ECONOMIC VIEWPOINT

The Price Is Right: Unpacking Our CPI Inflation Forecast

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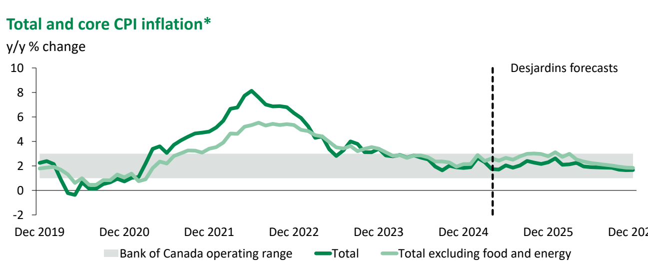
HIGHLIGHTS

- Just when it seemed that the worst of the pandemic price gains were over, the outlook for Canadian inflation has been hit with substantial offsetting policy shocks.
- The year started with the short-lived GST/HST holiday, which provided some temporary relief, particularly for food, from still-elevated prices following the pandemic. But as this came to an end, the trade war with the United States ramped up, and retaliatory tariffs added to the price of imported goods. Food prices are again notably impacted and will continue to be going forward.
- However, the elimination of the federal price on pollution will provide a substantial offset to this tariff-induced price hike, particularly for the year starting in April 2025. Lower interest rates and a likely lacklustre performance in the housing market should also help to keep downward pressure on shelter inflation—the primary expense for most households.
- Taken together, despite these offsetting policy impacts, we expect headline CPI inflation to remain near the Bank of Canada's 2% inflation target for the foreseeable future.

2025 has been quite a year for inflation forecasting, and it isn't even half over. Starting the year with a federal GST/HST holiday on selected items from toys to trees and beer to brunch, the price of some imported goods then moved higher on the tit-for-tat trade war with the United States. Add to this the recent elimination of the price on pollution and, by our estimation, all this policy-induced price volatility has left the inflation forecast tracking not far from the Bank of Canada's 2% inflation target (graph 1). But under the surface, there's a lot more happening than meets the eye.

Graph 1
Total CPI Inflation Should Stay Around 2% in 2025 and 2026

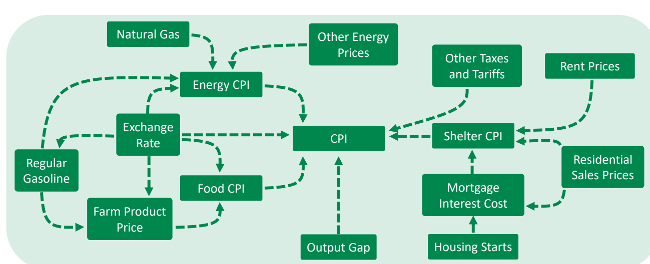


CPI: Consumer Price Index; * Calculated using fixed basket weights.
Statistics Canada and Desjardins Economic Studies

Inflation Forecasting Ain't Easy

At its highest level, our Consumer Price Index (CPI) inflation forecast is composed of three indexes: energy CPI, food CPI and total CPI less food and energy (hereinafter referred to as core CPI inflation). To varying degrees and through a variety of channels, each of these price indexes links back to the economy. Figure 1 provides a high-level illustration of these relationships.

Figure 1
Transmission Channels of Our Inflation Framework



CPI: Consumer Price Index
Desjardins Economic Studies

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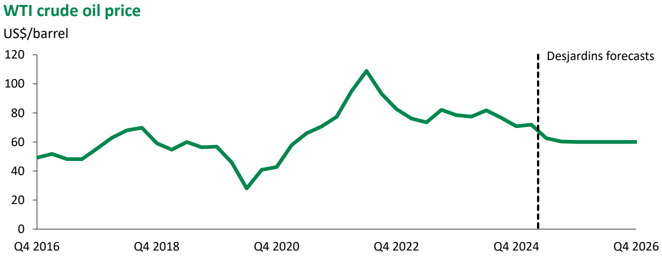
Energy Is Fueling the Inflation Forecast

As some of the most visible prices consumers see, either at the pump or in their monthly utility bills, energy prices are always a hot topic of conversation. And when we forecast energy inflation, oil prices play a key role, whether it's for the cost of gasoline, home heating oil or fuel for recreational vehicles. Our outlook for oil prices has been consistently marked down throughout 2025, as the Trump administration has taken actions intended to increase the supply of US crude production while dampening global demand through its antagonistic trade policies (graph 2). In contrast, natural gas and electricity prices tend to be a little more stable and less closely linked to the market prices of underlying commodities used as inputs.

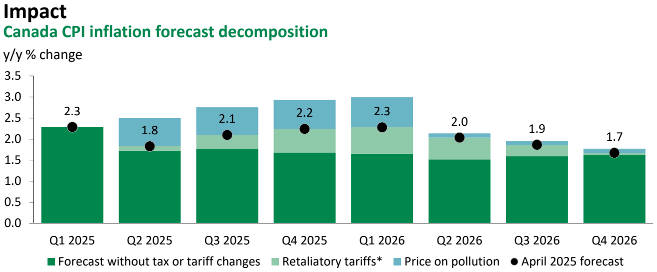
Graph 2
Lower Oil Prices Should Help to Pull Down Energy CPI Inflation



CPI: Consumer Price Index; WTI: West Texas Intermediate
Datastream and Desjardins Economic Studies

But arguably the most important factor contributing to the swing in our energy price forecast is the elimination of the federal price on pollution. By our estimate, getting rid of the consumer carbon tax reduced year-over-year CPI inflation by about 0.7 ppts (percentage points) in April 2025 relative to the alternative (graph 3). To put this in context, we've estimated that the contribution of retaliatory tariffs to headline inflation over the year starting in April 2025 should be about 0.3 ppts. The drag from lower energy prices on headline price growth should last for about a year. After that, the fact that there will be no future carbon tax increases is likely to keep average annual inflation about 0.1 ppts lower than it would have been otherwise.

Graph 3
Eliminating the Price on Pollution Will Offset Retaliatory Tariffs' Price Impact

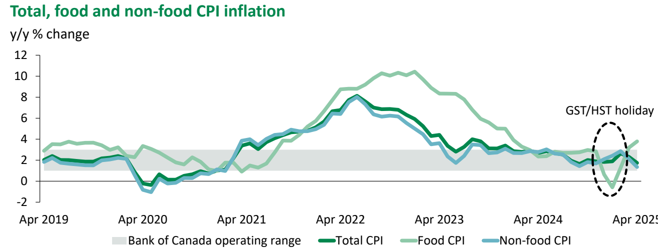


CPI: Consumer Price Index; * Up to and including tariffs announced as of May 20, 2025.
Government of Canada, Statistics Canada and Desjardins Economic Studies

Food CPI Can Be a Tough Nut to Crack

Energy also plays an important role in our forecast for food inflation, as transportation costs are a key input into the prices that Canadians see on store shelves. And the prices that farmers receive for the agricultural goods they sell, as measured by the farm product price index, also contribute to our food inflation forecast. Taxes impact food costs too, as witnessed earlier this year when the federal government included food at restaurants among the goods and services benefitting from the GST/HST holiday (graph 4).

Graph 4
Lower Food Prices Are No Longer Pulling Down Headline Inflation



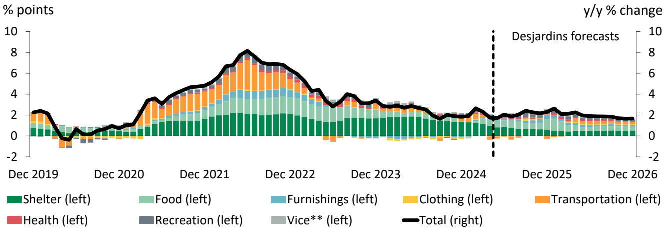
CPI: Consumer Price Index
Statistics Canada and Desjardins Economic Studies

But while the GST/HST holiday was short lived, retaliatory tariffs on imports from the United States may be in place for much longer. These target a broad group of fresh and prepared goods that Canadians enjoy, particularly in the winter months when our most productive farmland is covered with snow. And while reduced recently, these customs duties are estimated to have contributed as much as 0.4 ppts to food inflation in April 2025 relative to a year earlier, adding to the sting of higher food prices that have yet to come down following their pandemic surge. The depreciation of the Canadian dollar earlier in the year only exacerbated this pressure on household grocery bills.

Taken together, we think the combined impact on food inflation of tariffs on imports from the United States and a weaker Canadian dollar will more than offset the projected drag from energy prices. Food CPI inflation should keep advancing beyond its pre-pandemic pace as a result (graph 5 on page 3). And while the farm product price index has been declining on a year-over-year basis for the better part of two years, it's tough to know how the global trade war and increasing incidents of severe weather will impact it in the coming months and years.

Graph 5
Food Prices Are Likely to Become a Key Driver of Our Inflation Outlook

Total CPI inflation and its underlying decomposition*



CPI: Consumer Price Index; * Calculated using fixed basket weights; ** Alcohol, tobacco and cannabis.
Statistics Canada and Desjardins Economic Studies

The Fog of Core Inflation

Higher import tariffs and lower energy taxes won't just impact the cost of food and fuel, but will impact a broad group of other prices as well, both directly and indirectly.

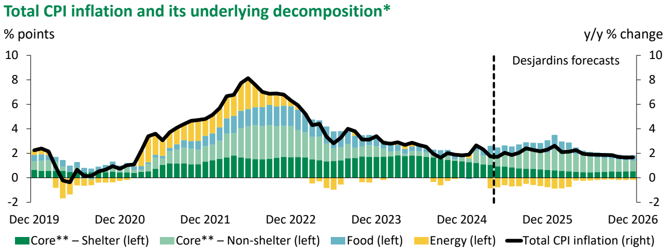
Tariffs Take the Reins of Core Inflation

Over the past couple of years, core non-shelter CPI inflation has seen its contribution to headline price growth gradually diminish. This followed the sharp rise in this group of prices due to pandemic-related supply chain constraints and rising services costs.

However, the tide has turned again this year and core non-shelter CPI inflation is expected to reaccelerate going forward, as retaliatory tariffs on imports from the United States feed into underlying price growth (graph 6). Consequently, core non-shelter CPI inflation should make a significant contribution to underlying inflation in 2025 and 2026, overtaking core shelter inflation as the primary driver.

Graph 6
Tariffs Should Replace Shelter as the Main Driver of Inflation

Total CPI inflation and its underlying decomposition*



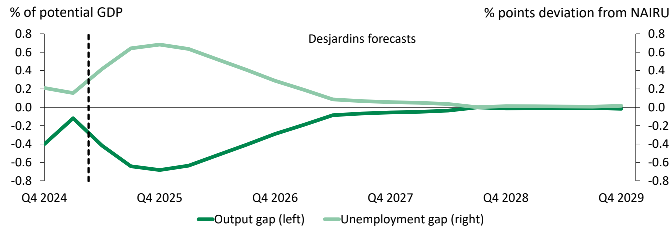
CPI: Consumer Price Index
* Calculated using fixed basket weights; ** Core refers to the total CPI index excluding food and energy.
Statistics Canada and Desjardins Economic Studies

Economic Slack Is Expected to Hold Inflation Back

At the same time that retaliatory tariffs will boost inflation, they will also offset it more gradually by weighing on economic activity as households and businesses reduce spending. When forecasting the impact of economic activity on inflation, economists tend to look at what's called the output gap—the difference between the level of economic activity and the potential output of the economy. And with the output gap expected to turn negative going forward, the unemployment rate should also move higher relative to its trend (graph 7). These catch-all indicators for belt tightening by households and businesses mean less demand and, therefore, less pressure on prices.

Graph 7
The Negative Output Gap Should Be Mirrored by the Unemployment Rate

Output gap versus unemployment rate gap



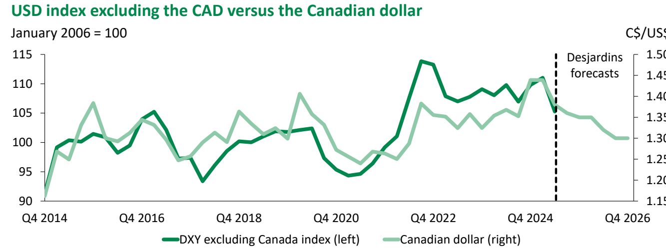
NAIRU: Non-accelerating inflation rate of unemployment
Statistics Canada and Desjardins Economic Studies

Going Loonie for Disinflation

Adding to the drag on headline inflation is the recent turn of events for the loonie. While volatility and a sharp depreciation characterized the start of the year, the Canadian dollar has since appreciated on souring demand for US assets and, hence, the US dollar (USD). Looking ahead, we expect the USD to continue to devalue against a broad group of currencies, including the Canadian dollar (graph 8). This will help to offset the inflationary impact of higher tariff-induced import prices.

Graph 8
We Expect the Worst Is Likely Over for the CAD

USD index excluding the CAD versus the Canadian dollar

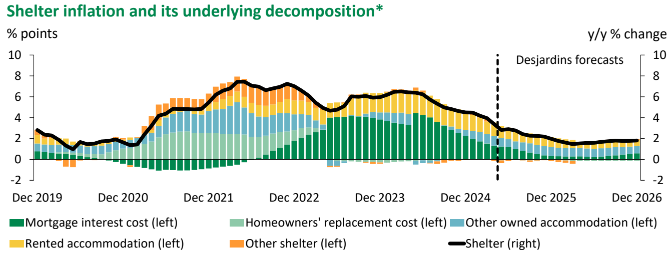


Note: Estimates and forecasts are for end-of-period values.
Federal Reserve and Desjardins Economic Studies

Finding Shelter from Shelter Inflation

To the relief of many, shelter inflation has begrudgingly started to come down from the 7.4% y/y peak reached in May 2022, and that pace of cooling has accelerated since the middle of last year. This has been broadly in line with the forecast we published more than a year ago. Looking ahead, we expect this trend to continue as the broad-based slowing in shelter inflation persists going forward (graph 9).

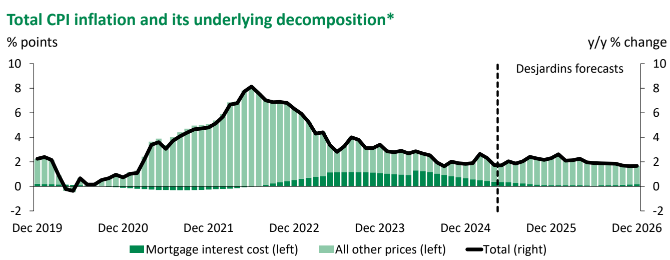
Graph 9
We Expected a Broad-Based Slowing in Shelter Inflation Ahead



* Calculated using fixed basket weights.
Statistics Canada and Desjardins Economic Studies

Unpacking shelter CPI, the biggest contributing component is owned accommodation, which has started to track meaningfully lower for roughly the past year. There are a couple of reasons for this. The first is sharply lower mortgage interest cost (MIC) inflation, which turned lower two years ago roughly when the Bank of Canada paused its hiking cycle and subsequently cut interest rates (graph 10). Another important driver has been the sustained weakness in new home price growth following the pandemic surge, which has helped to slow the advance in homeowners' replacement cost. Broadly flat existing home prices since late 2022 have also played a role. Looking ahead, owned accommodation CPI inflation is expected to continue to slow, as interest rates move lower still and home prices grind sideways on faltering demand. This despite the inflationary impact of higher prices for imported construction materials on shelter costs.

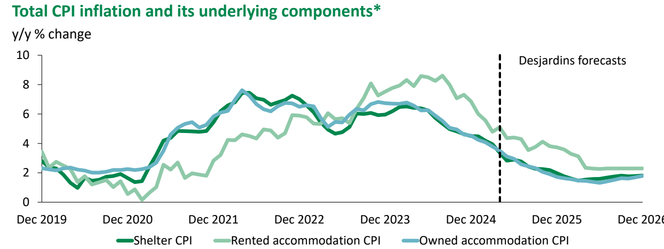
Graph 10
Mortgage Interest Cost Should Continue to Fade as a Driver of Inflation



CPI: Consumer Price Index; * Calculated using fixed basket weights.
Statistics Canada and Desjardins Economic Studies

The other big contributor to core shelter inflation is rented accommodation CPI. Last fall we published research outlining our framework for forecasting rent inflation, building the national forecast by starting at the city level. The path of rent inflation since that time has been consistent with our forecast, as non-permanent resident admissions have declined and year-over-year growth in market rents have turned negative. And despite some wiggles on a month-to-month basis, we are of the view that the trend of slowing rent inflation growth will persist going forward, acting to further slow shelter inflation (graph 11).

Graph 11
Rent Inflation Is Expected to Continue to Track Lower



CPI: Consumer Price Index; * Calculated using fixed basket weights.
Statistics Canada and Desjardins Economic Studies

Conclusion

Taken together, despite all of the shocks hitting the outlook for Canadian inflation in the first half of 2025, price growth is moving in the right direction. Indeed, we are of the view that it will remain around the Bank of Canada's 2% inflation target for the foreseeable future. This will allow the Bank to turn its attention to weaker economic activity and a softening labour market as the impacts of the Trump trade war hit home.