Economic Update

October 16, 2023

Bank of Canada Q3 BOS survey flagged softer demand backdrop against elevated inflation expectations

- The third quarter Bank of Canada Business Outlook Survey this morning reported firms on balance were expecting lower sales growth alongside slower investment and hiring activities, but pricing setting behaviour has yet to 'normalize'.
- The overall BOS indicator, which encompasses indicators related to past and future sales expectations, growth in input / output prices and credit conditions as well as labour capacity, dropped to the lowest level on record, outside of the Global Financial Crisis and the COVID pandemic period.
- Importantly, around half of the businesses surveyed in Q3 still reported price-changing practices that were more frequently and by larger amounts than normal, given persistent cost pressures that remained the number one concern for businesses in Q3.
- Longer period contract renegotiation, uncertainties associated with future inflation and rising borrowing costs were all factors that were contributing to elevated cost pressures.
- Still, on balance, the extent of abnormal price setting has been normalizing back closer to pre-pandemic. And growth in both input prices and output prices is expected to further decelerate, as wage growth moderates (planned wage growth slowed again in Q3) and commodity prices (for the most part) stayed lower. Softening demand is also making it more difficult for companies to pass on higher input costs to customers.
- Indeed, expectations for future sales activities among Canadian businesses deteriorated sharply as higher interest rates continue to put the brakes on aggregate demand. That echoes the sentiment reported by consumers in the separate CSCE survey. Consumers are expecting to further cut down spending in the quarter ahead, as cost of living continued to rise, and debt servicing grew increasingly more difficult given higher interest rates. Both businesses and consumers in Canada also recognized that the negative impacts from rising interest rates are far from done at this point.
- Finally, inflation expectations have continued to trend lower for Canadian businesses, with more of them confident that tighter monetary policy is playing a role in slowing price growth in Canada. More

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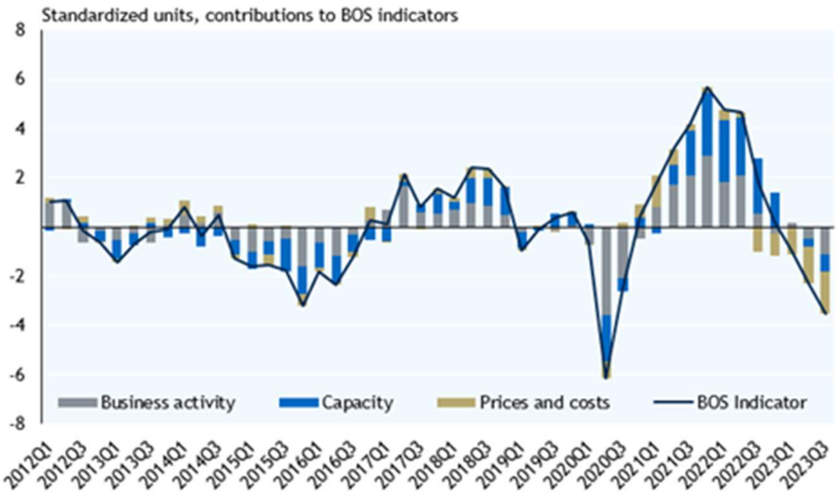
concerningly, inflation perceptions among consumers remained higher and have diverged from actual inflation prints. And that's contributing to elevated near-term inflation expectations - Canadian consumers expected inflation will remain at 5% for the next 12 month according to the CSCE survey, comparing to 4% headline CPI last reported for August.

- **Bottom line:** The contrast between slowing economic activity and more persistent price pressures in Canada was apparent again in the Bank of Canada quarterly survey results this morning. Elevated inflation expectations on the part of consumers and persistently abnormal price-setting behaviour reported by businesses will be concerning for the Bank of Canada. However, the central bank is well aware that inflation lags the economic cycle and there have been more evidence that higher interest rates are working to slow economic activities, including the results from this morning's surveys. Businesses and consumers in Q3 were both expecting a weaker economic backdrop moving forward, as aggregate demand keeps pulling back with higher interest rates continuing to drive up household living costs. The next round of monthly CPI data tomorrow will be watched closely for more clues on trends in domestic price pressures. Our own base-case assumption is that the BoC will not need to hike the overnight rate further.

Bank of Canada BOS indicator deteriorated sharply in Q3



Source: Business Outlook Survey, RBC Economics