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.

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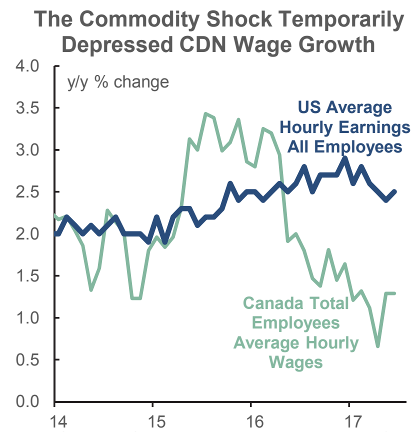
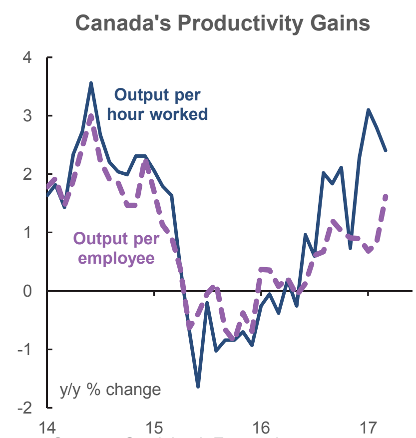
Chart 1



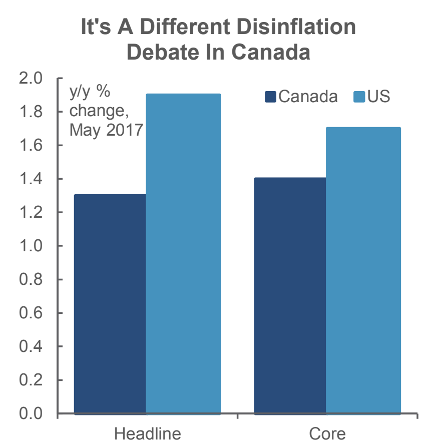
Sources: Scotiabank Economics, Bureau of Labor Statistics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada, Bureau of Labor Statistics.

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

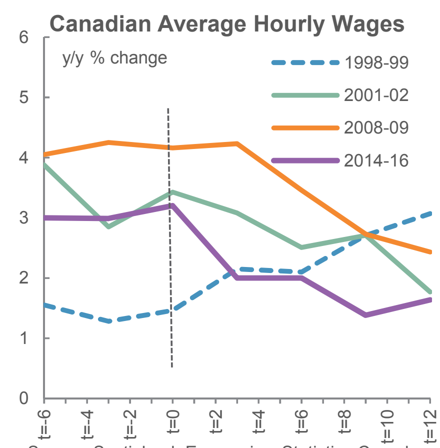
On inflation itself, here too the starting points are materially different in the two countries. Canada doesn't have a PCE style measure like the one the US Fed prefers but chart 3 compares headline CPI and core CPI inflation rates in the two countries. There are methodological differences (e.g., how 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

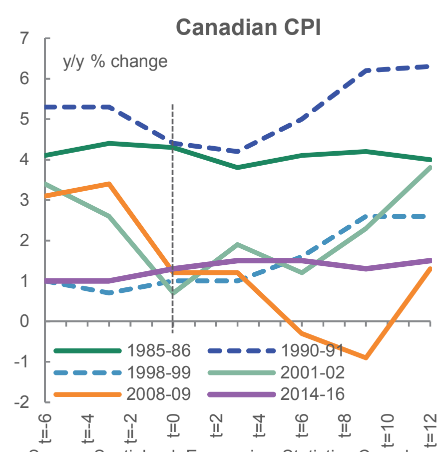
Of course, the Fed has already hiked by 100bps to a Fed funds target range of 1.0–1.25% with another 25bps on the way in December in our forecast. By contrast, Canada retained emergency-era levels of monetary policy stimulus at a 0.5% overnight rate until a quarter point hike this week. The Fed's tightening 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



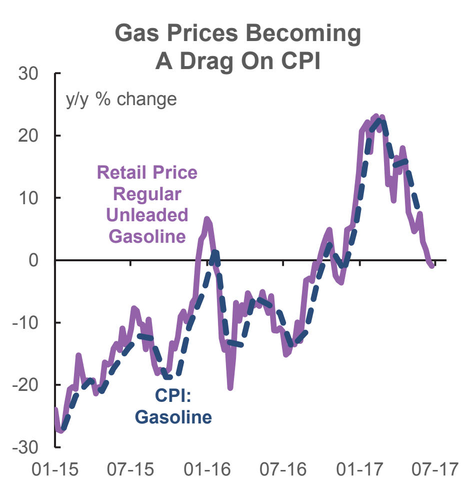
Source: Scotiabank Economics, Statistics Canada. t=0, lowest WTI price during specified period.

Chart 5



Source: Scotiabank Economics, Statistics Canada. t=0, lowest WTI price during specified period.

Chart 6



Sources: Scotiabank Economics, Statistics Canada, Natural Resources Canada.