

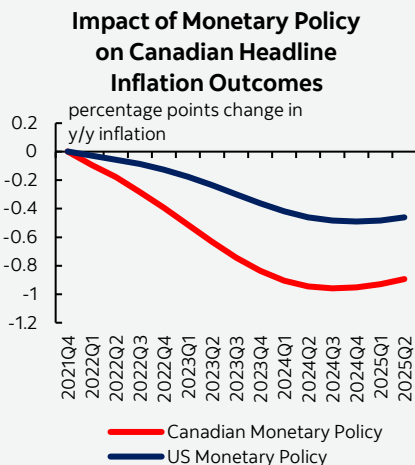
Contributors

**Jean-François Perrault**  
SVP & Chief Economist  
Scotiabank Economics  
416.866.4214  
[jean-francois.perrault@scotiabank.com](mailto:jean-francois.perrault@scotiabank.com)

**René Lalonde**  
Director, Modelling and Forecasting  
Scotiabank Economics  
416.862.3174  
[rene.lalonde@scotiabank.com](mailto:rene.lalonde@scotiabank.com)

**Farah Omran**  
Senior Economist  
Scotiabank Economics  
416.866.4315  
[farah.omran@scotiabank.com](mailto:farah.omran@scotiabank.com)

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

## How Much of an Impact is the BoC Having on Inflation?

- While central banks the world over have raised interest rates considerably in an attempt to slow economic activity and bring inflation back to targets, much of the decline in Canadian headline inflation so far is linked to factors well beyond the influence of Canadian policymakers. These include the decline in international oil prices, the normalization of global supply chains and a decline in US inflation.
- Nevertheless, the Bank of Canada’s actions have had meaningful impacts on the inflation fight. We estimate the Bank of Canada’s policies have shaved about 0.6 percentage points from the level of inflation so far, which will rise over time to account for about 1 percentage point by the end of 2024 given the lags in the transmission of monetary policy.
- Moreover, given how US inflation and growth dynamics impact Canada, we find rate hikes by the Federal Reserve have so far shaved an additional 0.2 percentage points from Canadian inflation, which will build through 2025 to account for about 0.5 percentage points.

Inflation has bedevilled policymakers across the globe over the last year. Many central banks, including our own, have raised interest rates considerably in an attempt to engineer a return of inflation to target. This note examines the impact of these rate increases on Canadian inflation so far and the likely impact going forward. Not surprisingly, much of the decline so far in headline inflation is linked to factors well beyond the influence of Canadian policymakers. Nevertheless, the Bank of Canada’s efforts are paying off. We estimate that BoC policies have shaved about 0.6 percentage points from the level of inflation so far. Given the lags of monetary policy, this impact will rise over time and account for about 1 percentage point of the total decline in inflation by the end of 2024. This may not seem meaningful, but it represents the difference between a 3% inflation rate in 2025 and 2%. Moreover, efforts by the Federal Reserve to tame inflation in the United States have also supported the Bank of Canada’s efforts, helping to lower Canadian inflation by an additional 0.2 percentage points so far, with slightly more than a doubling of that impact expected over the coming year.

Headline Canadian inflation has fallen a lot. From a peak of 8.1% in June 2022, inflation now stands at 3.3%. This decline is attributable to a broad range of factors which we assess empirically using our macroeconomic model of the Canadian economy. Our approach to modelling inflation is rich, in that it includes the output gap, oil prices, US inflation, the exchange rate, unit labour costs, a measure of supply chain pressure and internally generated inflation expectations. Topping the list of individual factors is the decline in international oil prices over this time, but the normalization of global supply chains and a decline in US inflation have also been key drivers. The output gap, a key driver of inflation dynamics in Canada, has so far had relatively little impact in bringing inflation down given that the impact of pent-up demand, which pushes up excess demand, has partly offset the depressing impact of monetary policy on the output gap.

To estimate the impact of monetary policy on inflation to date, we simulate our model from 2021Q4 using two different paths of the monetary policy rate: the realized path of monetary policy and our expectations for that path going forward beyond today, and the policy rate path of our forecast made in 2021Q3, which did not foresee the massive rise in inflation to come and in which we assumed that the Bank of Canada would gradually raise its rate to a neutral setting through 2025. The difference in inflation performance between these two scenarios can be thought of as an estimate of the impact of the Bank of Canada’s actions in response to the inflation surge.

The results suggest that the Bank of Canada’s actions have had a meaningful impact on inflation, with some qualifications. Chart 1 shows the impact to date and the impact going forward. As of 2023Q2, we estimate that Canadian monetary policy has shaved 0.6 percentage points from the level of inflation to date. While this may appear small relative to the total decline in inflation so far, this is a very large impact given the historical movements in inflation and the size of the inflation control band (of 1 to 3%). Moreover, as monetary policy operates with a lag, the impact will build going forward. At its peak, monetary policy will account for about a full percentage point of the decline in inflation. In other words, inflation in 2025 would be around 3% without the tightening we have seen so far (chart 2).

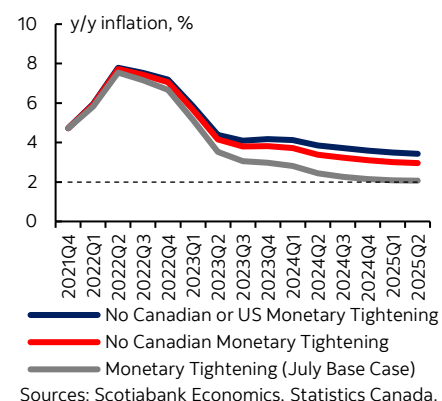
As US inflation and growth dynamics also feed into Canadian inflation and growth dynamics, US interest rate hikes have also helped reduce Canadian inflation. Using the same approach to identify the impact of monetary policy as we did for Canada, we find that rate hikes by the Federal Reserve have so far shaved an additional 0.2 percentage points from Canadian inflation and we expect that impact to build through 2025 for a maximal impact of 0.5 percentage points on the level of inflation. At peak impact, US monetary policy will have reduced Canadian inflation by about half the amount the Bank of Canada will have achieved.

In interpreting these results, it is important to keep in mind that changes in interest rates only have modest impacts on the output gap and that the output gap has only modest impacts on inflation. It takes big moves in interest rates to achieve reasonably modest impacts on inflation.

These results are obviously subject to some uncertainty. Our model is an empirical and estimated representation of the Canadian economy, but it cannot capture all of the intricacies of the situation we have experienced in the last 2 years. For instance, it could very well be that inflation expectations have responded more, or less, to the Bank of Canada communications and policy than we estimate based on historical relations. This could have a big influence on the outcome. It could also be that the Bank of Canada has lost some credibility over time given the distance of inflation from target. This would mean a weakening of the transmission mechanism, blunting the impact of monetary policy on the economy and inflation, or perhaps requiring more aggressive rate policies to achieve the same outcome.

Chart 2

**Path of Canadian Headline Inflation Under Different Monetary Policy Scenarios**



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 constructed 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: Scotiabank Europe plc; Scotiabank (Ireland) Designated Activity Company; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Grupo Financiero Scotiabank Inverlat, Scotia Inverlat Casa de Bolsa, S.A. de C.V., Grupo Financiero Scotiabank Inverlat, 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 authorized 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 authorized 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., Grupo Financiero Scotiabank Inverlat, and Scotia Inverlat 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.