Inflation hits three-year high, strengthens case for more rate hikes

By David Parkinson
March 23, 2018 – *The Globe and Mail*

Canadian inflation surged to its highest rate in more than three years in February, strengthening the case for further interest-rate increases from the Bank of Canada.

Statistics Canada reported that the 12-month increase in the consumer price index was 2.2 per cent, up sharply from 1.7 per cent in January, and the fastest 12-month pace since October, 2014.

February also marked the first time in six years that the average of the Bank of Canada's three gauges of core inflation – the underlying inflationary trend across the broader economy, filtering out short-lived distortions and sector-specific volatility – inched above 2 per cent, the central bank's inflation target, which serves as its formal guide for determining interest rates. Two of the three measures registered 2.1 per cent, while the third sat at 1.9 per cent. The average was up 0.2 percentage points from January.

The inflation numbers came in considerably hotter than anticipated; economists' consensus estimate was a 1.9-per-cent overall reading, with a 1.8-per-cent average for the core measures. The surprise sent the Canadian dollar up a half-cent against its U.S. counterpart in morning trading, as the figures revived expectations for the Bank of Canada to raise interest rates again relatively soon to keep inflation under wraps – a prospect that had been fading recently amid tepid economic data and the central bank's growing concern about U.S. trade protectionism.

"The Bank of Canada's dovish tone of late will surely be challenged in light of today's robust core inflation numbers," said Toronto-Dominion Bank senior economist James Marple in a research note.

"The numbers can be choppy on a monthly basis – and a portion of the January-February strength is probably tied to recent minimum wage hikes in Ontario. It is difficult, though, to argue that there hasn't been some firming in underlying price growth," said Nathan Janzen, senior economist at Royal Bank of Canada, in a research note.

Statscan said all eight major sectors comprising the index posted year-over-year gains. Higher gasoline prices were a key contributor to the 12-month inflation, up 12.6 per cent from a year earlier, which largely reflected a downturn in the comparable year-earlier numbers. The cost of housing, interest on mortgages, automobiles and restaurant food also showed strong gains.

CPI was up 0.6 per cent month over month, led by higher travel, internet and clothing costs. On a seasonally adjusted basis, the gain was a more modest 0.2 per cent.

The rising inflation trend reflects Canada's strong economic pace last year, which absorbed much of the excess productive capacity in the economy. The Bank of Canada estimates that the economy is now running essentially at full capacity – a condition that typically puts upward pressure on prices. It has already raised its key interest rate three times in the past eight months in anticipation of growing inflationary pressures.

The inflation data prompted bond traders to ramp up their expectations that further rate hikes are coming in the near term. The bond market has now priced in an 80-per-cent likelihood that the Bank of Canada will raise its key rate by another quarter percentage point by its May rate decision, up from 67 per cent the day before the inflation numbers came out.

But the CPI numbers overshadowed another key economic report released Friday, on January retail sales, that added to the evidence that the economy has lost momentum. Retail sales rose a less-than-expected 0.3 per cent month over month on a value basis, and inched up a thin 0.1 per cent on a volume basis, showing little bounce-back from a disappointing December.

The retail sales report reinforces the view that the economic activity isn't growing fast enough to further squeeze the economy's capacity – which means, by extension, that it isn't adding much to underlying inflation pressures, despite the higher CPI numbers.

"We still think the recent slowing in growth will be more important for the Bank [of Canada] in assessing the longer-term inflation trend and when to hike interest rates again," said Canadian Imperial Bank of Commerce economist Andrew Grantham in a research report. "[We] remain comfortable with our call for only one more move this year."

"While the high-side inflation surprise does slightly bump up the risk of the Bank [of Canada] going earlier, we continue to believe that amid serious trade uncertainty and signs that growth has notably simmered down, they will remain patient and wait until the second half the year before hiking again," added Bank of Montreal chief economist Douglas Porter.