CIBC Economics

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Canada's inflation outlook: Who bears the burden of higher costs?

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Excepting fuel prices, there are no choppy waters in Canadian inflation these days, with the CPI sitting at 2.2% excluding gasoline. But the Bank of Canada is worried about what's happening upstream, where the currents of producer prices and input costs are running more rapidly. So even with energy prices not expected to keep escalating, the Bank sees inflation staying above 3% through much of 2027, about one percentage point higher than projected in July.

The assumption here is that, with a lag, businesses will pass on the cost increases evident in producer and imported goods prices down to consumers. All else equal, that's what every business leader will attempt to do. But sticker shock for consumers can, in some economic conditions, see demand fall off sharply enough so that, in short order, the goods are back "on sale". In that scenario, wholesale and retail margins, and even foreign suppliers trying to maintain volumes in Canada, end up absorbing much of the cost increase.

Our analysis of current conditions, including lingering slack in the labour market, only moderate growth in worker incomes, and importantly, a starting point with higher than normal profit margins for wholesalers and retailers, suggest that those margins, rather than consumers, will bear a significant share of the burden of higher costs. If so, the implication is that inflation will not escalate nearly as much as the Bank expects, leaving less urgency for further rate hikes ahead.

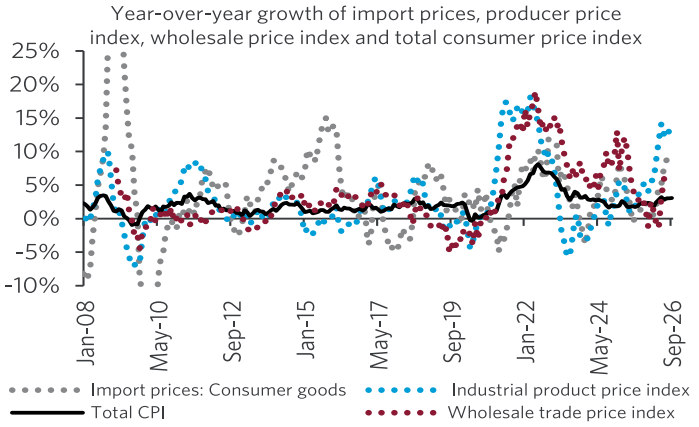
Digging into the BoC inflation forecast

What's notable in the inflation outlook presented in Bank of Canada's October Monetary Policy Report is the degree to which inflation will escalate and spread beyond energy prices, and persist at higher levels even with oil prices levelling off. Digging into the details, most of the upward revision to inflation in 2027 is in non-energy components. Much of that shows up in an eye-popping escalation in core goods prices, which are forecast to peak at a 3.6% year-on-year pace, which would be the second highest in the past 30 years, exceeded only during the pandemic period. That would see its contribution to headline CPI more than triple from its current level, to a full percentage point, and only a small part of that increase would come from newly imposed Canadian counter-tariffs.

So it's not about the oil shock getting uglier, it's about a pass through from oil and other costs to the rest of the CPI basket. That heightened assessment may be driven by the Bank's use of a new forecasting model, Prima, which highlighted the relationship between individual producer prices and their consumer price counterparts. While we don't have access to its inner workings, by emphasizing cost-push inflation, Prima might be putting less weight than the Bank's prior models on demand conditions and the output gap, a measure of the extent to which there is economic slack or an overheating relative to supply.

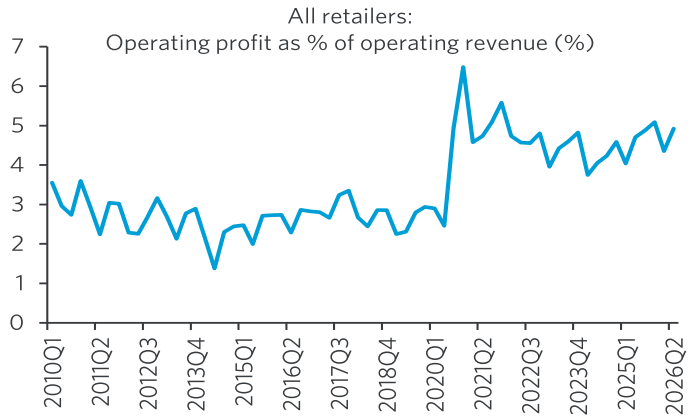
The Bank certainly had reason to cast its eyes on upstream measures of inflation, which have escalated materially. The wholesale trade price index is up 7.3% year on year, while consumer goods crossing into Canada from abroad are up 8.9% and the industrial product price index, Canada's producer price measure, is up 14.5% over the past 12 months. The Bank is likely remembering what it saw in 2021-22, which included the shock to oil and grain prices on the onset of the Ukraine war,

Chart 1: Surges in upstream prices don't always move the CPI a lot



Source: Statistics Canada, CIBC calculations

Chart 2: The aggregate retailers profits remains more elevated than pre-COVID as a share of revenue



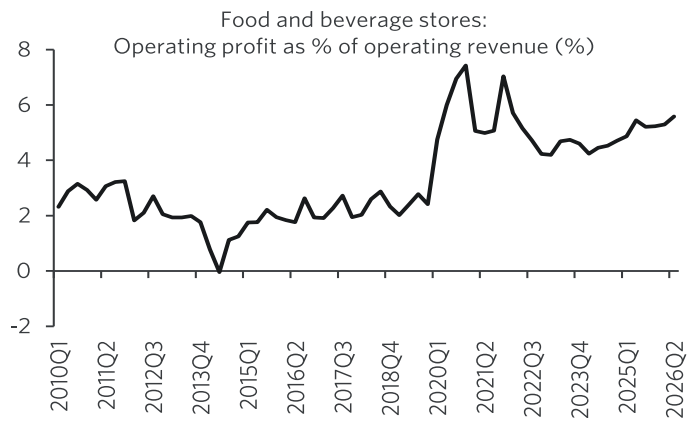
Source: Statistics Canada and CIBC calculations

Chart 3: Consumer goods wholesalers' profit margins are also elevated



Source: Statistics Canada and CIBC calculations

Chart 4: Same thing with food and beverage stores' profits



Source: Statistics Canada and CIBC calculations

and with somewhat of a lag, saw Canada's CPI pace also turn sharply higher.

But the historical record shows these upstream price measures tend to be much more volatile than the CPI, and we've seen some dramatic escalations in producer or import prices that barely generated a ripple in the CPI (Chart 1). So we need to dig into the factors that separated the post-COVID, Ukraine war outbreak from other cases where the CPI proved much more immune to upstream supply side shocks.

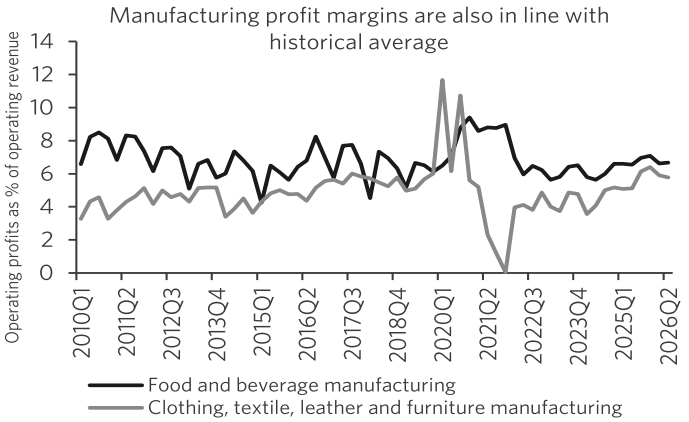
Margins are a potential cushion

No wholesaler or retailer is going to sell goods at a loss, and nor can it persist for long while running sub-par rates of return. So these parts of the goods supply chain to consumers can only have the flexibility to reduce the hit to volumes by absorbing some cost increases when their starting point gives them a bit of cushion before ending up with red ink or an inability to service debts.

Fortunately for consumers, current margins for both wholesalers and retailers appear to leave room for that outcome. Operating profit margins in retailing increased during the pandemic, and while off their highs of that period, remain well above the average that prevailed in the prior business cycle (Chart 2). Margins for food and beverage stores, where Canadian-made goods have a higher share than is the case in many other consumer goods sectors, are similarly elevated versus historical averages (Chart 3 and Chart 4). One step upstream, and wholesale margins also look to have room to absorb cost increases while not falling below levels that were sustained in the pre-COVID business cycle.

Looking further up the supply chain, Canadian manufacturers that are paying more for components and energy also aren't looking that squeezed just yet. In the two areas where Canadian factories have a significant domestic share for consumer goods, food/beverage processors and clothing/textiles/leather/furniture, profit margins are sitting close to historical norms (Chart 5).

Chart 5: Manufacturing profit margins aren't yet being squeezed in consumer goods



Source: Statistics Canada and CIBC calculations

Learning from the past, but which past is relevant?

Of course, none of these participants in the supply chain would be happy eating into their margins. But competitive forces, and demand conditions, could compel them to do so, however reluctantly, depending on the state of the economy at the time. As we saw in Chart 1, the historical response in consumer prices to upstream price pressure has varied a lot from one business cycle to the next. So which of these historical cases seems most akin to where we are today?

Not, it seems, the example set in 2021-23. When Russia invaded Ukraine in February 2022, spiking world oil and grain prices, Canada's economy was already overheated on the demand side, as economic stimulus at home and the US led to booming activity. The jobless rate was at only 5.5% that month, and ended up bottoming at 4.8% that July. You would have to go back to Bryan Adams' summer of '69 to find a lower July unemployment rate. That compares to a still-elevated 6.7% jobless rate today.

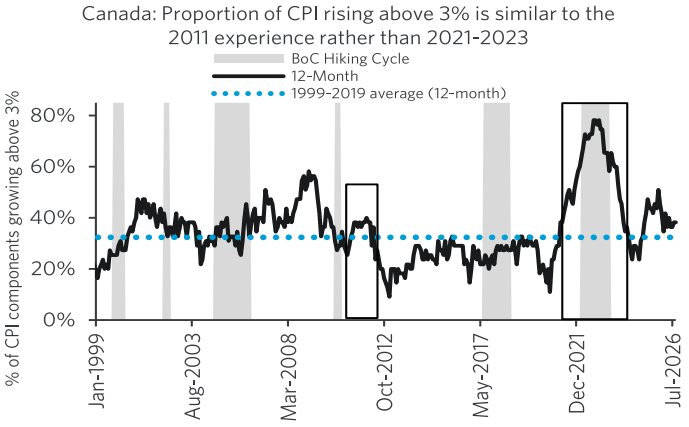
The tight labour market and booming hiring gave households ample spending power with which to face higher prices and keep on buying. As of Q1 2022, aggregate wages and salaries were up 10.5% over the prior year. Today, the comparable gain is at only 4.4%, reflecting weaker population growth, slower hiring, and less upward pressure on pay scales in a labour market with some visible slack.

The experience back in 2011 looks to be much more relevant, in terms of the economic conditions prevailing at that time. The 2011 oil price surge emanated from a supply shock akin to what we've seen in the past year. It was tied to supply disruptions from the Arab Spring, and saw WTI crude oil price peak at roughly $110/barrel in the spring of 2011, remaining high into 2012 amid renewed Middle East supply tensions, including threats regarding the Strait of Hormuz. As is the case today, the inflation pressures in early 2011 had yet to spread across a broad range of CPI components. That's a sharp contrast with conditions when oil prices spiked after the Ukraine war, since even prior to that, a much higher-than-normal share of CPI components were running at 3% or higher (Chart 6).

Both this year, and back in 2011, economic slack was leaning against a broader upturn in inflation. In 2011, the Canadian economy was operating below its non-inflationary potential, as it was still clawing its way back from the 2008-2009 Great Recession.

One concern expressed by the Bank of Canada is that, when asked, respondents in the Bank's last two business outlook surveys indicated that a higher than typical proportion of firms were facing larger cost increases and were also expecting to pass on significant price hikes ahead. But until they see the demand response, and gauge that those price hikes can stick, they can be optimistic about their ability to sustain their margins.

Chart 6: The proportion of prices rising above 3% is currently at similar level to 2011

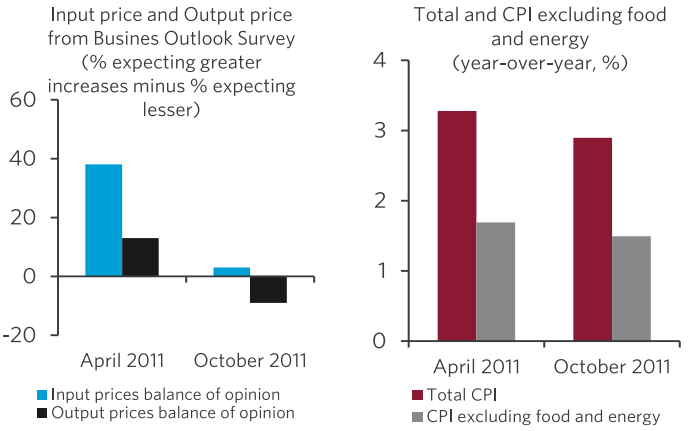


Source: Statistics Canada, Bank of Canada and CIBC calculations

Back in 2011, a slightly different set of questions in the Business Outlook Survey had the same warning signs about inflation. The April 2011 survey included a tilt towards firms expecting an escalation in the inflation rate on their input costs, and also, if to a somewhat lesser extent, the balance of opinion foresaw escalating output prices (Chart 7, left). In reality, while headline inflation was boosted by that year's oil shock, competitive pressures and the sluggish pace of demand left inflation outside of the energy sector seeing a much more moderate and quite temporary upturn (Chart 7, right). That fading of inflation came even as the Bank of Canada opted to keep rates on hold throughout that period.

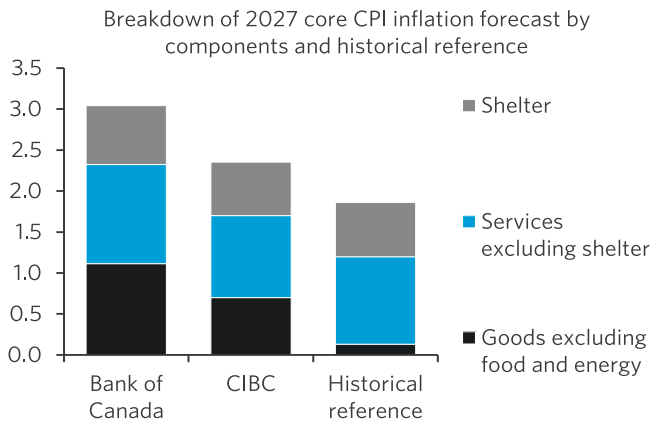
True, the inflation rate in 2011 was somewhat dulled by the lagged response to an earlier appreciation of the Canadian dollar. But that would have also impacted upstream prices. The currency didn't appreciate any further after April, and therefore wasn't the reason behind firms' inability to pass on cost increases in the way that they had expected at the time of the BOS survey.

Chart 7: Firms expected to pass on cost increases in 2011, but that didn't happen



Source: Bank of Canada Business Outlook Surveys, Statistics Canada and CIBC calculations.

Chart 8: Breakdown of 2027 inflation forecast by components



Source: Bank of Canada, CIBC forecast and calculations

Note: 2027 is the average of quarterly contributions, Bank of Canada and historical reference contribution estimates to CPI excluding food and energy are reweighted based on contributions to total CPI by components published in the October MPR.

Core goods inflation will tell the story

What's clear today is that, at the consumer level, inflation is still isolated to the energy component, with CPI ex-gasoline still close to the Bank of Canada's 2% target. If world oil prices level off and then begin to ease off, where total inflation heads will then heavily depend on what happens to core inflation, and within that, the Bank of Canada's concerns lie largely in its worry that core goods prices will be pushed upwards by upstream cost increases for fuel and other commodities.

Judging by past cycles, and not just the 2021-23 experience, that fear looks to be somewhat overstated, given the cushioning impacts of economic slack and room in existing margins for wholesalers and retailers to absorb some cost increases. CIBC's forecast does allow for core, ex-food/energy inflation to drift above the 2% target, with core goods prices contributing more to that tally than has historically been the case, but total inflation could be held in check by a gradual easing in gasoline prices.

In contrast, the Bank of Canada's 3% core inflation forecast is driven off a very sizeable acceleration in core goods prices (Chart 8), one that would be more akin to what we would expect in a hotter economy than what we are facing right now. Its path for interest rates will, of course, depend on whether it in fact sees those fears validated by incoming data in the months ahead.

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