will have a consumption pattern that precisely matches the national average.

CHART 1: SELECTED CONSUMER PRICE INDEX COMPONENTS - APRIL 2011



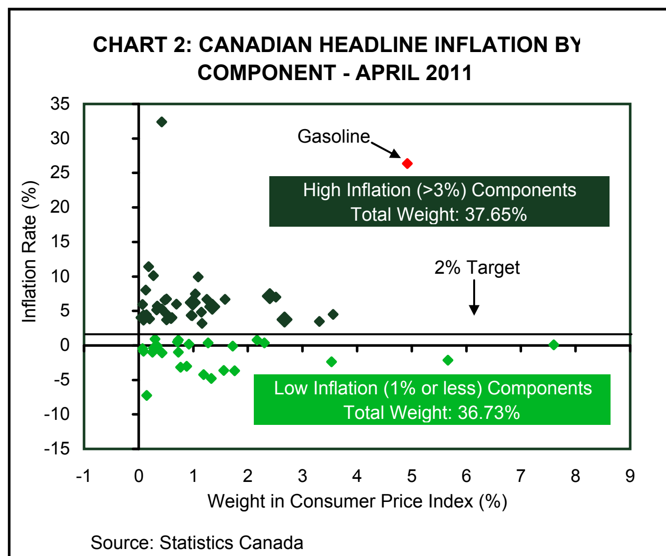
Source: Statistics Canada

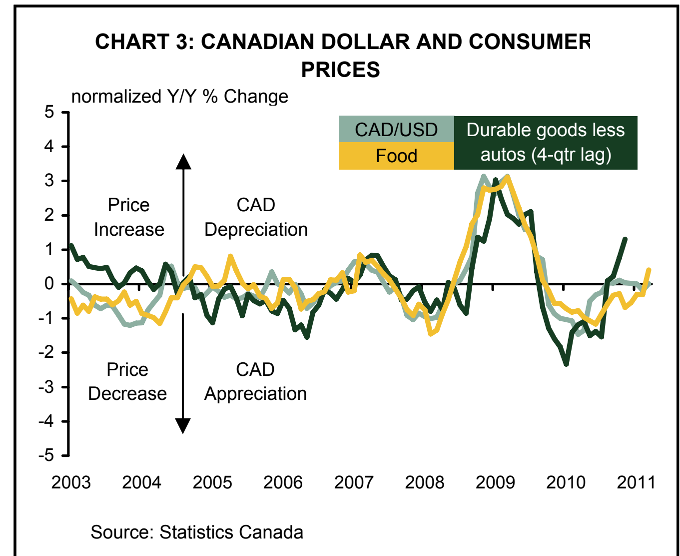
Another part of the answer lies in perception. It is natural for an individual to put the emphasis on prices that are rising rapidly, especially when the most visible price of all – gasoline – is leading the upward charge. Yet, as we show in the chart, there are a number of prices that are either flat or falling that has kept the overall level of inflation in check. Lower interest rates have led to outright declines in

mortgage interest costs, clothing prices have been on a continuous decline since 2000, and auto prices have stagnated since the recession (Chart 1). In fact, in April's inflation report, for every component that recorded a relatively high inflation rate of greater than 3% there was a corresponding component with equal weight that recorded a low inflation rate of less than 1% (Chart 2). Furthermore, some prices for rapidly-advancing computers and internet access services are adjusted downward to build in the impact on consumer value from quality improvements.

Why does the central bank tend to focus on a core measure of inflation that strips away some of the most important prices like gasoline?

The Bank of Canada's (BoC) over-riding goal is to achieve a 2% inflation rate over the medium term. The challenge that the BoC faces is that a number of prices are notoriously volatile – such as fresh fruits and vegetables, gasoline, and natural gas. For example, global food commodity prices, as measured by the UN food price index, rose by almost 70% over an 18-month period, reaching their peak in June 2008. However, by February 2009, prices had given back all of those gains and returned to their pre-2007 level. In Canada, retail food inflation recorded similar volatility, rising to 8% in March 2009, only to fall back to 1.7% by November. These type swings can distort the underlying inflation picture and complicate the central bank's task of setting an appropriate level of short-term interest rates. As a result, it puts considerable short-term weight on a measure of inflation that excludes these volatile components, referred to as the core inflation rate. The Bank of Canada's ability to look past what it deems to be "temporary" increases in





food and energy prices is due to its success in anchoring inflation expectations. In the 1970's in both Canada and the U.S., major increases in energy prices would spread to broad wage and price inflation. With expectations now pinned at close to 2%, the risk of a wage-inflation spiral is much lower.

If the Canadian dollar is at parity, why are we still paying more for identical goods than Americans?

The higher prices that Canadians pay compared to Americans for identical goods and services cannot be boiled down to one or two factors. The relatively small size of the Canadian market, lower degree of competition and higher prices dictated by manufacturers through contracts are often cited as key reasons for the price differentials. The relatively small size of the Canadian market translates into higher costs of shipping and distribution of goods. For some consumer items, differences in tax structures can drive a wedge between prices on both sides of the border. For instance, in Canada, federal and provincial excise taxes account for as much as one-third of the price at the pump whereas in the U.S. it is closer to 10%.

Is the Canadian dollar providing any benefits in the form of lower prices?

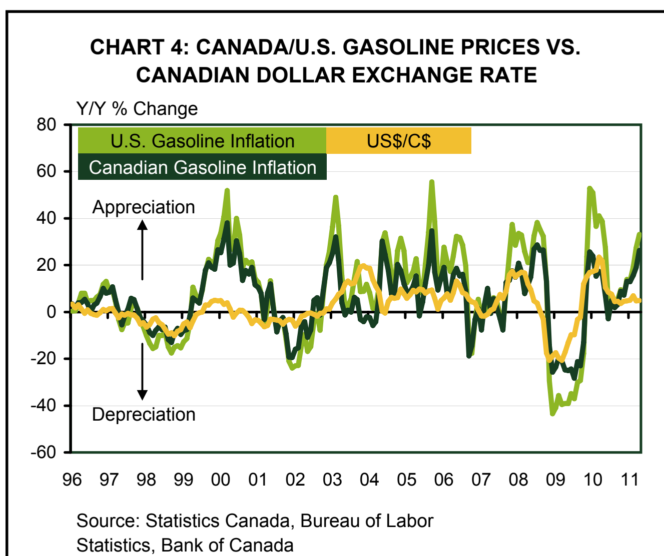
Yes, we do believe that a high Canadian dollar is translating into some benefits to consumers in terms of lower prices, but it is not substantial and it is limited to specific types of goods. Prices of durable goods – such as furniture, home appliances – and any sector that has a highly traded component – such as food – tend to move in the opposite direction of the Canadian dollar. This is apparent when movements in the currency are charted against movements in the prices of these goods. (Chart 3). And in light of the

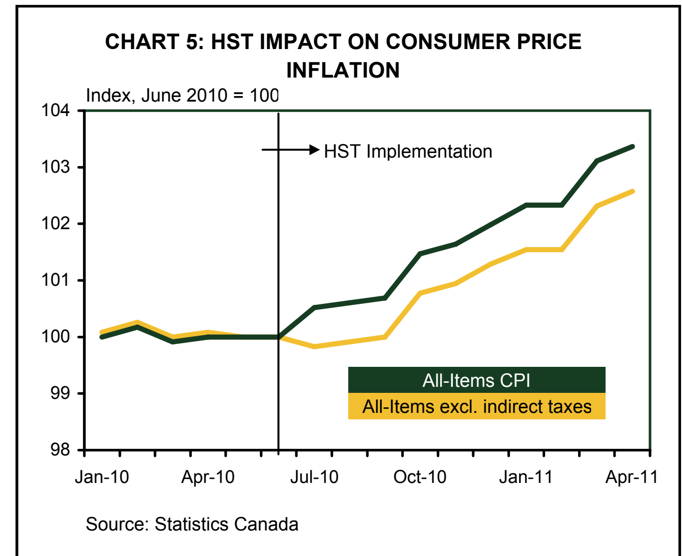
strength of the Canadian currency over the past year, it is no coincidence that some of these areas are posting some of the weakest increases in prices on a year-over-year basis within the CPI. Given the usual lags due to pre-buying of retail goods, some of the benefit of this past year's currency surge may still be forthcoming. Still, the focus in Canada remains on the fact that price convergence between domestic prices and those in the U.S. remains elusive.

There is an interesting relationship between the Canadian dollar and gasoline prices. Both are heavily linked to crude oil prices and tend to rise and fall together in lockstep. This fact helps to create a shock-absorber effect whereby large swings in oil prices translate into lesser swings in prices at the pump in Canada relative to the United States (Chart 4). The other factor that generates a relatively more stable trend in gasoline prices is the higher tax burden in Canada.

What impact has the harmonized sales tax (HST) had on retail prices?

In June of 2010, TD Economics estimated that roughly 17% of the CPI would be immediately boosted by the implementation of the HST in B.C. and Ontario. Indeed, in July 2010, 17% of the CPI exhibited a material increase in prices. The increase was concentrated in household goods and services – such as natural gas, electricity, and internet services – while other notable impacted categories included recreational services, tobacco, and gasoline. In order to isolate the impact of the HST, Statistics Canada calculates a consumer price index that excludes the impact of indirect taxes. The data from June 2010 onwards indicate that the HST drove prices up nationally by about 0.8 percentage points, creating a gap between the two indexes (Chart 5). In B.C. and Ontario, where the HST was implemented, the gap was estimated by Statistics Canada to be 1.5 percentage points.





That being said, the implementation of HST, which economists have heralded as a productivity-enhancing reform, was meant to eliminate what is referred to as shadow taxation. Previously, businesses were unable to claim the provincial sales tax paid on intermediate inputs and passed on those increased costs to consumers. Implementing the HST meant that businesses could claim the full amount of tax paid on those inputs and that those cost savings would eventually be passed onto consumers. This takes time, however, and TD Economics expects about half of the 0.8 percentage point gap to close within the next two years as businesses pass on those cost savings.

Why have gas prices been so high recently?

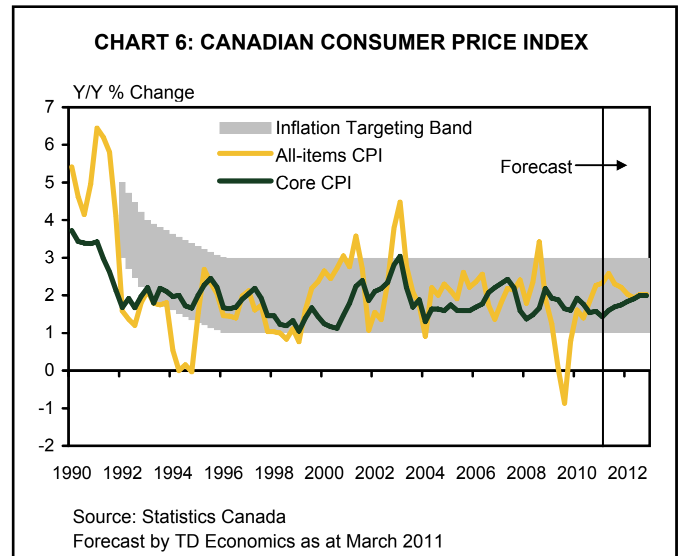
Many Canadians remember that in mid-2008, crude oil was trading above $140 per barrel and the price at the pump was running at around $1.40 per litre. In May, gasoline prices again hit that $1.40 per litre and yet crude oil prices were only around $100-$115 per barrel. Moreover, there has been a period when crude prices were actually pulling back while gas prices were still rising. These recent developments have puzzled consumers.

The main reason for this apparent anomaly is the relative tightness of the wholesale gasoline market in North America. In short, refineries have not been keeping up with demand. Oil refinery utilization rates have been quite low throughout 2010 and 2011 and have only recently begun to perk up. As a result, continent-wide gasoline inventories have declined substantially, hitting a mult-year low. Inventory levels in early May were more than 15% lower than they were in

February, and there were additional concerns surrounding refinery capacity given the threat of flooding in key refining states along the Mississippi river. A comparison of Canada and U.S. gasoline prices point to similar trends in pump prices adjusting for the impact of the Canadian dollar. It is our expectation that while there is likely to be some easing in the tightness in the wholesale market, Canadian gasoline prices will remain elevated (i.e., above $1.20 per litre) through the peak summer driving season.

What's the outlook for inflation? Will gas and food prices continue to rise?

TD Economics' baseline view is that headline inflation will fall back in the coming quarters and converge on the trend rate of 2% (Chart 6). As long as gasoline prices do not embark on another leg up, the upward pull of recent increases in CPI inflation will begin to fade in the coming months. Food prices will continue to be among the bigger pockets of upward price pressure as the impact from last year's increases in global food commodity prices moves down the supply chain to Canadian retail stores. Other prices, on average, are likely to edge up but remain at or below 2%. This is consistent with a relatively high unemployment rate and still-benign wage pressures.



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