Economic News

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CANADA

The currency effect on inflation cannot be ignored

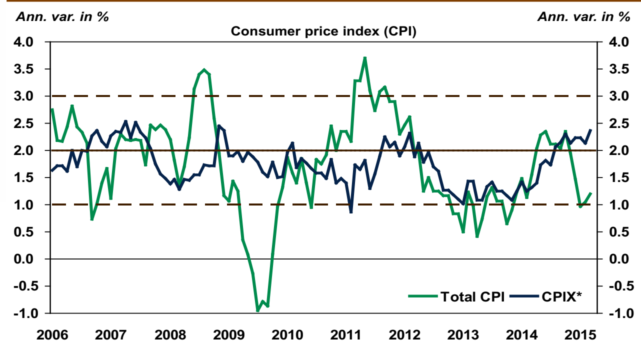
The oil price correction has triggered a major decrease of inflation in several advanced countries since mid-2014. Canada was not spared, with inflation falling from a little more than 2.0% in mid-2014 to 1.2% in March 2015. This retreat is directly attributable to the price of gas at the pump, which has posted an annual decrease of around 20%.

One might have thought that such a sharp fall in gas prices would have led to a more generalized decrease in consumer prices, particularly through lower transportation costs. Instead, Canada is seeing some acceleration in most prices, as demonstrated by the 2.4% increase in inflation measured by the Bank of Canada's (BoC) core index (which excludes eight of the most volatile components and the effects of indirect taxes) in March, its highest level since 2008.

It is fairly clear that acceleration in core inflation stems in part from the weak Canadian currency, which has fallen around 15% from mid-2014 to the end of March 2015. We note that certain inflation-boosting components include a high proportion of imports, such as clothing and travel tours. In its April *Monetary Policy Report*, the BoC estimates that depreciation of the exchange rate actually adds 0.3% to 0.4% to the core inflation rate.

In the same report, the BoC seems to want to ignore the currency effect on inflation. As such, it deems that underlying inflation is below 2.0%. It is normal for central banks to ignore temporary external shocks, such as the recent dive in oil prices. The erosion of the Canadian dollar is, however, a different phenomenon, as it partially reflects Canadian monetary policy. While the BoC is not directly targeting an exchange rate level, this variable is one of the transmission mechanisms by which monetary policy influences the economy and inflation in Canada. Governor Poloz recently noted that the key rate cut in January led to lower rates across the entire yield curve and a lower Canadian dollar. The strength of core inflation should therefore be seen, in part, as a consequence of very expansionist monetary policy. Given that BoC leaders seem to especially fear too-low inflation, this is a positive consequence, and proof of the effectiveness of monetary policy.

Core Canadian inflation in March at its highest since the end of 2008



* Bank of Canada's core index.
Sources: Statistics Canada and Desjardins, Economic Studies

Implications: Given the weakness in total inflation and the downside risks weighing on the Canadian economy, it is perfectly acceptable at the moment to tolerate core inflation slightly above the 2% target. However, the effect of the Canadian dollar on inflation should not be ignored for too long. All other things being equal, the weaker the dollar and the higher the core inflation rate, the more important it will be for the BoC to begin quickly tightening its monetary policy once the effects of falling oil prices on the economy and total inflation disappear. As such, we are calling for a very gradual increase in key Canadian rates beginning around mid-2016.

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