Economic Commentary

May 20, 2021

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Surging inflation? Not so fast

To little surprise, Canada headline CPI inflation shot higher in April to 3.4 per cent year-over-year, marking the highest reading since May 2011 (3.7 per cent). This compared to a 2.2 per cent headline rate in March. With U.S. inflation coming in at 4.2 per cent, the latest Canadian numbers feed into fears of a period of higher inflation, highlighted by strong gains in commodity and input prices.

That said, the latest numbers reflect a combination of rising prices and base year effects. In the latter point, prices fell during fell sharply during the early stages of the pandemic (1.2 per cent from February through April) lifting year-over-year comparisons. This effect on headline inflation will unwind in coming months as price levels rebounded in mid-2020.

Nevertheless, the CPI trend has gathered steam. Gasoline prices rose 62 per cent year-over-year, due in large part to base year effects but also added to momentum with a 1.8 per cent monthly gain. Excluding energy prices, the CPI was up a mild 1.6 per cent from a year ago, although monthly gains were still firm at 0.4 per cent. Upward price momentum was supported by higher shelter prices with a 0.5 per cent monthly, and 3.2 per cent year-over-year increase. Effects of higher construction material costs lifted the replacement component of ownership costs (up 1.5 per cent m/m and 9.1 per cent y/y), while utilities costs also increased. Mortgage interest costs and rent declined. Health and personal care services also rose sharply by 1.9 per cent m/m with a 2.2 per cent y/y gain. Much of this may be one off gains as higher costs of personal protective equipment, and commodity prices are passed on.

Core measures of year-over-year inflation rose by 0.2 percentage points for all three Bank of Canada measures with average of the three measures at 2.1 per cent.

Going forward we can expect CPI inflation to show ongoing volatility. The base year effects will fade by the summer tempering headline inflation. That said, we are also likely to see significant movements associated with temporary supply-side constraints, and effects of a waning pandemic. Recovery in hard hit sectors like tourism will likely drive one-time re-pricing of goods and services – similar to what has been observed in the U.S. Similarly, global supply bottlenecks and commodity price increases are likely to be temporary.

The extent to which higher CPI inflation becomes persistent depends on wage momentum. Wage indicators have been quite volatile through the pandemic, partly owing to job losses for lower paid workers, which has inflated aggregate numbers. While surveys suggest growing labour shortages, some of this reflects challenges created by the pandemic for labour availability, such as health fears and childcare needs. Labour market slack persists, with participation and employment rates below pre-pandemic levels.

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