

Uniquely Canadian Wage And Price Pressures

It is important to address one area of pushback from global accounts that are viewing Canada in an international context. They are somewhat reasonably skeptical as to how little ol' Canada can so confidently lean against global debates on why inflation and wage growth dynamics are disappointing and hike nonetheless. Hence, for example, if there is uncertainty in the US that is causing the Fed to stall out at least temporarily, then why should it not be a reasonable expectation for this to be the case in Canada? There are some good supporting parallels to be sure, but **it is important to acknowledge the role played by unique made-in-Canada arguments that are influencing domestic wage and price developments.**

DIFFERENT WAGE DYNAMICS

For one thing, the starting point on wage pressures is sharply different and so are the influencing factors going forward. US wage growth is running at about two and a half times faster than it is in Canada (chart 1). **It is entirely possible that the US can have at least temporarily lost momentum on once-faster wage growth while Canada gains momentum going forward and converges upon higher US-style wage growth—or perhaps passes right by.**

As one consideration, the aftermath of the commodity price slide in mid-2014 took down income growth. At the broadest level, the terms of trade shock dragged nominal GDP growth lower as a proxy for broad incomes and then trickled into workers' wages and profits that shared the income shock. That effect may be maturing as resource labour finds new employment in a booming job market at reduced wages. **As labour gets re-priced, fresh wage growth can be restored at more normal rates thereafter.** This recent research note from BoC staffers would support this interpretation: "...the drag from the commodity price decline appears to have peaked in early 2016 and has since been gradually dissipating. Unlike Canada, US wage growth has not been overly affected by industry-specific dynamics following the commodity price decline." The piece went on to say "These findings suggest that Canadian wage growth should be expected to pick up as labour market slack is taken up and the effects of the commodity price decline fade."

On that note, **Canada arguably has less labour slack than the US** and it is closing much more rapidly north of the border. The unemployment rate adjusted for US concepts is about one percentage point higher in Canada but the labour force participation rate is three percentage points higher in Canada.

Further, as illustrated in chart 2, **productivity growth in Canada has been accelerating in support of wage growth.** If productivity was a source of drag on wage growth in 2015 and early 2016, then what is encouraging is the speed with which productivity growth has been recovering over the past year even as job growth has been very strong. This is the best of both worlds. Since last July when job growth began to super-accelerate, Canada has created a whopping 377,000 jobs or over 400,000 annualized. That would be akin to about four and a half million US jobs created over this same period! Yet all of these workers have been hired alongside improving productivity. Employers may have to begin to reward productivity with faster average wage increases if this keeps up.

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1

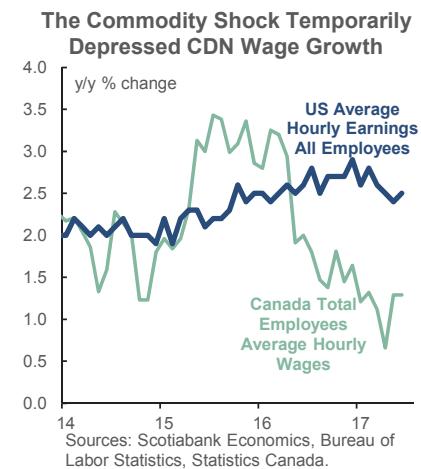


Chart 2

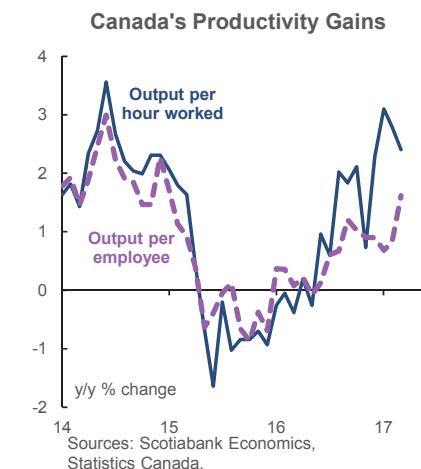
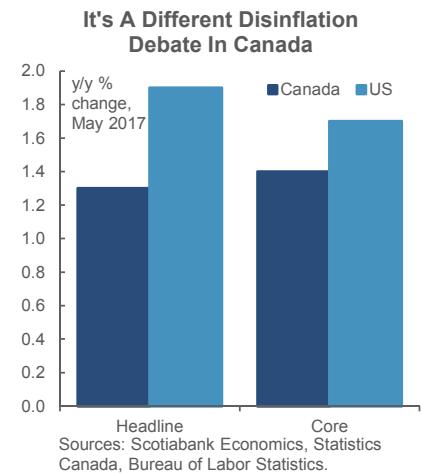


Chart 3



A further point is the role played by aggressive minimum wage hikes planned in Ontario and Alberta that will, on their own, add over a full percentage point to national wage growth in 2018 and a few tenths to 2019. This latter effect is transitory and a central bank should look through it, but when combined with the prior two arguments **it is entirely conceivable that the present gap in relative wage growth rates will close into next year and Canada may surpass the US with made-in-Canada wage growth of 2½%+**. That would offer a more constructive backdrop to getting back to the BoC's 2% inflation target. Growth in nominal personal disposable income that is presently running at about 4% y/y should be supported by firmer wage gains in the context of the BoC's Business Outlook Survey that showed companies indicating continued strong hiring intentions. If so, then raising rates can be accommodated to a point by income gains.

AND DIFFERENT INFLATION DYNAMICS

On inflation itself, here too the starting points are materially different in the two countries. Canada doesn't have a PCE style measure like the one the US Fed prefers but chart 3 compares headline CPI and core CPI inflation rates in the two countries. There are methodological differences (e.g., how housing is captured), but on balance Canada has less inflation than the US. Our in-house modelling approach to an augmented Phillips curve model that incorporates output gaps, a real effective exchange rate, food prices and unit labour costs gives us confidence in forecasting higher core inflation next year. Regardless, the downside risk to Canadian inflation and the debate over what's driving it is less material at a lower starting point than in the US in my opinion.

It is thus vitally important to understand how different Canadian wage and price dynamics are in relation to debates elsewhere and the transitory commodity income shock is at the centre of it all. Indeed, how things are playing out is similar to the lead-up to and aftermath of past periods when, say, oil prices slid by a comparable percentage amount for a comparable period of time. I've used charts 4 and 5 for ages to illustrate wage and price pressures in the quarters leading up to a trough in past oil price corrections and the ensuing quarters. The pattern to date in the current episode has been fairly typical. The pattern thereafter is also likely to be fairly typical in that a multi-year income and price shock is now at the point of shaking out toward firmer wage and price pressures going forward. These arguments are independent of the transitory influences of highly distorting gasoline prices on CPI (chart 6) and the BoC's point that energy and autos explain all of the deceleration in headline CPI from Q1 to Q2. Our autos specialist Carlos Gomes explains that automakers started the year hiking new car prices on C\$ weakness but then increased discounting as a likely transitory impact upon inflation.

THE FED IS FURTHER AHEAD OF THE BOC

Of course, the Fed has already hiked by 100bps to a Fed funds target range of 1.0–1.25% with another 25bps on the way in December in our forecast. By contrast, Canada retained emergency-era levels of monetary policy stimulus at a 0.5% overnight rate until a quarter point hike this week. The Fed's tightening connotes a little more flexibility for pausing to evaluate inflation uncertainties versus Canada where monetary and fiscal policy have somewhat overstimulated the economy on the path to posting an average growth rate of about 3¼% over the past four quarters—well in excess of the US four-quarter average that we estimate to be just under 2½%. Canadian monetary policy is now transitioning toward sterilizing prior policy stimulus in light of unique domestic influences that must be treated as being at least as important as global considerations affecting many countries.

Chart 4

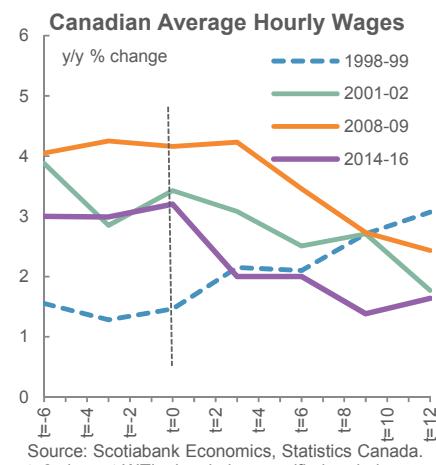


Chart 5

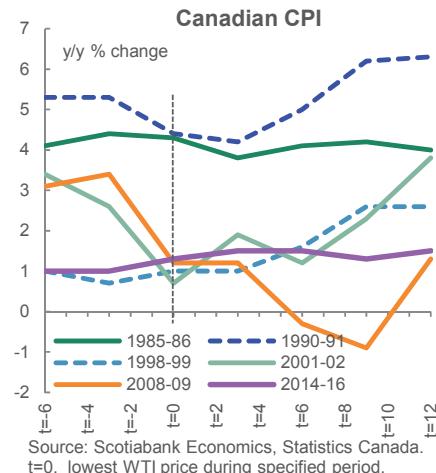
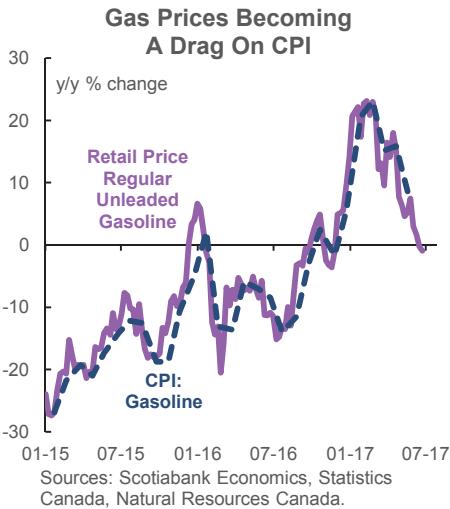


Chart 6



This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not construed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a "call to action" or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.