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GLOBAL ECONOMICS

INSIGHTS & VIEWS

June 1, 2026

Could Oil Prices Test the Credibility of the Bank of Canada?

- **Persistently high oil prices with sensitive inflation expectations are an important macro risk.** With the 2022 episode still fresh, a renewed oil price surge comes at a time when inflation expectations are more sensitive, raising the risk that shocks may carry larger and more persistent effects than in the pre-COVID period.
- **We assess the risk of prolonged geopolitical conflict involving Iran combined with an endogenous credibility framework.** Embedding time-varying credibility in our macro model, we allow expectations to evolve with inflation outcomes, capturing how a sustained oil shock can weaken the BoC's inflation anchor and alter price-setting behaviour.
- **Expectations are the key amplifier.** We find that the central bank credibility is still below its historical average, making the current situation fragile. If the Middle East conflict drags on and credibility slips further, inflation would become more persistent and rises more sharply, requiring materially tighter policy.
- **Loss of credibility is costly.** In a prolonged shock, de-anchored expectations could push inflation up to ~2pp above baseline, force aggressive rate hikes (+140bps), and trigger a significantly deeper economic slowdown.

The renewed surge in oil prices has brought back a familiar concern; that inflation could once again slip out of control. With the 2022 episode still fresh in mind, both markets and households are highly sensitive to price shocks. Shocks that would have been relatively benign in the pre-COVID period may now carry much greater weight.

Our baseline remains that oil prices eventually normalize, allowing inflation to gradually converge back to target. But the risk scenario is becoming increasingly relevant for the Canadian economy: one in which oil prices remain elevated for longer, sustaining cost pressures and, crucially, testing the resilience of inflation expectations.

WHERE DOES THE BOC CREDIBILITY STAND?

When inflation is close to target, firms and households place substantial weight on the central bank's objective and temporary shocks have limited and short-lived effects. But when inflation persistently deviates from target, credibility of that anchor weakens, and persistent shocks lead to very different inflation dynamics. So before turning to the scenario analysis, we must first evaluate where the credibility of the central bank's target stands, because the starting point matters.

To evaluate the state of the central bank's credibility, we rely on a modelling framework, used in **previous work**, embedded in our macro model that mimics endogenous credibility. In this setup, agents form expectations as a combination of the inflation target, recent inflation, and expected future inflation. The key feature is that the weight on the central bank's target varies over time with inflation outcomes and expectations. As past and expected inflation moves away from target, firms place less weight on the target and increasingly rely on observed and expected inflation when setting prices. This shift makes inflation more backward-looking and more persistent, less self-correcting and more sensitive to ongoing shocks. See Appendix A for modeling details.

Chart 1 illustrates this mechanism through the weight placed on the inflation target over history, which we interpret as a proxy for the central bank's credibility. At a high level, the index captures how much confidence agents place in the central bank's ability to deliver on its target based on recent and expected inflation outcomes.

Unsurprisingly, this measure deteriorated sharply during the pandemic period, as inflation rose well above target and remained elevated. The longer inflation stayed high, the more agents adjusted their behaviour, gradually placing less weight on the 2% anchor.

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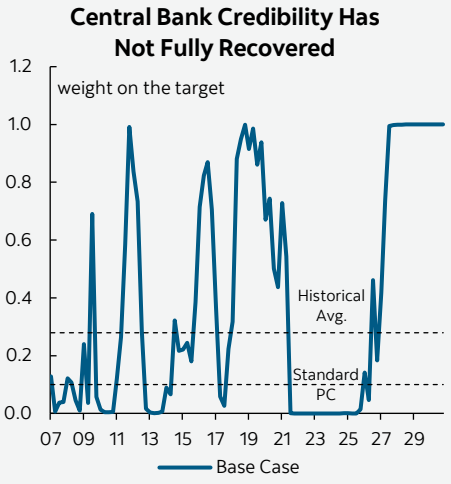
Chart 1



Source: Scotiabank Economics.

More recently, inflation has come down significantly, but core inflation has been slow to fully return to target, leaving the central bank credibility still below its historical average. That said recent incoming data, including the April CPI print, point in the right direction, and we expect progress on core inflation to continue which should allow credibility to rebuild completely in the near term.

Still, the current starting point remains fragile. This leaves the inflation process more exposed to renewed shocks than in a fully anchored regime. In particular, in an environment where households are highly sensitive to visible price increases—especially gasoline and food—a sustained rise in energy prices could once again weigh on expectations. This is what we explore next.

WHAT COULD GO WRONG?

A prolonged geopolitical conflict involving Iran would tighten global oil markets for an extended period and generate significant supply chain disruptions. But even if oil prices do not rise further and instead remain elevated for a prolonged period, the implications for inflation could still be substantial. Beyond the direct impact on inflation, the persistence of the shock amplifies its indirect effects. Elevated fuel and transportation costs push up production costs across a wide range of sectors, from manufacturing to services. Since firms cannot absorb these cost increases indefinitely, they ultimately pass them on through higher prices. In other words, temporary shocks can be absorbed, but persistent shocks tend to alter behavior.

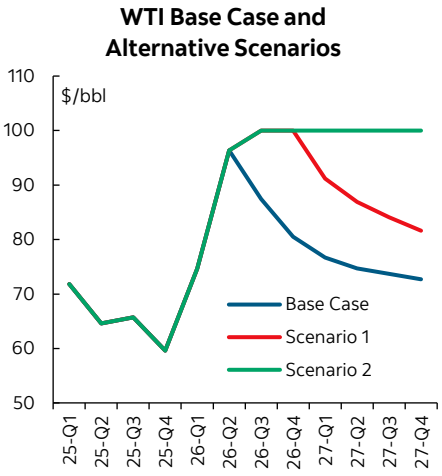
Another key mechanism operates through inflation expectations. When expectations are well anchored, firms broadly trust the central bank's target and tend to look through small, temporary deviations in inflation. The degree of this so-called "rational inattention" is beneficial, as it allows central banks to guide inflation back to target following transitory shocks. However, when shocks are large and persistent, well-anchored expectations can no longer be taken for granted, especially since the credibility of the BoC has not yet fully recovered, as shown in chart 1 again.

The 2022 episode provides a clear illustration. As inflation surged, measures of expectations began to drift, forcing central banks to respond more aggressively to regain control. In the case of a persistent shock, such as one in which conflict in the Middle East drags on, these pressures could re-emerge. While we don't think a repeat of 2021–2022 is the most likely scenario since the economy is currently in excess supply and fiscal policy is not as stimulative as it was, it is still an important upside risk. To assess the magnitude of the potential issue, we turn to a scenario analysis of a more prolonged conflict combined with a modeling device designed to capture endogenous changes in the central bank's credibility.

ALTERNATIVE SCENARIO: PERSISTENTLY ELEVATED OIL PRICES AND SUPPLY CONSTRAINTS WITH UNANCHORED EXPECTATIONS

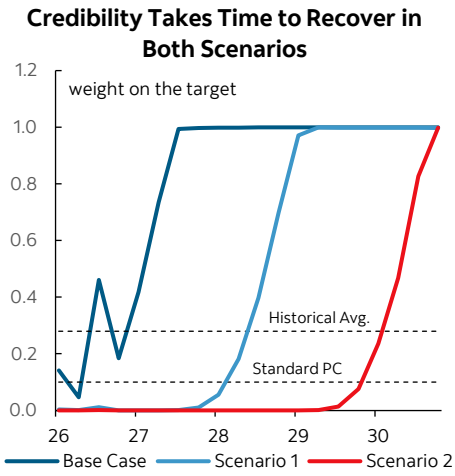
To quantify the upside risk to inflation, we construct scenarios built on three common pillars. In Scenario 1, we assume (1) oil prices remain elevated at $100 through the end of 2026; (2) supply chain frictions persist, as proxied by continued pressure on delivery times; and (3) central bank credibility is endogenous, allowing inflation expectations to de-anchor. Scenario 2 extends the same three assumptions, but over a longer horizon, with elevated oil prices and supply bottlenecks persisting through the end of 2027. Chart 2 shows the three oil price (WTI) scenarios.

Chart 2



Source: Scotiabank Economics.

Chart 3



Source: Scotiabank Economics.

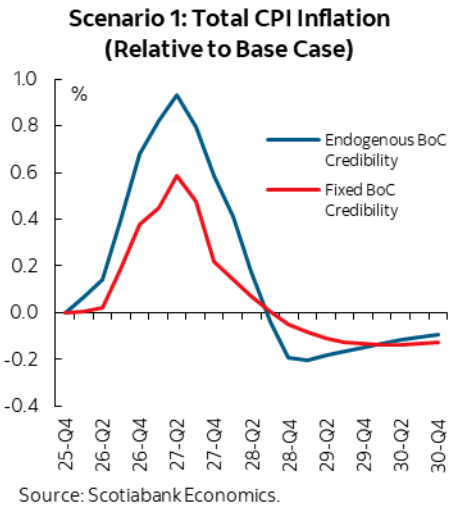
The inflation expectation de-anchoring mechanics is critical here. Rather than assuming that expectations are well anchored, we allow them to evolve endogenously using the framework described above (chart 3). This mechanism becomes particularly relevant in these alternative scenarios since energy prices play an important role in shaping inflation expectations. Households observe gasoline and food prices frequently and tend to extrapolate these movements into broader inflation beliefs. As a result, expectations are especially sensitive in an environment of persistently high oil prices. If households and firms come to believe that elevated inflation will persist, those beliefs can feed directly into wage demands and pricing behavior.

LOST CREDIBILITY = MORE PERSISTENT INFLATION, DEEPER ECONOMIC DOWNTURN

The simulation results point to a clear asymmetry in inflation dynamics, one that hinges critically on whether expectations remain anchored.

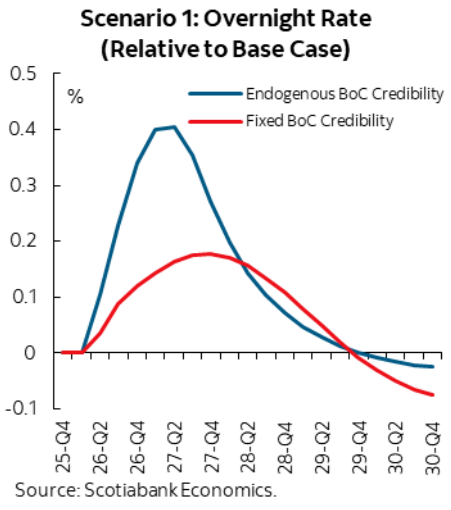
In the first scenario, the oil shock pushes inflation higher by roughly 0.6% above the base case, if expectations remain well anchored (chart 4), reaching 3.1% in 2026 and 2.7% in 2027 (table 1 shows the impact of the scenarios on the dynamics of the main macro variables). The impulse remains generally contained; firms and households continue to use the inflation target as their reference point, limiting second-round effects. In that environment, the BoC retains the flexibility to "look through" part of the shock. The result is only a modest tightening of monetary policy, with rates increasing by a limited amount to stabilize inflation over time (chart 5).

Chart 4



Source: Scotiabank Economics.

Chart 5



Source: Scotiabank Economics.

Table 1: Canada - Oil Price and Supply Constraints - Effects Relative to Base Case

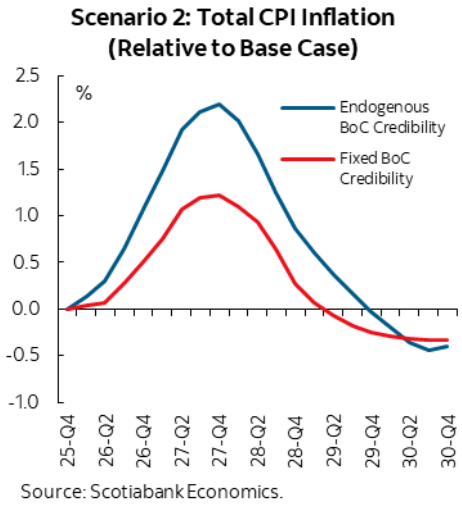
Case		Total CPI Inflation		Policy Rate		GDP Growth	
		2026	2027	2026	2027	2026	2027
Base		3.0	2.2	2.56	3.00	1.3	2.0
Scenario 1	Fixed Credibility	3.1	2.7	2.62	3.16	1.2	2.1
	Endogenous Credibility	3.3	3.0	2.73	3.36	1.1	2.0
Scenario 2	Fixed Credibility	3.2	3.3	2.75	3.68	1.2	2.0
	Endogenous Credibility	3.5	4.2	3.01	4.34	0.8	1.2

Source: Scotiabank Economics.

The picture changes materially once credibility starts to slip. In the case where credibility is endogenous and inflation expectations begin to de-anchor; inflation increases by 1% and is more persistent, reaching 3.3% in 2026. The key issue is that the inflation process itself changes: firms no longer price off the central bank's target, but instead increasingly rely on observed and expected inflation. At that point, the central bank loses a key stabilizing channel; it can no longer rely on credibility to do part of the work. Restoring that credibility requires a much more forceful response; the policy rate needs to rise by roughly 40 bps to bring inflation back under control. The policy rate in this case is 3.25% on average in 2027.[1] The central bank will regain its credibility by the end of 2027.

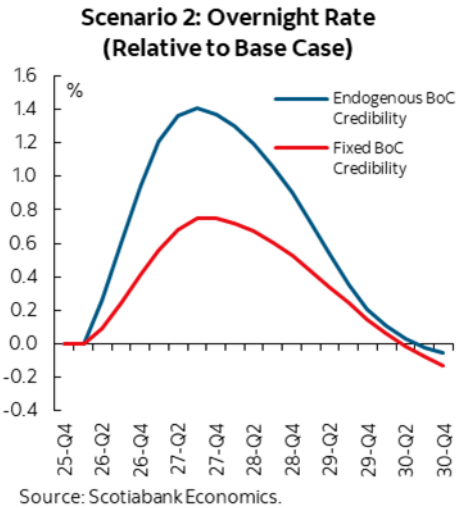
The problem becomes significantly more acute in a prolonged shock environment. In the second scenario, when oil prices remain elevated through 2027, the inflation impulse compounds (chart 6). With a loss of credibility, inflation response peaks at 2% above the base case, reaching 4.2% in 2027, and the policy response becomes significantly more aggressive, with rates rising by 140 bps above the base case (chart 7). This would bring the policy rate at 4.25% on average in 2027.[1] In this case, the central bank only gets its full credibility back at the end of 2029.

Chart 6



Source: Scotiabank Economics.

Chart 7



Source: Scotiabank Economics.

[1] The monetary policy rule in these simulations remain the same in both cases. However, in an optimal policy setting, the central bank would likely put more weight on inflation deviations knowing that inflation expectations can de-anchor. This would mean an even more reactive policy rate, and tighter policy rates.

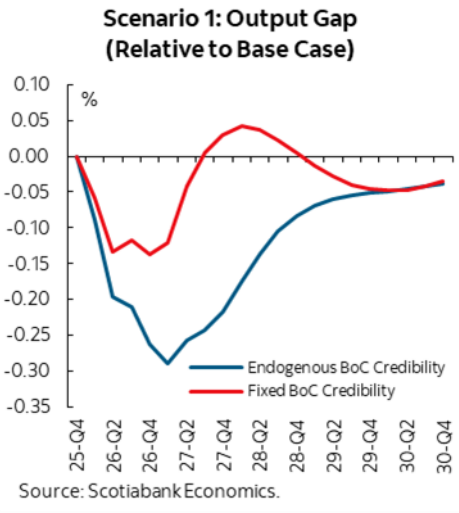
THE COST OF DISINFLATION RISES SHARPLY

One of the key results from these simulations is that once expectations de-anchor, the economic cost of bringing inflation back down increases materially.

When credibility is intact, part of the disinflation process comes "for free"; agents expect inflation to return to target, which helps anchor price setting even as shocks hit. This shows up clearly in the simulations. The impact on the economy of the scenario with fixed credibility is small; higher oil prices provide some income support to the Canadian economy via the terms of trade, but it's largely offset by persistent supply chain disruptions, and the small monetary tightening.

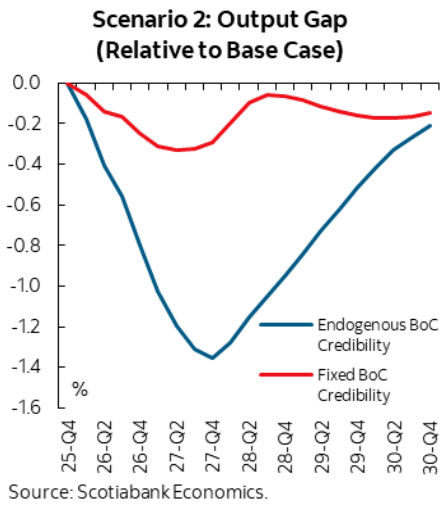
But when the anchor weakens, disinflation has to be engineered through demand destruction, i.e. weaker growth, softer labour markets, and a larger output gap. Simulations show the level of output would need to drop by 0.3% to bring inflation back to target (chart 8). This is twice as much as in the fixed credibility case, for the same oil shock. The effect is dramatically more pronounced in the second scenario where oil prices remain elevated until the end of 2027 (chart 9), with output falling by 1.4%. GDP growth would be significantly lower at 0.8% this year and 1.2% in 2027 in that case. Put differently, the economy has to endure a much deeper slowdown to generate the same disinflation outcome.

Chart 8



Source: Scotiabank Economics.

Chart 9



Source: Scotiabank Economics.

BOTTOM LINE

The key message is that a more persistent oil price profile can quickly become destabilizing if expectations are not well anchored. This is precisely why a risk management approach is essential in situations like this. Acting early and communicating clearly the commitment to controlling inflation can help prevent expectations from drifting in the first place, avoiding the need for a strong downturn in economic activity to regain control of inflation. Credibility, once lost, is definitely costly to rebuild.

APPENDIX: PHILLIPS CURVE WITH ENDOGENOUS CREDIBILITY

To model endogenous credibility of the central bank, we start with a standard Phillips curve, in which inflation is a function of expected inflation, the output gap, the first difference of the log of the real effective exchange rate and the first difference of the log of the real price of oil and lags of the PMI supplier's delivery index, and the year-over-year growth rate of the Unit Labour Cost (ULC) in deviation of its equilibrium growth:

$$\pi_t = \pi_t^e + \gamma.output_{gap_{t-2}} + \xi.\Delta lrer_{t-1} + \delta.\triangle\ lpoil_{t-1} + \beta.\frac{pmi_{t-1} + pmi_{t-2}}{2} + \mu * ulc\_gap_{t-2}$$

Here, inflation expectations are a combination of backward- and forward-looking agents' expectations. Assuming a constant share of backward-looking agents, ω, and a constant share, $(1-\omega)$, of forward-looking agents, inflation expectations can be rewritten as follows:

$$\pi_t^e = \omega.\pi_b^e + (1-\omega).\pi_f^e$$

Backward-looking agents' expectations are a function of the inflation target and past inflation, while forward-looking agents' expectations are a function of the inflation target and future inflation. In forming their expectations, backward-looking agents assign $\varphi_{\exp}^b$ as a time-varying weight on the inflation target, π_t^*, and $(1-\varphi_{\exp}^b)$ as a time-varying weight on past inflation. Similarly, forward-looking agents assign $\varphi_{\exp}^f$ as a time-varying weight on the inflation target and $(1-\varphi_{\exp}^f)$ as a time-varying weight on future inflation:

$$\pi_t^e = \omega.[\varphi_{exp}^b.\pi_t^* + (1-\varphi_{\exp}^b).\pi_{t-1}] + (1-\omega).[\varphi_{exp}^f.\pi_t^* + (1-\varphi_{\exp}^f).\pi_{t+2}]$$

$\varphi_{\exp}^b$ is a function of the moving average of the gap between recent inflation and the target, while $\varphi_{\exp}^f$ is a function of the moving average of the gap between the expected inflation rate and the target. Therefore, these time-varying weights have the following functional form:

$$\varphi_{\exp}^b = \frac{e^{-(mave(inf\_gap_{t-1})^2}}{2\theta_t^2}$$

$$\varphi_{\exp}^f = \frac{e^{-(mave(inf\_gap_{t+1})^2}}{2\theta_t^2}$$

where θ_t is the key estimated coefficient that determines the speed at which agents will reorient their inflations expectations from the inflation target to recent and future inflation. The larger θ_t, the slower agents will move away from the target when they form expectations if the inflation deviates from the target. Thus, θ_t is proportional to the agents' tolerance of deviations of recent and future inflation from target.

Combining both time-varying expectations creates our total anchored inflation expectations index, which is modelled as follows:

$$\psi_{exp} = \omega.\varphi_{\exp}^b + (1-\omega).\varphi_{\exp}^f$$

$$\psi_{exp} = \omega.\left[\frac{e^{-(mave(inf\_gap_{t-1})^2}}{2\theta_t^2}\right] + (1-\omega).\left[\frac{e^{-(mave(inf\_gap_{t+1})^2}}{2\theta_t^2}\right]$$

The resulting modified Phillips curve is:

$$\pi_t = \omega.\left[\frac{e^{-(mave(inf\_gap_{t-1})^2}}{2\theta_t^2}.\pi_t^* + \left(1 - \frac{e^{-(mave(inf\_gap_{t-1})^2}}{2\theta_t^2}\right).\pi_{t-1}\right] + (1-\omega).\left[\frac{e^{-(mave(inf\_gap_{t+1})^2}}{2\theta_t^2}.\pi_t^* + \left(1 - \frac{e^{-(mave(inf\_gap_{t+1})^2}}{2\theta_t^2}\right).\pi_{t+2}\right] + \gamma.output_{gap_{t-2}} + \xi.\Delta lrer_{t-1} + \delta.\triangle lpoil_{t-1} + \beta.(pmi_{t-1} + pmi_{t-2})/2 + \mu * ulc\_gap_{t-2}.$$

We estimate our modified Phillips curve with non-linear least squares using the generalized method of moments (GMM). The estimation results are summarized in table 2.

Table 2: Phillips Curve Estimation Results

	Coefficient	t-statistic
ω	0.74149	29.7
θ	0.00169	6.6
γ	0.02295	3.9
ξ	0.0186	3.8
δ	0.00614	5.7
β	-0.0002	-7.2
μ	0.0102	2.1

Sample: 2007Q1-2025Q4
Source: Scotiabank Economics.