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Economic Development Winnipeg

WEEKLY ECONOMIC DIGEST

LATEST INFLATION FIGURES - MUCH ADO ABOUT NOTHING

BASE YEAR (2020) AND TRANSITORY EFFECTS ARE DRIVING THE CURRENT INFLATION SURGE.

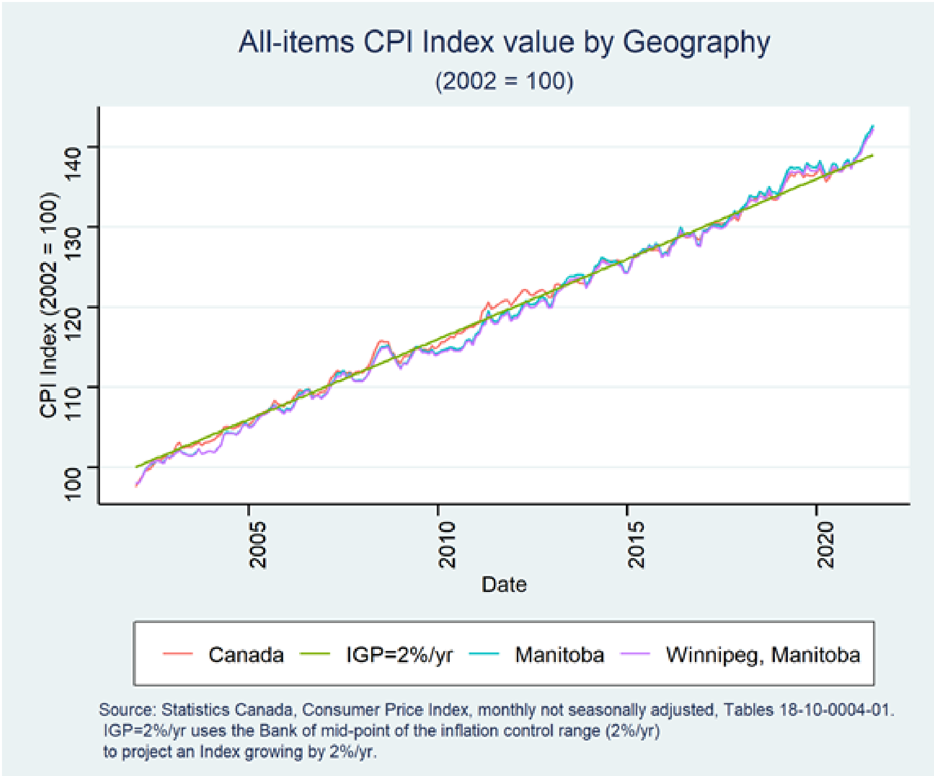
Chris Ferris, Senior Economist

Bottom Line

The adoption of inflation targeting in 1995 has proven to be one of the great wins of Canadian macroeconomic policy. Inflation expectations are firmly anchored at the Bank of Canada's targeted rate of 2 per cent – the centre-point of the control range of 1 to 3 per cent. The Bank of Canada's inflation targeting regime aims to bring CPI inflation within the control range over a 24-month period.

Too much or too little inflation can be harmful to the economy, thus changes to inflation attract significant attention by the media, politicians, policy makers, and other actors in the economy when inflation falls outside of that control range. In this issue we review changes to CPI inflation considering the effects of the COVID-19 pandemic. **Weak prices in 2020 led to low base-year prices, leading to what appears to be strong price increases as the economy recovers. At this point in time, it appears that these items are primarily transitory (temporary) in nature**, however it is always important to watch prices and the real drivers of them in case the increases become structural in nature.

CONSUMER PRICE INDEX ANALYSIS



All-items CPI for Canada, Manitoba and the Winnipeg CMA

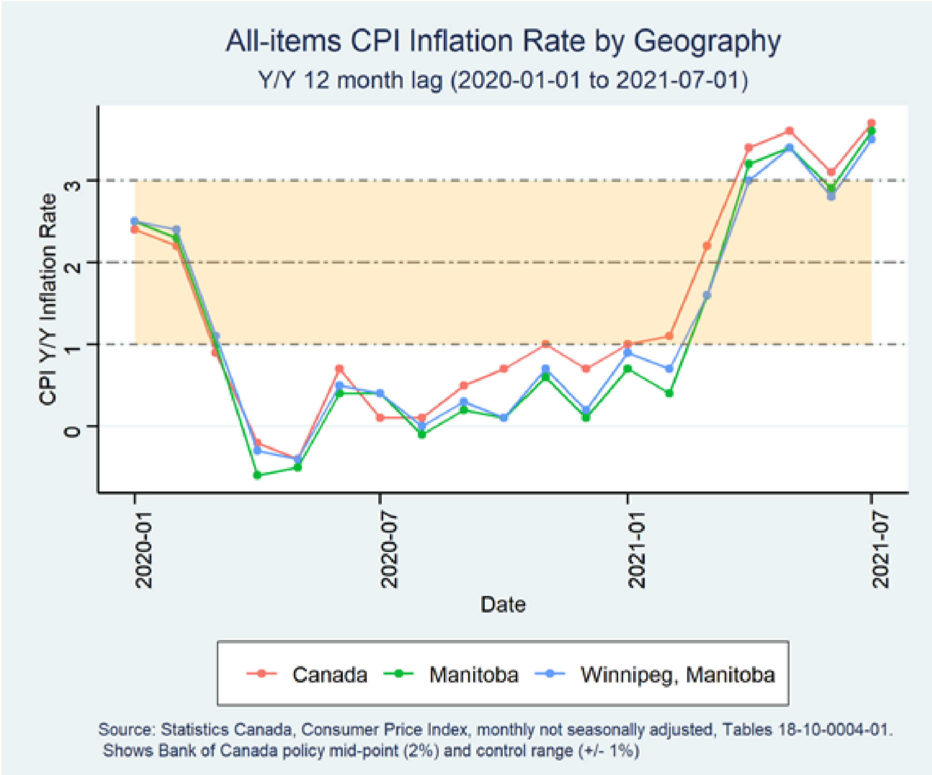
The COVID-19 pandemic lockdowns and various restrictions have played uneven havoc on labour markets, industrial sectors, and consumer prices. For reference, we are looking at the monthly consumer price index for July 2021, which was released by Statistics Canada on August 18, 2021.

This week we are reviewing the all-items Consumer Price Index (CPI), monthly, not seasonally adjusted price series - for Canada, Manitoba, and the Winnipeg CMA.

We know that the Bank of Canada’s annual inflation target has a mid-point of 2% per year. We constructed a time series set equal to 100 in January 2002 and increasing linearly by 2% per year up to the current date (IGP=2%/yr). When plotted with the actual all-items CPI price series for Canada, Manitoba, and Winnipeg CMA, we can see that the fit is quite tight, implying that **inflation is still well anchored to inflation expectations**.

Source: Statistics Canada, Table 18-10-0004-01, Consumer Price Index, monthly, not seasonally adjusted.

CPI INFLATION



Low Base Year (2020) Effects

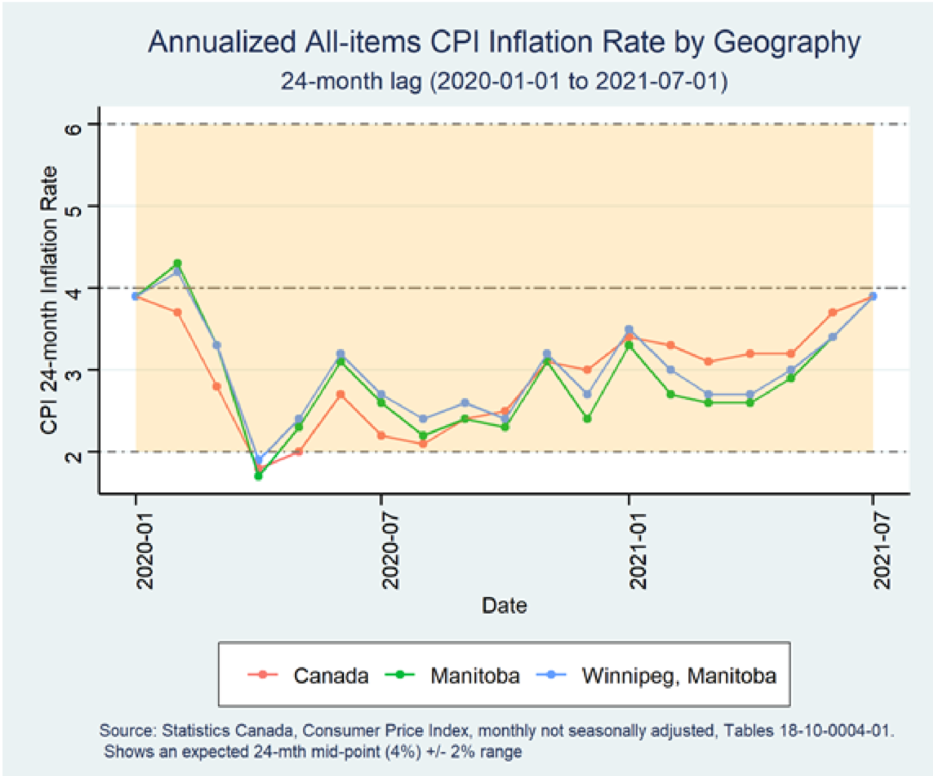
The chart above shows the year-over-year change in the CPI (inflation). For March 2020 to February 2021 (vs March 2019 to February 2020, respectively), there was a relatively sharp drop off in the CPI index. This softening of prices was induced by the COVID-19 pandemic and reactions to it.

We see inflation in the March 2020 to February 2021 period falling well below the Bank of Canada's inflation control range of 2% +/- 1%. **Due to base year effects (the weakened CPI during this period) we can expect to see inflation tend to be strong between March 2021 through February 2022**.

This is in-line with the Bank of Canada's July 2021 Monetary Policy Report's statement on page 16: "*CPI inflation has increased in recent months and is expected to remain at or above 3 per cent for the remainder of 2021*."

Source: Statistics Canada, Table 18-10-0004-01, Consumer Price Index, monthly, not seasonally adjusted.

CPI INFLATION



Stripout base year effect - 24-month lag

Making comparisons over time has become more challenging than the automatic application of a year-over-year comparison. In some cases, we have resorted to comparing to a pre-pandemic base (e.g., February 2020). In other cases, we have been able to switch to year-over-year analysis again since the time series has been recovered long enough so that comparisons are no longer showing a false-positive gain due to a low base period.

To strip out the CPI base year effect coming from March 2020 to February 2021, we calculated a 24-month lag, instead of a 12-month lag. This allows us to compare July 2021 to July 2019. We would expect to see inflation average around 4 per cent over two years, with an expected range of +/- 2%. We can see that July 2021's 24-month lagged value is approaching the mid-point of this adjusted control range. **This illustrates the importance of thoughtfully considering base year effects, particularly for a highly visible time series like inflation.**

Source: Statistics Canada, Table 18-10-0004-01, Consumer Price Index, monthly, not seasonally adjusted.

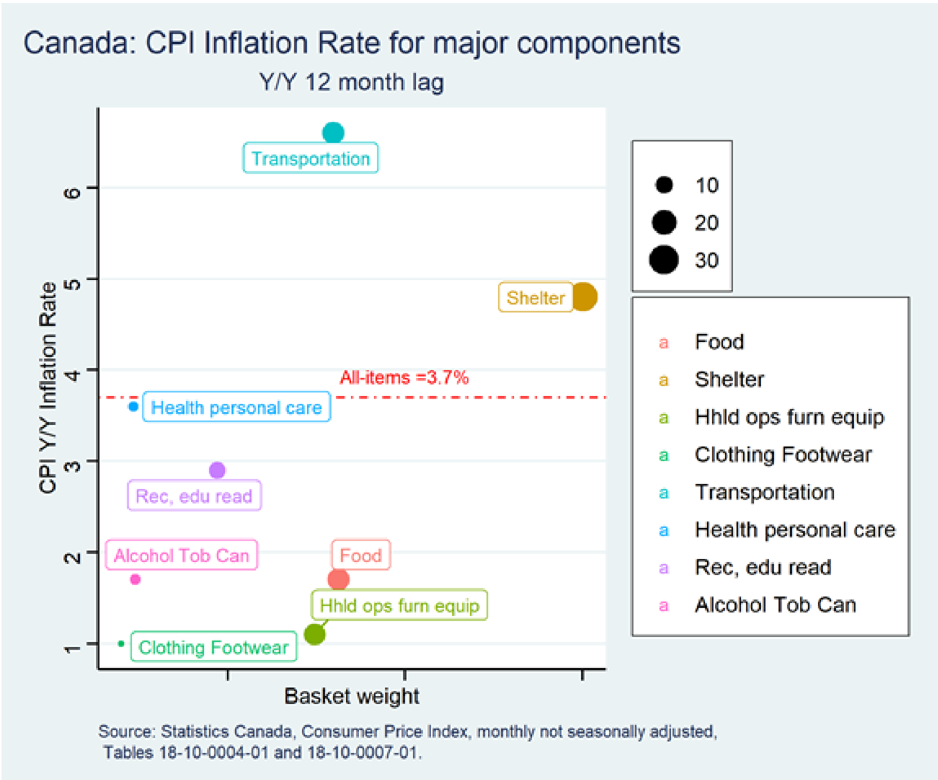
CPI INFLATION - BY MAJOR COMPONENT

Transitory or Temporary Effects

The Bank of Canada's July 2021 MPR analysis goes on to describe transitory effects:

1. After weaking due to the pandemic (due to falling demand), **gasoline prices** now exceed pre-pandemic levels,
2. **Other prices** that likewise weakened due to the pandemic (falling demand) are recovering with the reopening of the economy, and
3. **Supply constraints** (e.g., shipping bottlenecks, and shortages of semi-conductors) are putting upward pressure on prices of goods like motor vehicles.

These **transitory effects** are expected to fade-out over time as value chains adjust, similar to how random-length lumber prices have come down sharply after peaking in May 2021.

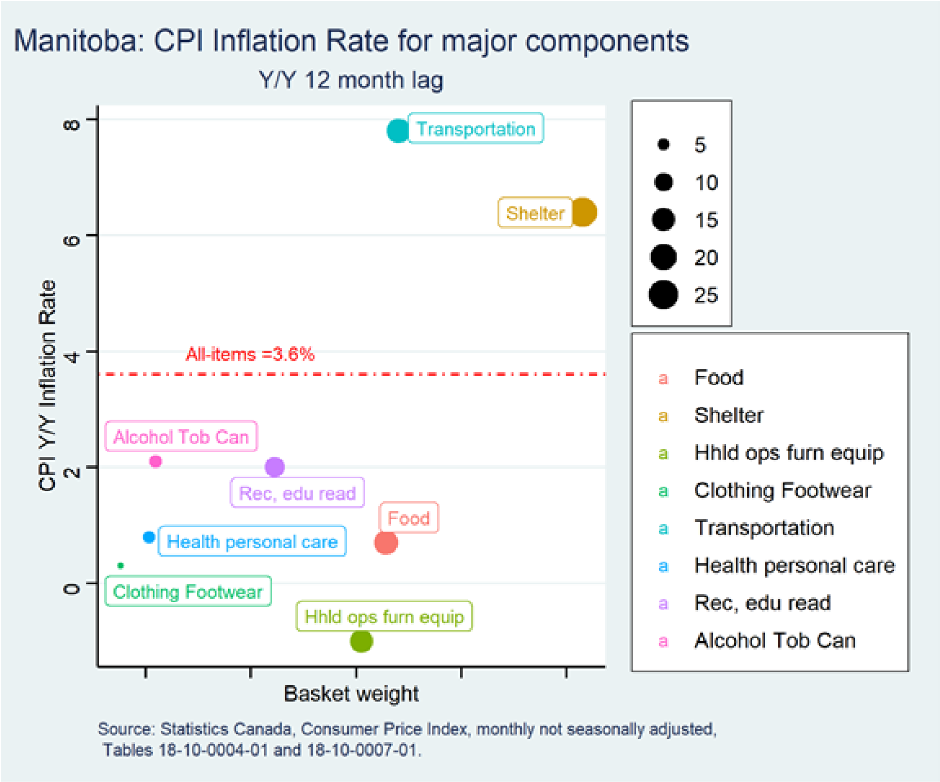


Consider July 2021 Y/Y Inflation by Major Components

In July 2021, Canada's all-items y/y inflation rate is being pulled higher by the major categories of **Transportation** (includes fuel) and **Shelter**. These are two of the large weight components of the CPI Index.

Source: Statistics Canada, Tables 18-10-0004-01, and Table 18-10-0007-01. The chart above uses 2020 basket weights to adjust the size of the inflation rate points by major component.

CPI INFLATION - BY MAJOR COMPONENT



In July 2021, Manitoba's all-items y/y inflation rate is likewise being pulled higher by the major categories of **Transportation** (includes fuel) and **Shelter**. These are also two of the largest weight components of the CPI Index in Manitoba.

Note: The chart above uses 2020 basket weights to adjust the size of the inflation rate points by major component.

INQUIRIES AND CONTACTS

If you require help accessing government programs, contact our YES! Winnipeg team through the **Help us help you form**.
General inquires: **wpginfo@edwinnipeg.com**
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