Canada Flash

Level effects and softening energy prices pull down CPI

Canadian CPI cooled on both a MoM and YoY basis in March to 0.4%MoM and 1.9%YoY. The drop in the YoY rate is largely due to the level effect from March 2011. Essentially, the abnormally high food and energy prices of early 2011 muted the 12-month increase in inflation. Moreover, the MoM rate would be unaffected by the year-ago rate and yet it also showed signs of moderating inflation pressures. The fact that MoM annualized rate of inflation was 2.0%, and that food and energy prices softened (-0.5%MoM in March) suggests inflation could be moderating. On core inflation, the trends appear consistent with the Bank of Canada's(BoC) expectations of converging core and headline inflation at around 2.0%(Core:1.98 Total:1.93). However, the anticipated schedule appears accelerated, as the BoC's most recent forecasts assumed convergence in 2Q12. Thus, the recent softening could allow the Bank of Canada to delay adjusting its accommodation.

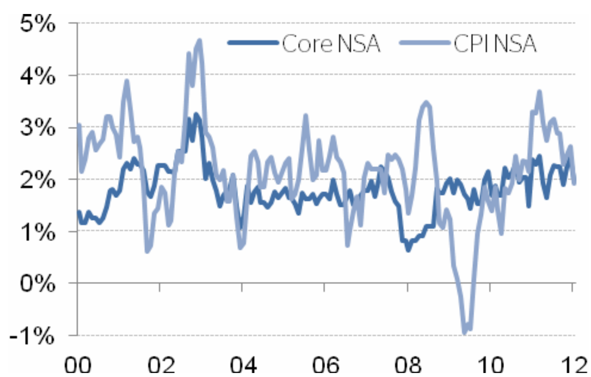
- **Level effect pulls down headline inflation**

  While energy and food prices cooled on a MoM basis, the biggest contributor to the 0.7pp drop in CPI inflation was the level effect from March 2011. The commodity price run-up in 2011 created high levels of inflation in Canada. In addition, there were regional tax increases that added to the upward pressure on prices. Thus, due to these statistical effects, inflation in March plummeted on a YoY basis. Regardless of yearly statistical effects, MoM consumer price inflation was also below consensus expectations and at an annualized rate was at the BoC target of 2.0%. Moreover, food and energy, which contribute to about 30% of consumer price inflation declined by 0.5%MoM. As such, inflation trends may be cooling early than anticipated.

- **Markets price in interest rate increases in October, inflation data suggest otherwise**

  Currently, options markets have nearly priced in a 0.25% interest rate increase in October 2012. This movement is likely a reflection of the revised policy statement communication. However, given the Bank's target of 2.0% inflation in the long-run, no clear signs of strong growth, and persistent external risks, we believe there is no strong impetus for an immediate interest rate increase. Assuming inflation continues to cool, we are still at the jawboning stage of the BoC for the near-term.

Chart 1
Canada Headline and Core Inflation
In YoY % Change, Not Seasonally-Adjusted



Source: Haver Analytics