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Who really fears inflation, the Bank of Canada or the Fed?

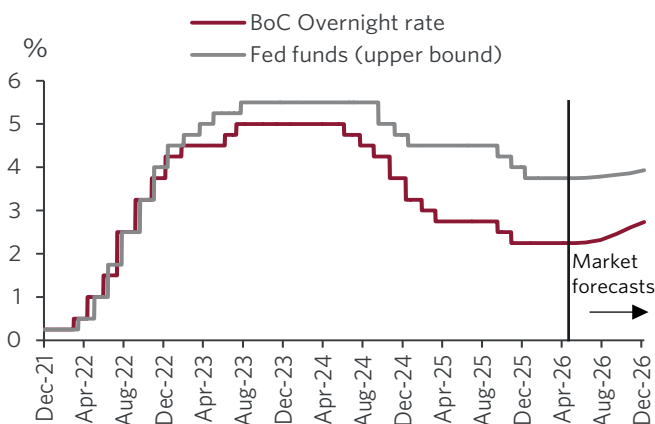
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Soaring oil prices, alongside price hikes for aluminum, helium and other supplies shipped through the now shuttered Strait of Hormuz, have markets looking at downside risks to global growth, and more immediately, upside risks to inflation. That's seen markets replace earlier expectations for a Fed rate cut this year with the possibility of a hike, and price in roughly two 25bp increases in Canada before year end. But which of those central banks should be in greater fear of inflation these days, and does current relative pricing for policy changes make sense?

How we got here

The simplest explanation for the more hawkish expectations for the Bank of Canada comes down to this: the BoC has already cut deeper than the Fed. Having moved largely in lock-step from the start of the pandemic to the end of 2022, the Fed subsequently hiked more aggressively, and when it came time to reverse course, the Bank of Canada eased earlier and more aggressively (Chart 1). Hence, market observers can be tempted to think that an earlier rate hike cycle for the Bank is just a move back to a more conventional rate differential.

Chart 1: Markets pricing in BoC rate hikes before year-end, but not quite a full move by the Fed

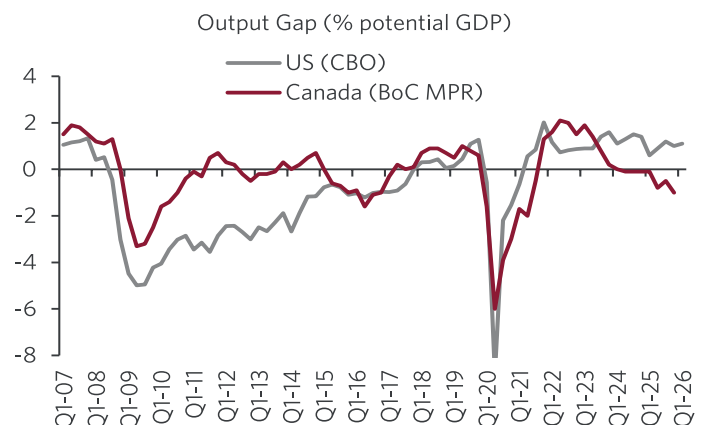


Source: Bloomberg, CIBC

But that's far too simplistic. There's no iron clad rule that neutral rates have to be identical across countries, and the Bank's estimate of neutral is in fact 50-75 bps lower than the Fed's US neutral estimate. Moreover, the underperformance of the Canadian economy in recent years makes a prima facie case for an easier policy stance by its central bank. Rates were diverging more than usual in 2024 just as Canada's output gap was diving into negative territory, indicative of increasing economic slack, while the US economy continued to grow above trend and CBO estimates pointed to a risk of overheating (Chart 2).

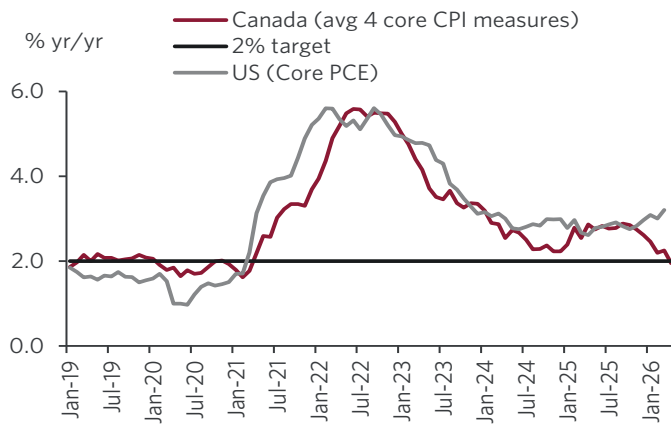
In 2024, that likely reflected the lower neutral rate in Canada, meaning that policy was perhaps more restrictive in Canada when the easing cycle was just getting underway. In 2025, Canada was in greater need of economic stimulus as the economic drag from tariffs did more damage to a Canadian economy that relied more heavily on foreign demand than its US neighbour. The US also was a greater beneficiary of the capital spending boom tied to AI, being the headquarters of the largest players in that space.

Chart 2: Excess supply in Canada but excess demand in the US



Source: CBO, Bank of Canada, CIBC

Chart 3: Core inflation was decelerating and close to 2% in Canada; US accelerating even pre-war



Source: Statistics Canada, BoC, BEA, CIBC

The growth and output gap differential also opened up a gap in inflation trends that added further justification to an abnormally wide rate differential. The two central banks judge underlying inflation somewhat differently, and to understand their policy choices, one needs to look at inflation through their respective lenses. Looking at an average of four measures of core inflation that the BoC now seems to be tracking, underlying inflation had come within a hair of the Canadian central bank's 2% target in 2024, and actually hit that mark last month. Not so in the US, where the core PCE price index got stuck just under 3% in 2024 and failed to decelerate any further (Chart 3).

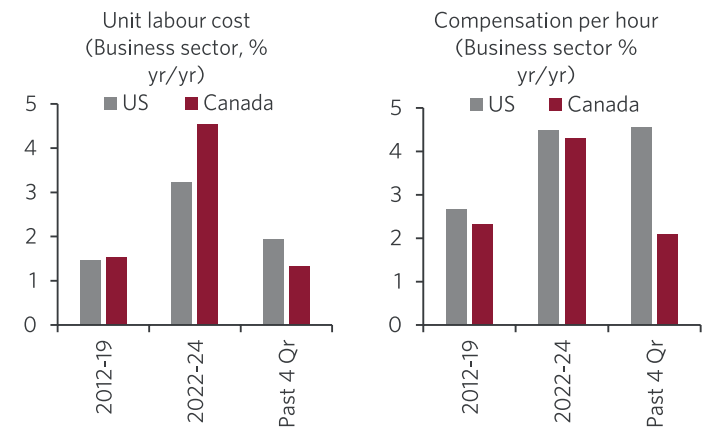
Where we're going on inflation risks

That's how we opened up that wider interest differential between the two countries. But where these economies sit today, and their growth prospects, will have a lot to do with shaping how immediately we might see inflation risks in either country. Remember that, for both central banks, a rate hike in 2026 would be implausible if oil prices were to reverse course in the next month or two. What the market is really doing is giving some probability weight to a scenario in which triple-digit crude prices persist. So what's really at play is the degree with which each country would be at risk of a more sustained inflation upturn with oil near its current levels.

Virtually every indicator suggests that it's the US that faces a greater exposure to accelerating inflation in a protracted oil shock, making a scenario in which the Bank of Canada hikes and the Fed stands pat seem implausible, at least until the Canadian economy puts in several quarters of improved economic performance.

The output gap, which is negative for Canada and positive for the US, is the broadest measure of that difference. Measuring potential output, the economy's non-inflationary ceiling, isn't straightforward, but the divergence in output gaps is well supported by other indicators. Take business sector unit labour costs, for example, where despite America's more impressive productivity trend, labour costs per unit of output have

Chart 4: Unit labour costs still rising faster in US even with higher productivity (L), due to strong wage inflation (R)



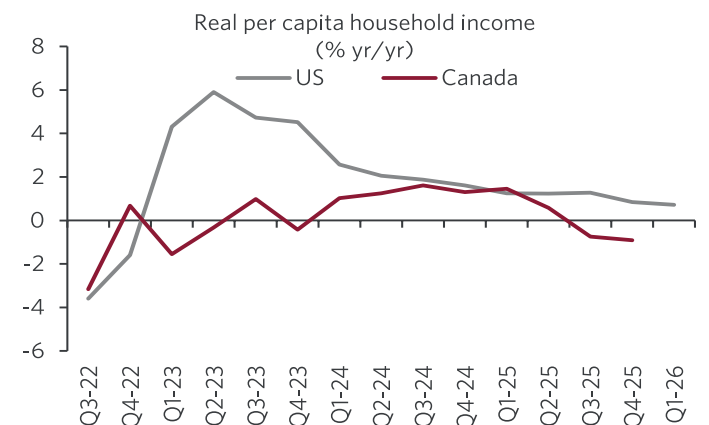
Source: Statistics Canada, BEA, CIBC

decelerated more sharply in Canada over the last four quarters (Chart 4 left). That reflects the much looser Canadian labour market, which has meant that worker compensation has slowed to roughly 2% in the last four quarters, while remaining firm at a 4% clip stateside (Chart 4 right).

Smaller gains for worker pay also translates into a less robust picture for purchasing power, a key ingredient in allowing businesses to pass on higher costs without denting sales volumes. Both countries have seen a slowing pace to total growth in real household incomes, in part capturing tighter immigration policies that have reduced population growth. But in per capita terms, the squeeze on Canadian households has been more dramatic, with real per capita incomes actually declining even before the recent spike in gasoline prices (Chart 5).

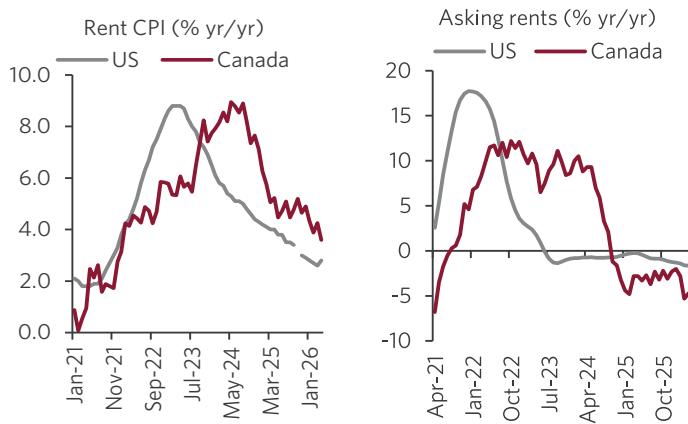
Rents are one heavily-weighted element in the CPI basket where the US has seen a sharper deceleration than what the Canadian data show. But a key leading indicator for that series, asking rents on newly available units, suggests that edge is

Chart 5: Household incomes weakening more in Canada



Source: Statistics Canada, BEA, CIBC

Chart 6: CPI rent series has eased more in the US (L), despite even weaker new asking rents in Canada (R)



Source: Urbanation, Apartmentlist.com, Statistics Canada, BEA, CIBC

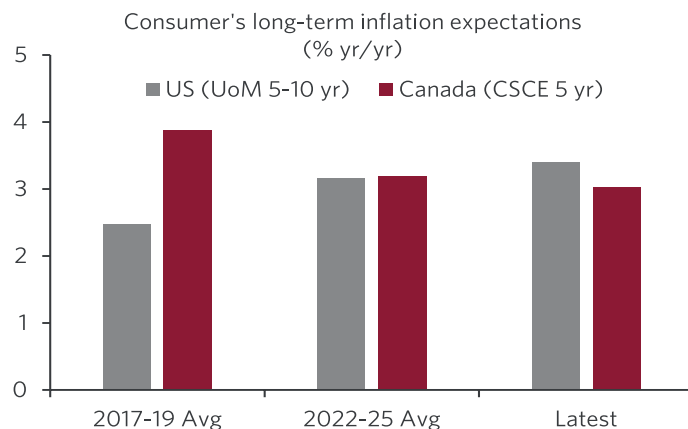
unlikely to last. Rents are falling in both countries on that benchmark, but more steeply on the northern side of the border (Chart 6).

Two other considerations

Central banks also look at two other factors in deciding whether to pull the trigger on rate hikes in response to a supply shock. One is whether long-term inflation expectations are becoming unhinged by an upturn in current inflation, because that can make it more costly to wrestle inflation back down again, have consumers rushing to buy now ahead of anticipated price hikes, and have businesses more willing to raise wages in anticipation of being able to pass on the cost increases in their prices.

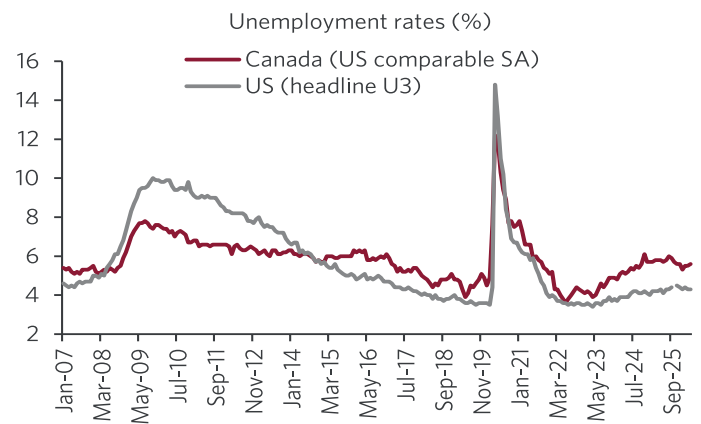
Thus far, we haven't seen much sign of that in either country, at least partly because even the most recent surveys won't have captured all of the impact of higher pump prices. Canada's survey of household inflation expectations consistently runs hotter than actual inflation, so although its only hair lower than a comparable US survey, it actually sits well below its pre-

Chart 7: Long-term consumer inflation expectations now lower in Canada than in US



Source: Bank of Canada, UoM, CIBC

Chart 8: Comparable jobless rate higher in Canada than US



Source: Statistics Canada, BLS, CIBC

COVID average, in contrast to the US University of Michigan survey, which is running hotter than where it stood in in the prior expansion (Chart 7).

Importantly, the Fed explicitly has a dual mandate, so in addition to its inflation target, it also tries to steer the funds rate to a level that generates full employment. While the Bank of Canada puts a clear priority on achieving its inflation target, it added references to employment goals the last time its mandate came under review. Even after adjusting for methodology differences, the unemployment rate in Canada remains meaningfully higher than that stateside (Chart 8).

What this all means

Our current rate forecast has both central banks on hold for an extended period, although we've penciled in a quarter point rate cut for the Fed in December that's conditional on an early end to the war. The Bank of Canada's own language, suggests that it won't be looking to hike rates this year in any scenario that sees the pressure from oil prices abating in the second half of the year on a resumption of shipments through the Strait of Hormuz.

But with that geopolitical outcome by no means certain, investors will put some weight on a scenario in which a more protracted conflict sees triple-digit crude prices extending from here to the end of the year. Our analysis suggest that the US would be more at risk of a broader inflationary spiral than Canada in that scenario, making it unlikely that the Bank of Canada would be hiking first and more aggressively than the Fed.

Further afield, things could look a bit different. A very extended rise in crude prices might be more of a positive for the Canadian economy than a negative, if it triggered an acceleration in energy-sector capital spending. Or, in our base case with a return to \$75/bbl oil prices, we could see the Bank of Canada nudging interest rates up to 2.75% by the end of 2027 if a favourable outcome in trade talks reduces the drag

on exports and business capital spending and begins to lower unemployment. But for this year at least, the bar to get the Bank of Canada into a tightening stance is higher than the market thinks, at least relative to what the case would be for the Fed.

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