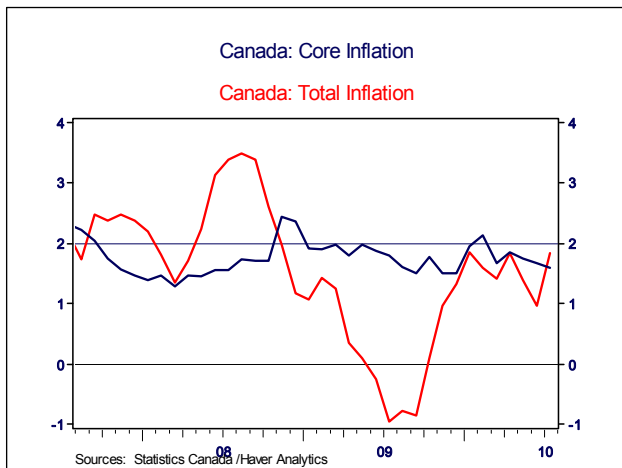


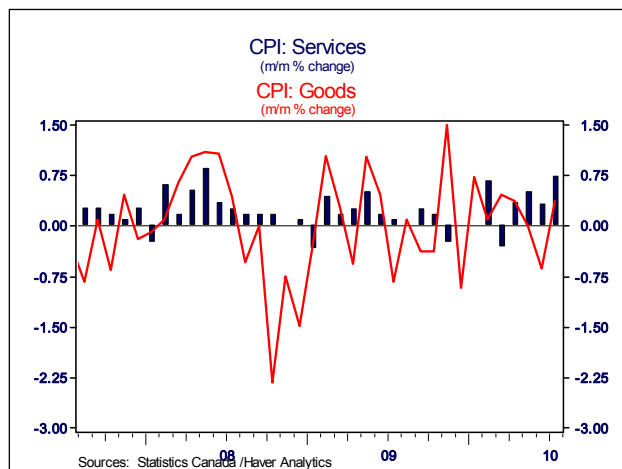


August 20, 2010

## Inflation a bit more moderate than expected in July



hairdressing, sports training, landscaping, repairs and maintenance carried out by a member of a trade association), real estate commissions, restaurant meals, sports club dues, hotel accommodations and domestic transportation by air, train and bus. Some goods also underwent the HST: tobacco-related products and gasoline, fuel oil and natural gas (only in Ontario).



Inflation rose in July to 1.8%, from 1% in June. Core inflation slipped by 0.1pp each month since May to reach 1.6% in July, comfortably below the 2% BoC target.

The Consumer Price Index for July was an eagerly awaited piece of data due to the harmonization of Ontario and British Columbia sales taxes with the GST—representing a 5% tax increase on the price of some goods and services—as well as the Nova Scotia government's 2% hike in the provincial sales tax. The impact of these tax increases on the CPI was slightly weaker than anticipated: 0.6% m/m instead of 0.7% m/m. As a result, the CPI advanced by just 0.5% compared with June. Thus, if we exclude the tax effect, the CPI would have been lower than June (-0.1%). The impact of the HST hit the prices of services the hardest: the service CPI edged up by 0.7% (m/m) in July, while the goods CPI ticked up by 0.4% (m/m). Some services in Ontario and B.C. were exempt from provincial taxation before the HST implementation; here are a few examples which affected most of the CPI components: professional services (funeral services, beauty and

Moreover, the core index fell for the second straight month (-0.1% m/m) in July, which has not happened since the end of 2008. This is due in part to the employee prices offered to buyers of new GM and Ford vehicles, which pushed new vehicle prices down by 2.4% m/m across the country, while leasing prices fell to the same extent. Consequently, these price cuts deducted 0.2pp from the monthly variation of the CPI. At the same time, clothing and shoe prices also declined (-0.1%). Usually, prices remain relatively stable from June to July, but it seems that, this year, retailers were obliged to offer steeper discounts to sell off their stock. Nevertheless, in the months ahead, Canadian households should expect the cost of a basket of groceries to rise due to a rebound in certain commodity prices since June, such as corn, oats, soybeans, wheat, coffee and pork. Even if Quebecers have seen prices going down by 0.3% m/m in July, they will also face a tax hike from January 2011.

In short, despite slightly weaker-than-anticipated inflation, this CPI report should not prevent the Bank of Canada from raising the policy rate from 0.75% to 1.00% at its September 8 meeting. However, the degree to which the recovery in the United States has been stumbling strongly suggests the Bank of Canada will take a break after September since, as Governor Carney so aptly puts it, "nothing is pre-ordained." The release of real GDP data on August 31 and the upcoming reports on employment will enable us to validate the extent to which job creation and household debt will influence consumption and housing construction, and whether business investment in non-residential construction finally makes a turnaround. Ultimately, it is hard to see how the O/N target rate can exceed 1% by the end of the year.

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