BBVA Research Flash

Canada

Higher inflation shifts Bank of Canada's attention

- **September core inflation increases from 1.9% to 2.2%, exceeding expectations and converging faster to the policy target, reaching 1.9% for 2011Q3 (BBVA: 1.7%)**
- **Headline inflation for 2011Q3 chimes in at 3.0% (BBVA: 2.9%)**
- **Uncertain external demand still suggests a tentative policy response, although higher inflation dispels views of rate cuts**

The core index's advance today represented the largest YoY increase since December 2008. September's core inflation data was heavily influenced by prices of passenger vehicles, clothing and auto insurance premiums. Headline inflation for the month also exhibited stronger effects of volatile price components than we expected, increasing 3.2% YoY for September (BBVA: 2.9%) on top of pressures from food and gasoline prices. The effects of these volatile components have been stronger than we previously expected. The data underscore our long-held expectation of no rate cuts in 2011 for the Bank of Canada (BoC).

BoC will continue to thread the needle between strong internal demand and an uncertain external environment. While BoC must be wary of slightly frothy housing and consumption indicators, it must also keep an eye on the interest rate differential between the Federal Reserve and concomitant currency competitiveness issues. Canada is not in risk of recession, but growth will not blow the doors off of market observers: we currently expect 2.1% GDP growth in 2012. BoC will also respond flexibly to inflation given many uncertainties stemming from the European sovereign debt negotiations that impact Canada's external demand environment. Next week, we expect Retail Sales to rebound from an exceedingly bad July figure and for the BoC Rate to remain at 1.0%. Our forecast remains for a next rate increase in June 2012. Two factors may influence this rate increase in the near term: European sovereign debt negotiations and emerging markets' growth rates. Both issues will affect demand for commodities and improve the external component of Canadian GDP, but both may not necessarily occur at the same time or in the same direction. As such, BoC will still be reading the dials on a variety of figures due in the next few weeks: retail-related consumption, monthly GDP, and the outcome of European negotiations.

Nathaniel Karp
Nathaniel.Karp@bbvacompass.com

Ignacio San Martin
Ignacio.Sanmartin@bbvacompass.com

Marcial Nava
Marcial.Nava@bbvacompass.com

Jeffrey Owen Herzog
Jeff.Herzog@bbvacompass.com

Hakan Danış
Hakan.Danıs@bbvacompass.com

Jason Frederick
Jason.Frederick@bbvacompass.com

Boyd Stacey
Boyd.Stacey@bbvacompass.com

Kim Fraser
Kim.Fraser@bbvacompass.com

BBVA RESEARCH | 2001 Kirby Drive, Suite 310, Houston, TX 77019 USA | http://www.bbvaresearch.com/ | Follow us on Twitter