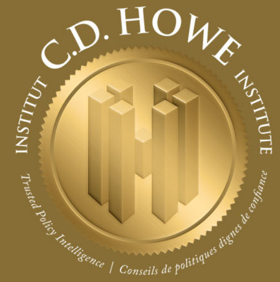
Intelligence MEMOS



From: Jeremy M. Kronick and Steve Ambler

To: Canadian Inflation Watchers

Date: December 13, 2023

Re: **Inflation is Easing: Let Us Count the Ways**

The Bank of Canada surprised no one by holding its target for the overnight lending rate at 5 percent last week. Early-December Statistics Canada releases showing a decline in **third-quarter GDP** and an uptick in the **unemployment rate** sealed the deal.

Nevertheless, the announcement made it clear that the Bank is not satisfied with the pace at which inflation is falling, stressed that the fight against inflation is not yet won, and stated that they stand ready to boost rates again if inflation numbers disappoint.

It's clear that the Bank is concerned about inflation expectations becoming unanchored from its 2-per-cent target. It continues to prioritize re-establishing any credibility lost in 2022 when it promised to keep rates low (they were 0.25 percent at the time), and want to avoid premature rekindling of demand – especially in the housing market – through expectations of much lower interest rates next year.

But, the truth of the matter is that almost all the key variables point to a softening economy and inflation headed in the right direction.

Year-over-year **inflation**, after stripping out the increase in mortgage interest costs (which increased by 30.5 percent year-over-year), was only 2.2 percent in **October**, and the seasonally-adjusted Consumer Price Index actually fell from September to October (although one month of data does not make a trend). Moreover, core inflation measures, including the Bank's preferred CPI-Trim and CPI-Median, while still above the top end of the Bank's 1- to 3-per-cent target range, were both down in October, to 3.5 percent and 3.6 percent, respectively (with annualized growth over the past three months of 3.2 percent and 2.7 percent).

Falling inflation is consistent with what we see in the money growth statistics, which measure the total amount of money in the economy. Money growth as an indicator of future inflation fell out of favour with central banks many years ago, but its value during volatile times has recently been evident. Narrow money, which refers to more liquid forms such as chequing accounts, is down year-over-year – a sign that inflation will continue to fall. And, while shorter-term measures – like three-month over three-month money growth rates – have rebounded, they seem to be slowly settling at the (positive) levels we saw just before the pandemic when inflation was right around 2 percent.

Moving to the real economy, Canada barely avoided two consecutive quarters of falling real GDP thanks to an upward revision to the second-quarter numbers. Breaking down the fall in the third quarter, a 1.8-percent increase in government final consumption expenditure – how much the administration spends on goods and services – prevented it from being much worse. Investment spending continued its chronic weakness. Exports fell 1.3 percent. Gross fixed capital formation decreased by 0.3 percent, with spending on non-residential structures, machinery and equipment falling by a whopping 2.7 percent.

Household consumption expenditure was flat for the second quarter in a row. The household saving rate increased to 5.1 percent from 4.7 percent between the second and third quarters. A likely explanation for this is that households are feeling squeezed by impending mortgage renewals and the prospects of increased debt servicing costs, forcing them to hold back on spending and set aside savings to cover increasing interest costs. Households with variable-rate mortgages are already suffering the consequences of the Bank's rate hikes.

Perhaps the strongest indicator of a weakening economy is the slowdown in household credit growth. In the second quarter of 2023, the stock of real credit was below where it was when the Bank started tightening monetary policy in the first quarter of 2022. Real mortgage credit was slightly higher, but was below where it was in the third quarter of 2022. There have been four quarters, out of the past six, of negative real credit growth since the Bank began tightening monetary policy. The number of negative quarters of real credit growth in the 30 years before? Zero.

As inflation continues to weaken, a 5-percent policy rate means that the Bank's real rate (the nominal rate minus inflation) is rising and looking increasingly restrictive. The Bank's desire to discourage premature speculation about rate cuts is understandable, as is its desire to signal continued determination to get inflation back to target. But it is making progress on inflation – and that progress will bring rate cuts with it.

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