CIBC Economics

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What can PPI tell us about CPI inflation in Canada down the road?

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Price increases often show up at the factory door before they reach store shelves, and so the recent news on that front in Canada has drawn our attention. Prices that producers are paying, as measured by the Industrial Product Price Index (IPPI), rose 13.5% from a year ago in August. So a key question for the Bank of Canada, as it works to keep inflation near the 2% target, is the extent to which higher costs for businesses today will mean higher prices for consumers tomorrow. That could be part of the Bank's calculus as it decides whether to respond to the recent producer price upturn, even as underlying CPI data shows that consumer inflation has yet to spread beyond a narrow list of goods tied to fuel prices. While we find that the PPI is signaling that inflation will stay elevated through Q4, there are many reasons to question its ability to project what happens over the longer horizon that is more material for monetary policy decisions.

The relationship between total CPI and IPPI hasn't always been constant

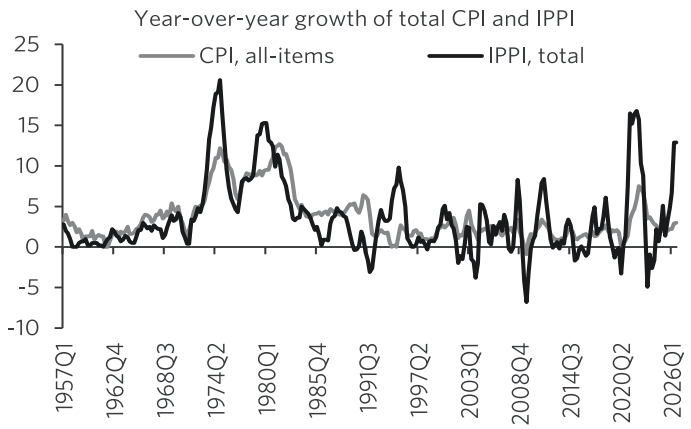
History suggests that producer price trends provide some clues about where consumer inflation is headed, but the reliability of that signal has varied over the decades. Looking back for a full 70 years, producer and consumer price inflation in Canada have moved somewhat in synch, with a correlation of 0.7 since 1957. However, that average hides a sharp shift around the adoption of inflation targeting in 1991.

Prior to 1991, year-over-year growth of total CPI and IPPI tracked tightly (correlation about 0.85) (Chart 1), and producer prices tended to lead consumer prices by several months. Cost increases at the factory level, such as those during the oil shocks of the 1970's, did show up in consumer prices. However, once inflation-targeting was introduced in 1991 and inflation expectations became better anchored, the correlation fell dramatically to just 0.44 in the period since 1991.

The IPPI has also became more volatile after 1991, and the lags for its link to the CPI shortened, reducing its value as a predictive tool. Indeed, through the 2000s and 2010s, producer and consumer prices moved together within the same month, largely because gasoline prices fed directly into both. Producer prices therefore offered little advance signal of where consumer price would head during this period.

That changed again during the post-pandemic period. Although we don't have a long series to go on in that window, since the pandemic, supply shocks have seemed to push up producer

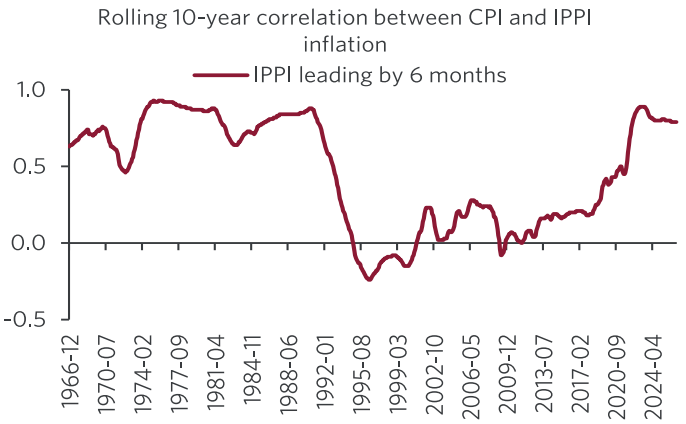
Chart 1: Year-over-year growth of total CPI and IPPI over the past 70 years



Note: 2026Q3 is average between July and August.

Source: Statistics Canada, CIBC calculation

Chart 2: The correlation between year-over-year total CPI and IPPI has not always been consistent



Source: Statistics Canada, CIBC calculation.

prices before they showed up in consumer prices, with a roughly 0.8 correlation peaking with an 6 to 8 month lead (Chart 2).

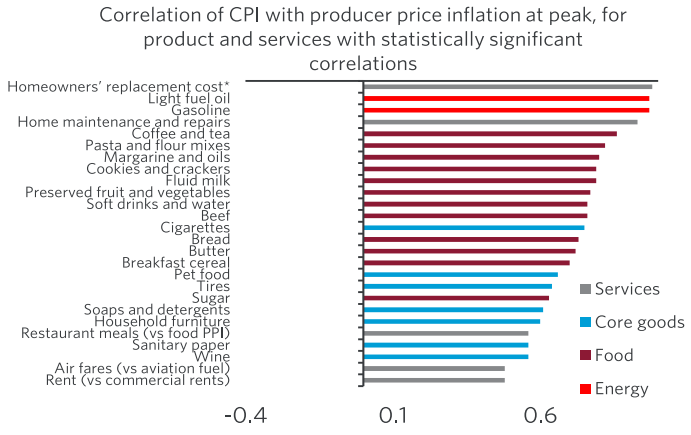
Energy products and some food items show the strongest correlation

As we've seen in the CPI, the PPI's escalation is much more evident in some particular components of that index, so it's important to dig further into those details to assess what they might mean for the CPI. We are able to map CPI inflation with producer price inflation for about 60 products and services. But we find that only a third of the weight of the CPI basket, mainly in energy, food and some household goods as well as some services components such as homeowners' replacement cost and restaurants, show a statistically significant link to producer prices. That means most items in the basket (roughly two-third of the weight of CPI) move largely independently of factory-gate prices.

The goods components with the strongest correlation, but no leading-indicator properties, are gasoline and light fuel oil (both at 0.97 at month 0), followed by some food products such as coffee and tea, pasta and baking products (Chart 3). On the services side, homeowners' replacement cost is derived using the new housing price index, so it shows a strong correlation (correlation 0.98 at month 0).

Other services components with significant correlation to producer prices, and where producer prices appear to lead consumer inflation, include home maintenance and repairs (0.96 at month 12), restaurants (0.56 at month 9) airfares and hotels (0.6 at month 3), rent (0.5 at month 9) and intercity transport (0.45 at month 3). With the exception of homeowners' replacement cost, the lags between CPI and PPI

Chart 3: How closely consumer prices follow producer prices by product and services at peak

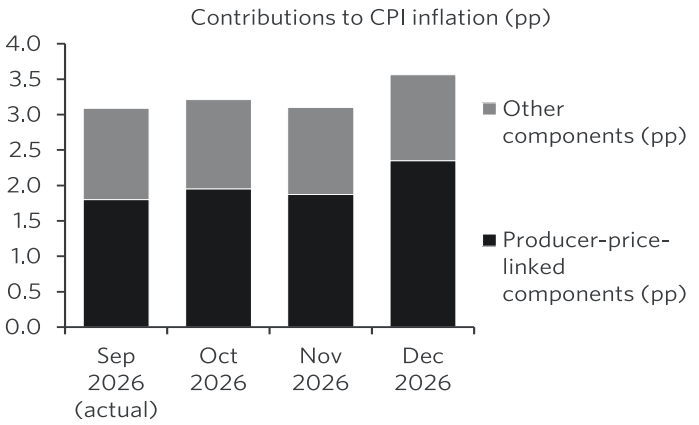


*Statistics Canada builds the CPI replacement cost index from new housing price index, so the correlation is mechanical.

Note: Bars show the highest correlation over lags of 0-18 months (with IPPI leading CPI) over the past 15 years.

Source: Statistics Canada, CIBC calculation

Chart 4: Monthly forecast of total CPI inflation incorporating signals from PPI



Source: Statistics Canada, CIBC calculation

at peak correlation are usually longer in services components than goods.

Since some of the strongest relationships are with energy and food prices, if we look CPI excluding food/energy, that core measure is less well tied to PPI measures. In the ex-food/energy basket, we found only 11 products and services with significant link between CPI and PPI, representing only a quarter of the ex-food/energy CPI basket. These include three shelter-related components and air fares, as well as some goods components. Therefore, we find that the predictive power of PPI drops significantly during periods with little energy and food price shocks, and the model performs on par with simple benchmarks during these periods.

Incorporating PPI signals to forecast CPI suggests 27Q1 could be higher

We attempt to incorporate the PPI signals to forecast total CPI inflation in the next three months to give us a sense where inflation can end up by year-end. We build the CPI forecast from the bottom up at the component level. For about a third of the CPI basket where we found a statistically significant relationship with PPI, we project the year-over-year inflation rates forward for those components using their historical relationships with PPI, and energy prices forecast using WTI crude futures while holding non-energy producer prices at their last observation over the forecast. For the two-third of the CPI basket where we did not find linkage with PPI, we assume these components would gradually return to their 2011-2019 average inflation rates over an average pace of 7 months. That results in year-over-year CPI inflation rising from 3.1% in September to 3.5% by December, and averages 3.3% in 26Q4, in line with our current forecast (Chart 4).

That in itself wouldn't compel an immediate hike in rates, since the impact of monetary policy on inflation would come with a lag, and the need to nudge rates higher is therefore dependent on where inflation looks likely to head in 2027. Mechanically applying the PPI correlations further out into Q1, including an

assumption that fuel costs align with WTI futures, would give us an average inflation forecast of 3.2% for 2027Q1, higher than our current forecast of 2.9% (Chart 5). An alternative scenario in which the components of the CPI not correlated with the PPI stay at their current year-on-year rates, rather than drift in the direction of their historical means, also has CPI inflation remaining above 3% in Q1.

But there's a big caveat with using a single tool, in this case the PPI-CPI correlations, to steer the forecast on its own as you stretch out the timetable beyond a single quarter. We don't, of course have the PPI data from here to the end of the year, and energy futures markets are dealing with considerable uncertainty over the prospects for a resolution of the Persian Gulf situation. Our base case forecast includes some cooling of those supply disruptions on a deal engineered by the Trump administration after the midterms, as we see the election results reinforcing pressure from the within the Republican Party to deal with gasoline price inflation.

This supply-side approach also could miss much of the downside pressure on inflation coming from the demand side of the Canadian economy. Canada has much less labour market tightness, and slower wage growth, than was the case when the Russia-Ukraine war led to an IPPI increase centered on energy and grains. The correlations from that period could therefore overstate the ability of the business sector to pass on cost increases in the current environment. Finally, we were also only able to map about a third of the CPI basket to the PPI, which means the bulk of the CPI still moves with other factors that will determine the overall trajectory of CPI inflation.

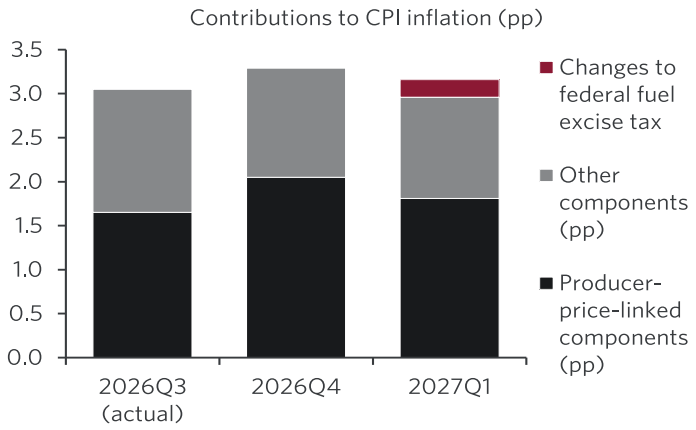
The implication for the policy rate

Our prior forecast for policy rates to remain on hold until a hike in January rested heavily on those other factors that could come into play. With core inflation running at 2%, we still believe that the Bank has time to see where both the Iran situation, and Canada-US trade tensions that could add to economic slack on this side of the border, play out in the weeks after the US midterm elections. If a deal to resolve trade tensions is forthcoming, and no resolution is reached on oil supply issues, hiking in December, or even in January, would not represent a significant delay. But if oil prices abate and trade tensions escalate, hiking now would be a step that the central bank would likely regret.

Of late, the tone from the Governor, and particularly in remarks to the press at the weekend's IMF meetings, suggests that he doesn't share our view. The PPI data, and supply shocks that have turned it higher, may be central to his concerns.

The October monetary policy report will showcase the Bank of Canada's new projection model, Prima, which provides forecasts for CPI inflation that emphasize firms' pricing decisions and the cost pressures they face. We don't know the full details of the model, but cost pressures are described to be estimated partly using producer price data as a starting point. We found that CPI inflation would top 3% for two consecutive quarters ahead with our more mechanical approach based on correlated PPI components. While we have noted several reservations about relying heavily on producer prices to guide an inflation outlook beyond a single quarter, our results might provide clues into what Prima would predict. As a result, we see rising odds of a rate hike this month, even with recent core CPI and employment data leaning the other way, based on the impression that the Governor's remarks last weekend were designed to have markets pricing in that outcome.

Chart 5: Quarterly forecast of total CPI inflation incorporating signals from PPI



Source: Statistics Canada, CIBC calculation

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