

Economic Spotlight

ENERGY PRICES CONTINUE TO BE KEY DRIVER OF INFLATION

Highlights

- Energy price increases continue to be the key driver of inflation in the United States, Canada and Alberta.
- In the United States, increases in energy prices have accounted for roughly one quarter of the increase in overall inflation for the first seven months of 2005. In Canada, energy has accounted for approximately one fifth of the overall increase in inflation. Inflation in the United States has averaged 3.0% for the first seven months, while in Canada inflation has averaged 2.0%.
- Alberta continues to have the lowest inflation rate among the provinces, averaging just 1.6% for the first seven months of 2005, as compared to the same time period in 2004. Increases in both natural gas (+8.2%) and gasoline (+10.1%) prices have boosted energy prices up 6.6% in the first seven months of 2005, contributing to one quarter of the overall increase in inflation so far in 2005.
- Core inflation (excluding food and energy) remains well contained, below 1.5% in both Canada and Alberta and at 2.2% in the United States.

United States

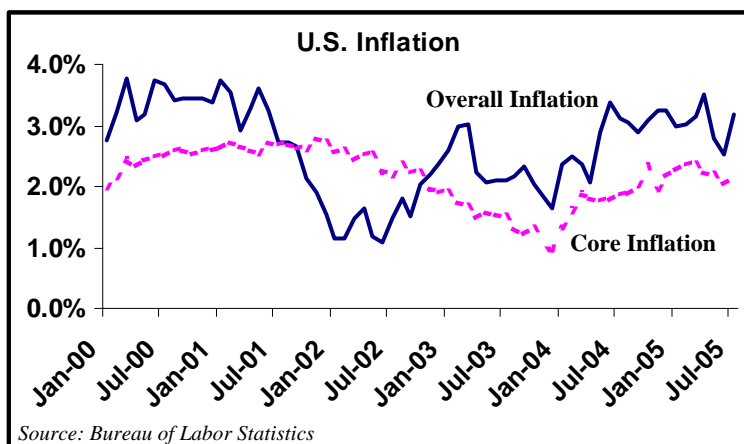
Over the most recent five-year period, inflation in the United States has averaged 2.5%. Energy and medical services have been the major drivers of inflation, while the apparel index has had a steady declining trend.

The effects of soaring oil and gas prices have yet to materialize in core inflation (excluding food and energy) figures for 2005. With oil prices increasing by over 50% since January 1, 2005, retail gas prices have only increased by 15.1% so far in 2005. The energy sector is expected to continue to give rise to inflation in the United States.

Medical services are also contributing to inflation in the United States, up 4.3% so far in 2005. Over the most recent five-year period, inflation in the medical services index has averaged around 4.4%.

Neutralizing the increase in energy and medical services is the apparel and new vehicle sales indices. The removal of textile import tariffs on Chinese products has pushed prices of apparels in the United States down 0.7% so far this year, which continued the declining trend that has occurred in nine out of the past eleven years. In the auto industry, strong dealer incentives in July lowered the new vehicles index by 1.0%. Over the past five years, the new vehicles price index has declined by an average 0.8% per year.

Even though U.S. core inflation has averaged just over 2% for the first seven months of the year, the U.S. Federal Reserve Board has expressed concerns about rising inflation stemming from non-



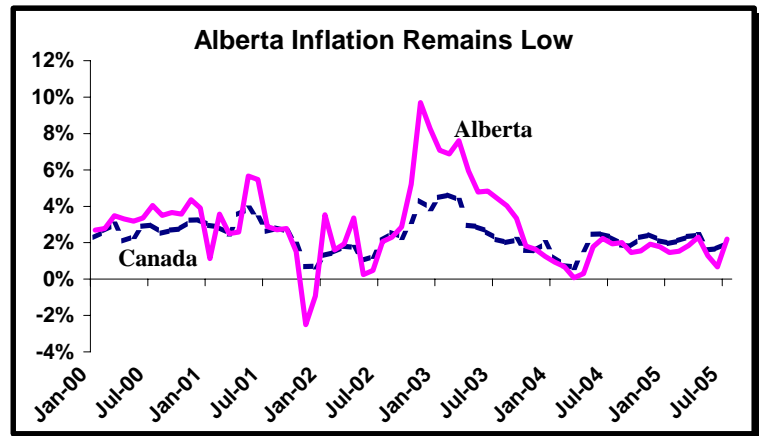
financial businesses having “increased pricing power”, or the ability to pass along higher input and wage costs onto consumers.

Canada

To date in 2005, Canadian inflation has averaged 2.0%, mainly as a result of higher energy prices and increases in homeowners’ insurance premiums (+7.2%) and property taxes (+4.3%). Lower consumer prices for clothing and footwear (-0.6%) and recreation activities (-1.7%) continue to partially offset the above mentioned increases. Canada’s core inflation remains benign at 1.3% for the first seven months of 2005.

Alberta

Inflation was highly volatile a couple of years ago in Alberta, as measurement anomalies associated with energy prices (specifically natural gas) and increases to both automobile insurance premiums and tobacco taxes created large swings in overall inflation. More recently, with the above mentioned anomalies passed through, Alberta’s inflation rate has been well contained, averaging less than 2%. So far in 2005, Alberta’s 1.6% inflation rate is the lowest among the provinces.



Source: Statistics Canada

Recent elevated energy prices continue to exert upward pressure on overall inflation, as gasoline and natural gas prices continue to rally higher. From a year ago, retail gasoline prices increased by over 16% in July, while the natural gas price index increased by almost 24% in July.

Lower prices for apparels (-0.9%), as is the case nationally and in the United States, along with home furnishings (-0.8%) have been offsetting increases in other categories, specifically energy.

Alberta’s labour market continues to tighten, with its unemployment rate averaging a mere 3.9% in 2005. The inflationary impacts regarding capacity constraints in certain sectors, specifically construction, do pose a risk to Alberta’s inflation outlook. For the first half of 2005, average weekly earnings have increased 4.9%, the highest among the provinces and well above the national average (2.2%). In the most recent five-year period, Alberta’s average weekly earnings have grown on average by 2.5%.

Overall, Alberta’s core inflation rate (excluding food and energy) has been well contained in 2005 at 1.1% and has yet to show significant effects from higher energy prices.

Global Inflation

Globally, inflation has been trending down over the last decade, from 14.5% in 1995 to 3.7% in 2004. Japan continues to struggle with deflation, while developing countries such as China have made vast improvements in their annual inflation rate, declining from 17% in 1995 to 3.9% in 2004 and moderating further to 1.3% in August 2005.

With the recent spike in energy prices, many Southeast Asian government (Indonesia, Thailand, India and Malaysia) subsidy programs intended to protect consumers from higher fuel prices have ended due to the growing expense of such programs. As a result, consumers in these countries are starting to experience huge energy price shocks, resulting in a run-up in inflation. Demand for energy products in these countries is expected to decline as consumers adjust to the higher price of fuels, possibly giving some relief to world oil demand with the potential of easing world oil prices.

Inflation Outlook

- Higher energy prices are expected to be the main risk to inflation in the near term. Pass-through effects to energy-sensitive core goods and services will lead to short-term increases in core inflation. Inflation is expected to return to more normal levels once the effect of higher energy prices are worked through.
- In the United States, overall inflation is expected to be just over 3% in 2005, up from 2.7% in 2004. As oil prices recede and economic growth slows, U.S. inflation is expected to be less than 3% in 2006.
- If the Chinese Yuan continues with its revaluation against the US dollar, the depreciation of the US dollar against other Asian currencies will give rise to US import price inflation, making goods Americans buy from China and other Asian countries more expensive.
- In 2005, inflation in Canada is expected to be around 2.2% in 2005 up from 1.8% in 2004. Similarly, Alberta's inflation rate is expected to be up slightly in 2005 at 1.9%, from 1.4% in 2004.