FEBRUARY 3, 2022, VOLUME 3, ISSUE 2

Economic Development Winnipeg

WEEKLY ECONOMIC DIGEST

INFLATION AND ADJUSTMENTS TO MONETARY POLICY

IMPLICATIONS FOR MANITOBA: NEED TO ADJUST PLANS FOR BORROWING AND DEBT REPAYMENT

Chris Ferris, Senior Economist

Bottom Line

Canada's Consumer Price Index (CPI) inflation rate fell below two per cent from March 2020 to February 2021. CPI inflation has been above two per cent since March 2021 and has exceeded three per cent since June 2021. 2021's inflation strength is due to the resulting weak base year effects, sector rebalancing and economic recovery in 2021.

Prices were pressured higher by rising commodity prices, various supply chain disruptions, supply shortages of various intermediary goods and a tightening aggregate labour market. The Bank of Canada expects to see inflation pressures (particularly from crude oil and supply chain disruptions), easing in the second half of 2022.

During the downswing in 2020, the Bank of Canada loosen policy, and has been tightening up policy on the upswing during 2021. While the bank did not change the overnight rate on January 26, 2022, and did not start shrinking its bond holdings, it did remove the extraordinary forward guidance. The Bank has indicated that a series of rate hikes are coming, and that their bond holdings will be shrinking – with the timing and strength of moves related to economic data. This could begin as early as the March 2, 2022, announcement date.

The Bottom Line (Continued)

While the Bank has not laid out an exact interest rate hike pattern, we could easily see 3 or 4 rate hikes occurring between now and the end of January 2023. Also, some level of shrinkage in their bond holdings over the next year. **So it would be prudent to review your borrowing and debt repayment plans and then adjust where needed**.

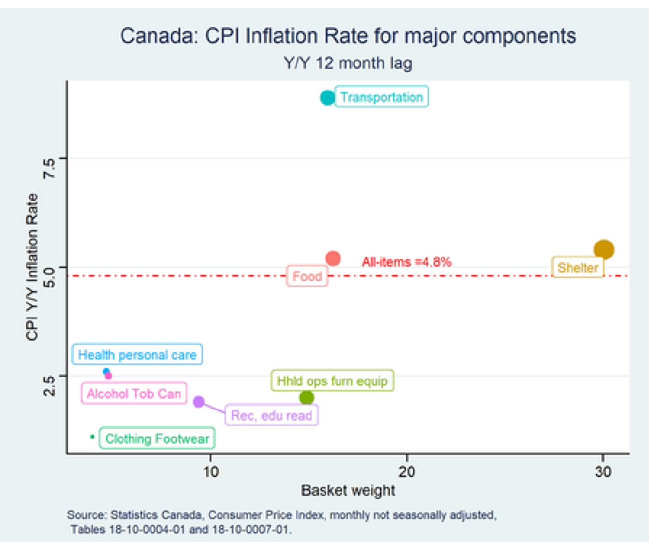
ANALYSIS

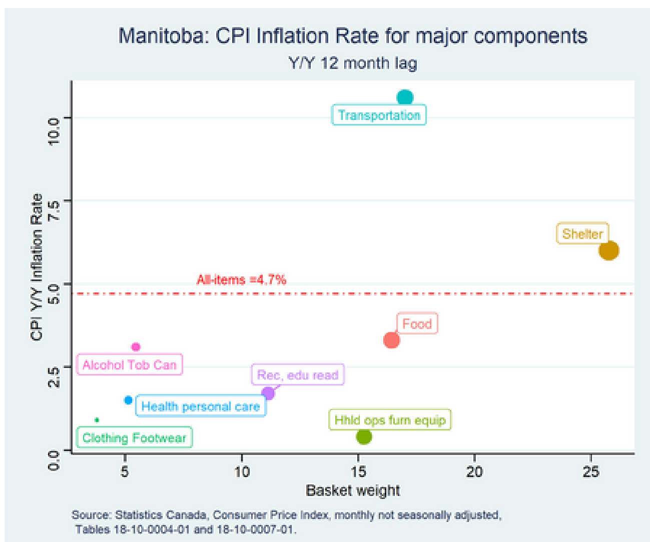
December 2021 CPI

Statistics Canada released the December 2021 CPI on January 19, 2022. On a year-over-year basis, CPI inflation was 4.8 per cent for Canada, 4.7 per cent for Manitoba, and 4.4 per cent for the Winnipeg Census Metropolitan Area (CMA). We may be seeing a turning point in all three geographies, with the all-items index falling month-over-month.

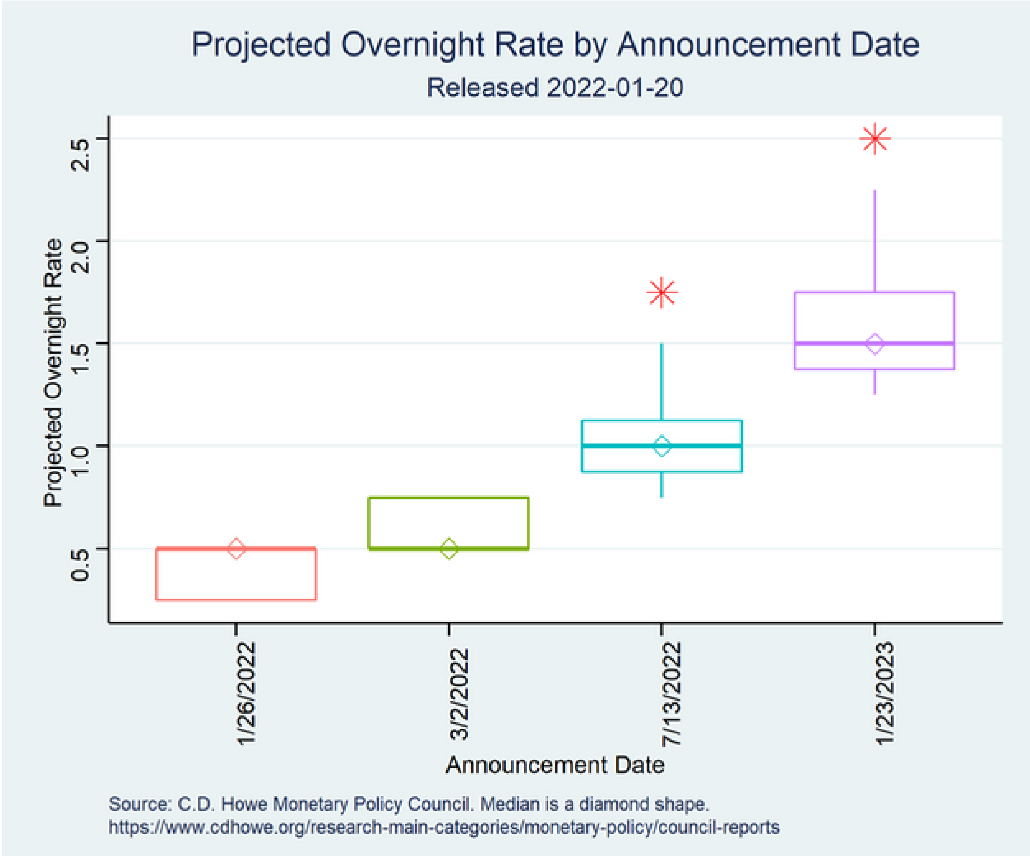
All-items Consumer Price Index			
Change	Canada	Manitoba	Winnipeg CMA
Year/Year	4.8%	4.7%	4.4%
Month/Month	-0.1%	-0.5%	-0.5%

The two major components exceeding the average inflation rate for both Canada and Manitoba are **transportation** (driven by rising gasoline prices – after the sharp drop in 2020), and **shelter**. For Canada, **food** prices are also above the average inflation rate.





THOUGHTS AROUND THE RATE ANNOUNCEMENT



C.D. Howe Monetary Policy Council

On January 20, 2022, the C.D. Howe [Monetary Policy Council] (MPC) had posted its thoughts on the Bank of Canada's rate announcements. Their median votes were for:

- January 26, 2022, rising to 50 basis-points,
- For the next announcement (March 2, 2022), holding at 50 basis-points,
- At six months out (July 13, 2022), increasing to one per cent, and
- A year-out (January 23, 2023), increasing to 1.5 per cent.

Eight members of the MPC voted for the Bank of Canada to shrink its holding of bonds, and only three voted to maintain. /1

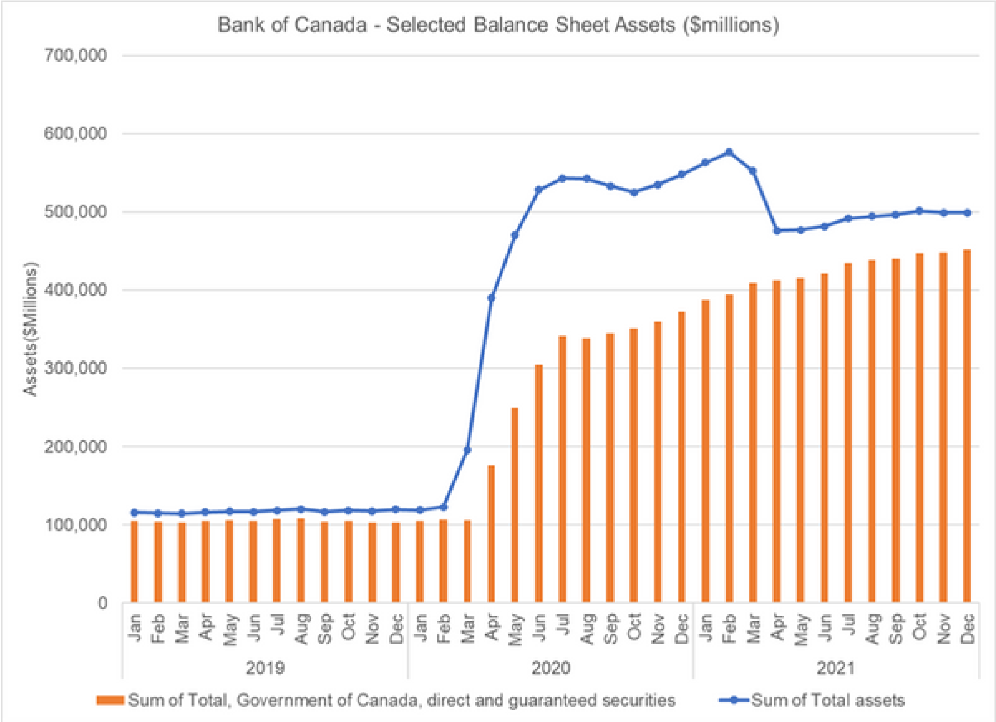
Bank of Canada January 26, 2022 Rate Announcement

The Bank of Canada announced that they were removing exceptional forward guidance, while keeping the policy rate at 25 basis-points. The Bank also chose to maintain its level of bond holdings on its balance sheet./2 Its total assets are approximately five times higher than its level in 2019, much of it in the form of Government of Canada bonds.

/1 The Bank of Canada's holding of bonds was greatly expanded early in the pandemic to help push effective rates lower. Shrinking their bond holdings towards a normal level over time will reduce this crisis stimulus.

/2 Source: Bank of Canada, assets, and liabilities, at month-end ($millions), Statistics Canada Table 10-10-0108-01.

RATE ANNOUNCEMENT (CONTINUED)



Uncertainty is still high, with the current COVID-19 wave (Omicron variant) being a source of this uncertainty. But with CPI inflation of 4.8 per cent in December 2021, the risks of inflation that's too high is still the biggest concern.

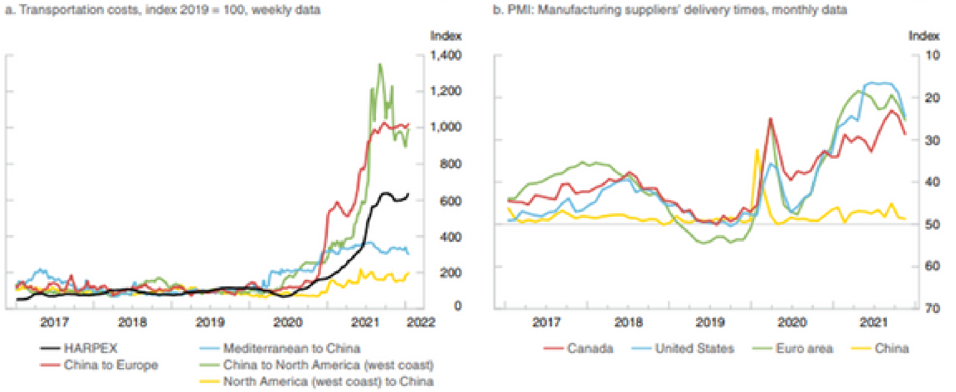
Tiff Macklem, the Governor of the Bank of Canada, made it clear that we should expect to see a **series of interest rate hikes**. The Bank will also consider exiting the bond reinvestment phase and reduce the size of its balance sheet. These could both begin occurring on March 2, 2022. The size and timing of changes will continue to be data driven.

Key issues driving inflation are **strong transportation costs** (particularly container traffic) between China and North America, and **supply chain disruptions** (a mix of local and offshore causes), select **commodity prices are also increasing**. **Lumber** prices have again surged, due to continuing strong demand and flood related disruptions to BC supply chains (**BoC Charts 1, 3, and 6 - on the following page**).

/3 Bank of Canada **January 2022 Monetary Policy Review**, Chart 1 on page 5, Chart 3 on page 7, and chart 6 on page 12.

RATE ANNOUNCEMENT (CONTINUED)

Chart 1: Transportation costs and the share of firms that report worsening delivery times have likely peaked but remain high



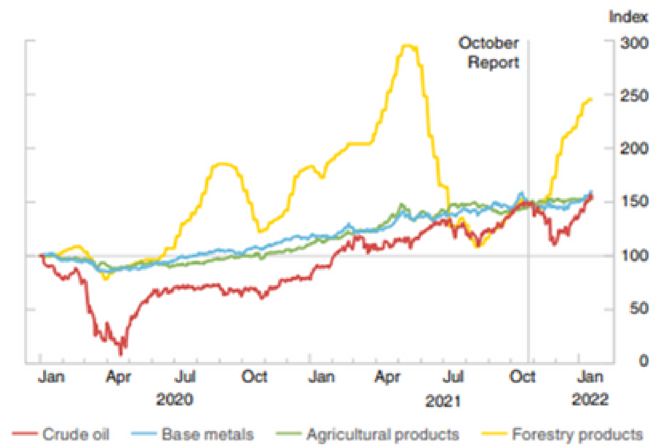
Note: All series in panel a are from the Freightos Baltic Index except the HARPEX (Harper Petersen Charter Rates Index). The Freightos Baltic Index provides market ocean freight rates for different trade lanes. The HARPEX reflects the worldwide price development on the charter market for container ships. The Purchasing Managers' Index (PMI) is a diffusion index of business conditions. For suppliers' delivery times, an inverted index is used to show that a reading less than (greater than) 50 indicates an increase (decrease) in delivery times compared with the previous month.

Sources: IHS Markit and HARPEX via Haver Analytics and Freightos Baltic Index via Bloomberg Finance L.P.

Last observations: HARPEX, January 21, 2022; Freightos Baltic Index, January 23, 2022; PMI, December 2021

Chart 3: Commodity prices remain high

Index: January 3, 2020 = 100, daily data

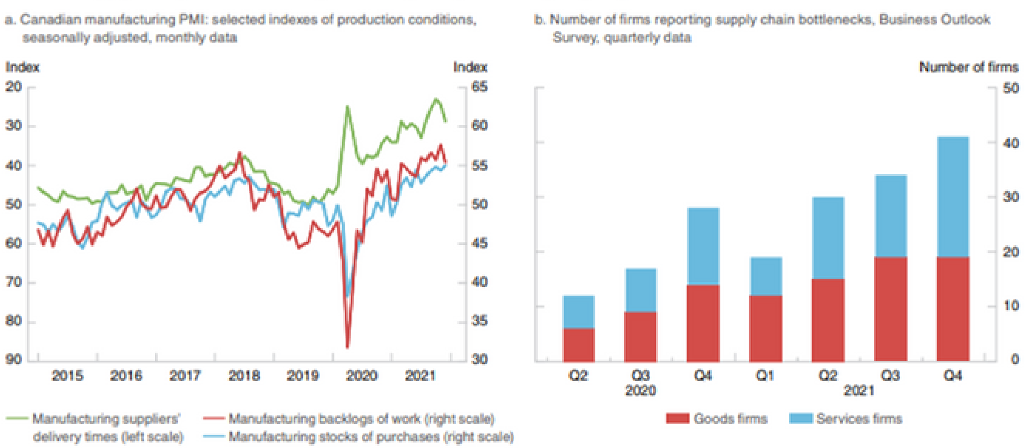


Note: All series plotted are components of the Bank of Canada commodity price index. The crude oil index is a weighted average of the benchmarks for West Texas Intermediate, Western Canadian Select and Brent.

Source: Bank of Canada

Last observation: January 21, 2022

Chart 6: Supply disruptions are leading to delivery delays and weighing on production



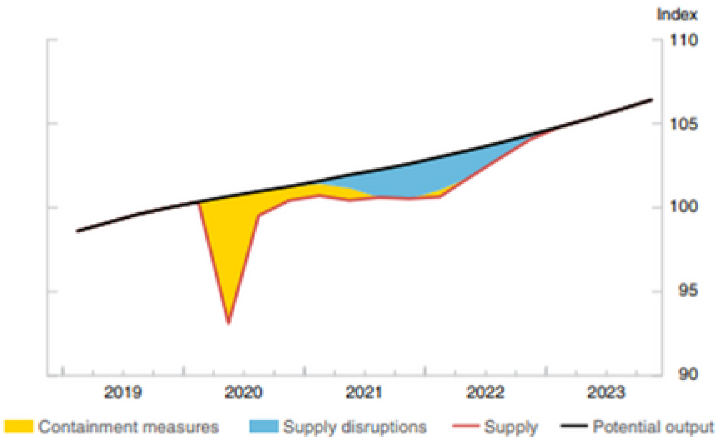
Note: The Purchasing Managers' Index (PMI) is a diffusion index of business conditions. For suppliers' delivery times, an inverted index is used to show that a reading less than (greater than) 50 indicates an increase (decrease) in delivery times compared with the previous month. Services firms reporting supply chain bottlenecks include firms in the retail and wholesale trade sectors affected by delays sourcing products and, to a lesser extent, firms in the transportation, warehousing, construction and hospitality sectors. Mentions of raw material constraints, transportation difficulties and logistics issues are counted as supply chain bottlenecks. The Business Outlook Survey samples about 100 firms.

Sources: IHS Markit via Haver Analytics and Bank of Canada

Last observations: PMI, December 2021; BOS, 2021Q4

Chart 8: Supply disruptions are expected to dissipate gradually over 2022

Index: 2019Q4 = 100, quarterly data

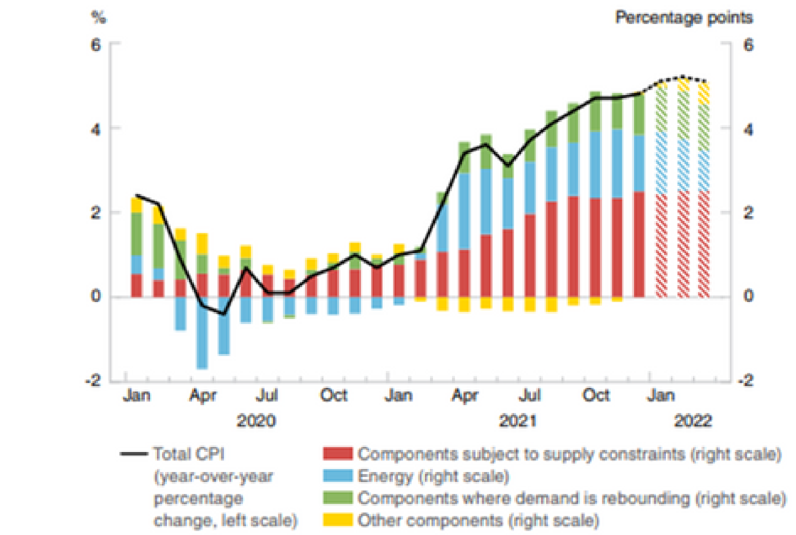


Note: "Supply disruptions" includes the short-term effects on supply of supply chain disruptions and labour market mismatch. The area labelled "Containment measures" in 2022Q1 also includes the effects on supply of worker absences due to the rise in COVID-19 cases. See **Box 1** for details.

Sources: Bank of Canada calculations, estimates and projections

Chart 9: Supply constraints and energy prices are pushing up inflation

Contribution to CPI inflation, in percentage points, monthly data



Note: "Components subject to supply constraints" includes motor vehicles, durable goods, food purchased in stores (excluding fruits and vegetables), and home repair and replacement costs. "Components where demand is rebounding" includes hard-to-distance services, transportation and travel-related services, food and alcohol in restaurants, rented accommodation and semi-durable goods.

Sources: Statistics Canada and Bank of Canada calculations and estimates — Last data plotted: March 2022

There are still differences in the pace of recovery of the **labour market**, but aggregate labour market slack is viewed as absorbed./4 Our own analysis of labour markets shows that labour markets will continue to experience challenges as some sectors ramp backup activity (particularly service sectors)./5

The Bank of Canada views supply disruptions gradually dissipating over 2022. COVID-19 containment measures are viewed as much less of an issue in 2022 compared to 2020 and 2021 (**Bank of Canada Chart 8**)./6

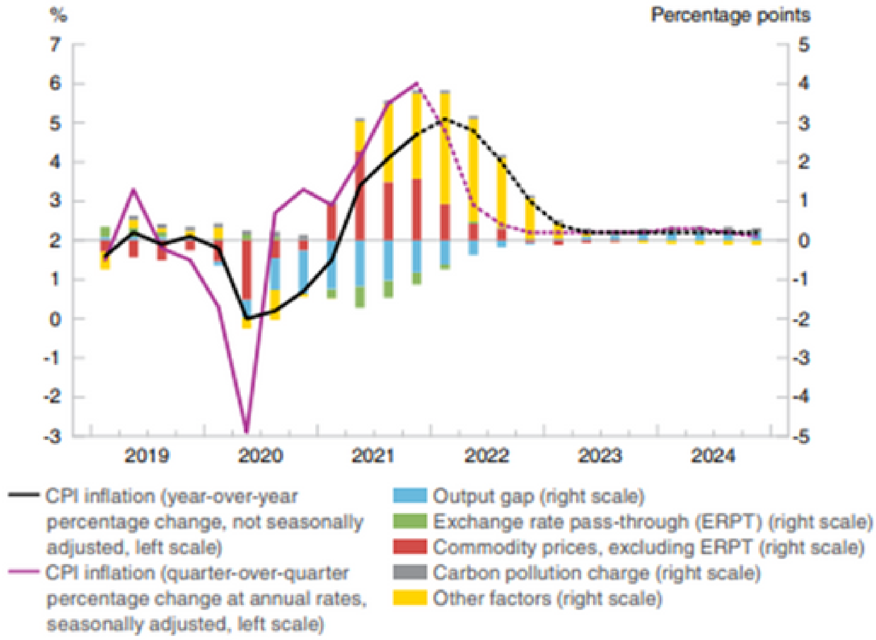
The Bank noted that supply constraints and energy prices are the key components pushing up inflation now and are projected to do so through much of 2022 (**BoC Chart 9**)./7

/4 Bank of Canada, ibid, Box 3, pages 14-15.
/5 WED, Vol. 3, **Issue 01**.
/6 Bank of Canada, ibid, Chart 8, page 16.
/7 Bank of Canada, ibid, Chart 9, page 16.

RATE ANNOUNCEMENT (CONTINUED)

Chart 15: CPI inflation is forecast to ease as pandemic-related forces fade

Contribution to the deviation of year-over-year inflation from 2%, quarterly data



Note: "Other factors" includes, in particular, the impacts of various supply-related disruptions on inflation, such as the effects of semiconductor shortages on motor vehicle prices, of shipping bottlenecks on goods prices, and of unfavourable weather conditions on food prices. Numbers may not add to total due to rounding.

Sources: Statistics Canada and Bank of Canada calculations, estimates and projections

The Bank forecasts that CPI inflation will ease as COVID-19 pandemic forces fade. The two key factors over 2022 will be commodity prices and supply chain disruptions (**BoC Chart 15**)./8

The Banks's caveats about their view: both downside and upside to inflation./9

Downside Risks to Inflation	Upside Risks to Inflation
More persistent effects of the pandemic on confidence: (Business, household)	More persistent supply bottlenecks and costs pressures
Reversal of growth in goods prices (As spending rebalances from goods to services)	Stronger household spending in Canada
Sharp deterioration of global economic and financial conditions	

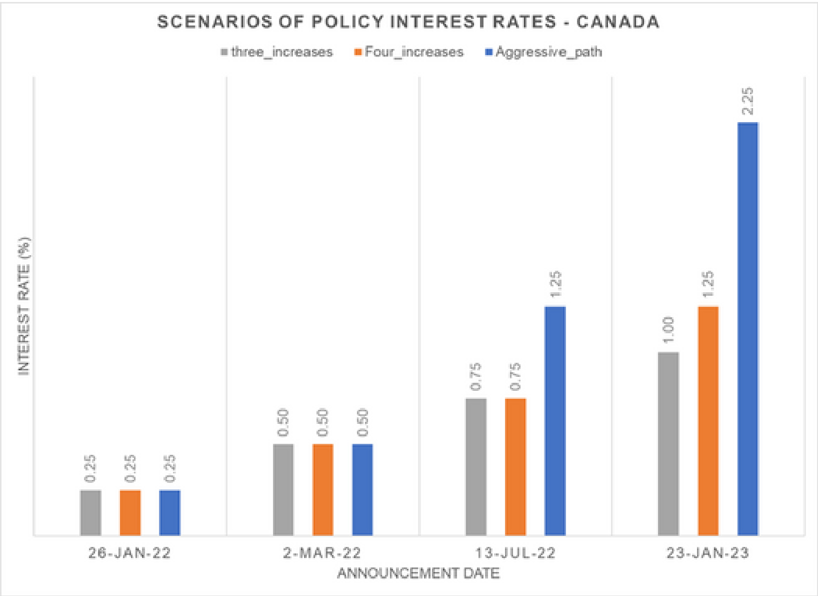
Looking Forward

A January 31, 2022 Bloomberg article, "**Fed's Daly Urges Gradual Shift, George Focused on Balance Sheet**," notes that there could be a mix of rate hikes (three or four in 2022, conditional on economic data), and shrinkage of the Fed's balance sheet. The Bank of Canada and the Federal Reserve are both in similar positions. Both have sizeable balance sheets they can shrink after growing them as part of COVID-19 support. Actual rate increase pacing will have to depend on economic data.

/8 Bank of Canada, ibid, Chart 15, page 22.
/9 Bank of Canada, ibid, pages 24-25.

LOOKING FORWARD

The following chart shows three hypothetical scenarios for Bank of Canada rate hikes. Three 25-basis-point rate increases over the next year, four 25-basis-point rate increases over the next year (every second announcement date), and eight 25-basis-point rate increases over the year (every announcement date)./10



Three or four rate increases in 2022 and a shrinking balance sheet may be a reasonable path for the Bank of Canada to take. We could easily see the overnight rate at one or 1.25 per cent by January 23, 2023. **The key thing to expect is that policy interest rates will be climbing this calendar year to move us towards a neutral interest rate.**/11

Thus, it would be prudent to review your borrowing and debt repayment plans shortly, adjusting where needed. For example, if a project's breakeven would be underwater with interest rates rising by 0.75 to 1.00 per cent, then the project should be shelved. A similar example with repaying personal loans. If the interest rate sensitivity shows difficulties repaying, then lower borrowing would be needed. In any case, talking with your financial advisors is highly recommended: accountants, bankers, or project consultants.

/10 We are unlikely to see interest rate hikes greater than 25-basis-points at a time, given that approximately 75% of all rate changes since early 1996 were +/- 25 basis-points. Interest rate moves of 50 basis-points or more tend to be downward moves (see **Bank of Canada key-interest-rates**).

/11 The Bank of Canada's last estimate of a neutral interest rate ranges between 1.75% and 2.75%, for a mid-point of 2.25%. **https://www.bankofcanada.ca/2021/04/staff-analytical-note-2021-6/**.

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**
Marketing & communications inquiries:
marketingandbranding@edwinnipeg.com

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