Canada: Inflation spikes but few signs of tariff impact

Sharply higher energy prices saw Canadian inflation unexpectedly spike in July. But so far, the impact of tariffs has been fairly modest and this is a key reason why we expect further rate hikes from the Bank of Canada

Source: Shutterstock

Inflation should be propped up for a little while longer

Canada's July CPI release has caught markets quite off-guard. At 3% year-on-year, the latest data is significantly higher than the 2.5% figure investors were looking for.

Admittedly, energy costs drove the majority of gains, following a 25.4% YoY rise in gasoline prices. But given that oil prices have stabilised, we suspect this represents something of a peak. In principle, this should see inflation ease off over coming months, but there are a few reasons to expect headline CPI to remain elevated for a little while longer.

Firstly, while July's wage growth was somewhat 'softer' (3% YoY, down from 3.9% a few months before), recent increases in Canada's minimum wage should start to translate into higher consumer prices. This, along with a modest depreciation in the Canadian dollar over recent months, should help to keep inflation aloft throughout the rest of the year.

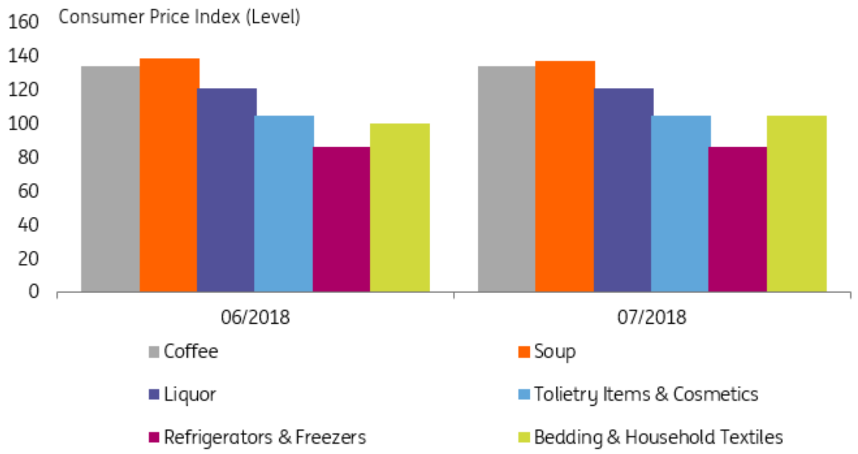
Canada's retaliatory US tariffs see minimal inflationary impact so far

Then there's the issue of tariffs - arguably the Bank of Canada's biggest headache at the moment.

In response to the US steel and aluminium tariffs, Canada retaliated with its own list of duties in early July - not only on metals but also 10% taxes on over 80 consumer products - including coffee, whiskey and bedding. This latest inflation report was the first to include the impact of these fresh tariffs.

In theory, these should immediately lift consumer prices, depending on the extent to which businesses absorb the extra costs. So far though, the impact appears to have been minimal.

Month-on-month change in consumer prices affected by the tariffs



Source: Macrobond

The Bank of Canada may face a difficult 2019

However, the threat of further US tariffs on Canadian goods, for example on the auto industry, is still a risk. In a more extreme scenario, the anticipated slowdown in inflation during 2019 could easily be offset by any fresh retaliatory tariffs from Canada, pushing prices up.

Further trade escalations would not only be a major risk to Canada's economic growth prospects, but would also likely dampen sentiment, which so far has been fairly resilient. For the Bank of Canada, it is the risk to growth, rather than inflation, that is likely to drive future policy decisions.

That said, the recent advance in Nafta talks shows that the negotiations are beginning to regain some momentum, which could potentially reduce uncertainty over coming months - although this is dependent on the 'type' of agreement that gets finalised (Take a look here to see what that could mean).

> We still think the direction of Canadian interest rates is up, but the risk of further rounds of

tariffs, or an undesirable Nafta outcome, could easily alter that.

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