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Chart 1

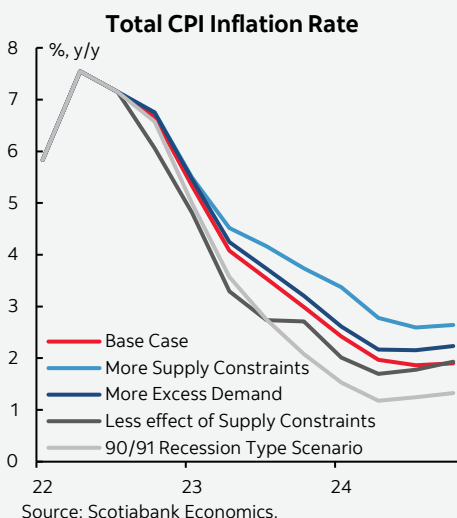
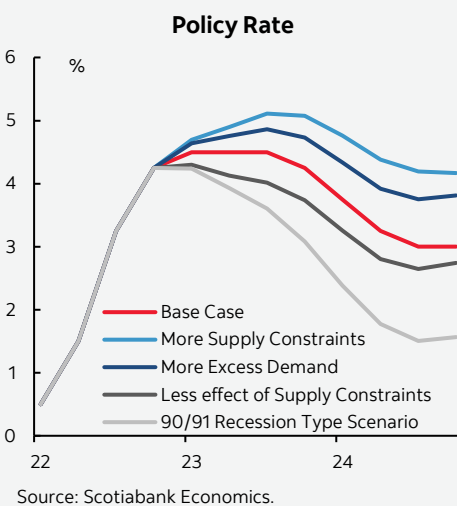


Chart 2



Spitballing Alternative Paths for Canadian Inflation

- Our **forecast** assumes a gradual decline in inflation that results principally from a fast improvement of the domestic and global supply constraints and bottlenecks, the recent fall of the price of oil and the expected slowdown of the US and Canadian economy. The pace at which inflation falls is limited by a forecast of solid wage growth in 2023, leading us to forecast inflation of around 4% this year, with a return to the 2% target in 2024.
- There is considerable uncertainty around this outlook. We investigate the effect of four alternative scenarios to give a sense of the risks around our view. Two are on the upside (more current excess demand and a deterioration of the supply constraints and bottleneck over the next 2 years) and two are to the downside (a faster effect on inflation of the recent important improvement in supply constraints and a 90/91 type recession).
- Though some scenarios are admittedly dramatic, they imply an upper and lower band for average inflation in 2023 of 3.3% to 4.5% (chart 1). Likewise, a 1990/91 recession could lead to a cut in the policy rate to 3.0% by the end of this year, while an important resurgence of supply constraints could see the policy rate rise further to 5.0% (chart 2).

Recent developments in Canadian inflation suggest that it is firmly on a downward path. This is of course much welcome following the post-pandemic experience with inflation. This experience has shaken our understanding of inflation dynamics and there is an ongoing debate about its drivers and, as a result, the appropriate policy response to it.

Our view is that most of the inflation we have experienced in Canada results from factors that, to date, have largely been beyond the control of the Bank of Canada. Global supply issues, high (though now lower) commodity prices, transportation bottlenecks and shipping delays, and of course low inventories. While these factors have the semblance of being supply issues, we take the perspective that the inflation challenge has its roots in the rapid acceleration of global demand resulting from the massive monetary and fiscal stimulus laid out during the early days of the pandemic in 2020. This created a wedge between global demand and supply that was exacerbated by COVID-19 supply challenges. There was always going to be a temporary dimension to the inflation shock—as supply rose to meet demand, and demand normalized as life returned to normal and central banks began to withdraw some stimulus. It was clear however, that the inflation shock was far more persistent than expected and that had a large impact on expectations, and of course eventually on wages. The deviation of inflation from targets and overheating in major economies necessitated a pronounced monetary tightening, as is now clear in actions taken to date.

Our **forecast** assumes a gradual decline in inflation that results principally the already observed decline in input prices. The pace at which inflation falls is limited by a forecast of solid wage growth in 2023, leading us to forecast inflation of around 4% this year, with a return to the 2% target in 2024. Monetary policy will have a limited impact on much of the decline in inflation that is expected as it essentially reflects global developments. That being said, a normalization of international factors will not be sufficient to return inflation to 2% hence the need for policy actions taken to date. In our current forecast, the Bank of Canada's policy peaks at its current level and is cut once near end-2023.

There is no question that our faith in our collective ability to forecast inflation has been shaken over the last couple of years. While Canadian inflation is evolving largely in line with models and forecasts now (our inflation forecast for 2023 has been reasonably stable since September), there is no question that forecasters and policymakers must be humble

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when forecasting inflation. A few months of data that align with general expectations do not make up for several quarters of serious underestimation. It is with this perspective in mind that we consider a few scenarios around our baseline view of inflation. We estimate two plausible scenarios which could result in higher inflation and two scenarios in which inflation might come down more rapidly than expected. In both cases we lay out implications for monetary policy and the outlook. The aim is simply to shed some light on alternative inflation paths in light of the inflation forecasting errors of the last two years.

We first consider two scenarios that could lead to higher inflation. The first assumes that excess demand is twice what we currently assume. The recent performance of the Canadian economy and labour market suggest that this assumption might be more realistic than would have been the case a month ago. This leads to inflation rising by about one third of a percentage point relative to our current forecast (2023: 4.2% vs 4.0% and 2024: 2.3% vs 2.0%) and, by the end of 2024, a gradual additional 75 basis points of tightening in Canada relative to the base case. In this scenario the peak response of the Canadian policy rate is 4.75% instead of 4.5% in the base case. The second assumes a further rise in input costs associated with additional disruptions in supply chains and higher oil prices, such as what might occur if the war in Ukraine deteriorated. In this scenario, inflation gradually rises by more than half a percentage point above our current forecast (2023: 4.5% vs 4.0% and 2024: 2.8% vs 2.0%), leading to a persistent peak policy rate of 5.00%. The policy rate is still at 4.25% at the end of 2024 compared to 3.0% in our base case.

On the downside, we consider a scenario where the economy is confronted by a 1990/91 type recession. This quadruples the amount of excess supply expected at end-2024 and leads to a roughly 1% decline in inflation relative to our current view. The fall in inflation and economic activity would force the Bank of Canada to cut rates immediately and rapidly, with the policy rate falling to 3% by the end of this year and 1.5% at the end of 2024. This is clearly a dramatic scenario, which is clearly at odds with the upward [revisions to the outlook](#) in recent weeks. A more realistic scenario is built around a faster passthrough of supply chain improvements to inflation as our inflation model incorporates an [estimated relation between supply delivery indices](#) and inflation. An acceleration of this channel would shave about one third of a percentage point from inflation by the end of this year. This would force the Bank of Canada to lower rates 50 bps below the base case at the end of 2023.

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