Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Inflation Watchers

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Re: **The Bank Needs to Talk About Geopolitical Supply Side Risk**

The Bank of Canada held its target for the overnight rate at 5 per cent again last week, as expected.

The clamour for a rate drop had begun, but the December numbers disappointed. Headline inflation ticked back up from 3.1 percent to 3.4, and core inflation flat or, in the case of CPI-trim – which filters out extreme price movements – slightly higher. So in its discussion last week, the Bank stressed upside risks to inflation coming from greater-than-expected persistence.

Unmentioned were geopolitical risks, particularly the effect of the disruption of maritime traffic in the Red Sea, its impact on shipping costs, and the knock-on effects on inflation. We think this risk is important and that the Bank should address it more directly.

If inflation spikes as a result of these disruptions, what should the Bank of Canada do and how should this affect the Bank's communication?

Rocket attacks from Yemen are forcing the 12 percent of global shipping that uses the Red Sea and Suez Canal around the Cape of Good Hope. As a result, spot rate for container shipments out of Chinese ports popped 16 percent in the week before January 12.

Rerouting a ship around Africa adds 10 days and more than $1 million in fuel costs to a trip between Europe and Asia. It also adds to the number of ships in transit, sailing instead of loading and unloading, causing an effective fleet reduction, leading to shortages. And shortages are emerging – Tesla has suspended production in its German plants – and customers are being warned of late-arriving goods. Increased import costs will lead to increased wholesale and retail costs and, with them, higher inflation.

A spike in inflation caused by **increasing transportation costs** is a classic supply-side shock in economics parlance – a problematic situation for the Bank.

Assume demand and supply are in balance and their curves intersect with inflation at 2 percent. The two types of shocks that can push inflation above 2 percent are a negative supply shock and a positive demand shock. Unlike a positive demand shock that pushes inflation above 2 percent as economic activity increases, a negative supply shock depresses economic activity but lifts prices amid shortages. If the bank needs to bring inflation down in these circumstances, a rate hike will exacerbate the already slumping economy.

After a two-year fight with above-target inflation, the Bank hopes to complete inflation's return to 2 percent while engineering a soft landing for the economy. Further increases in the bank's policy rate, given the current weakness of the economy, could very well bring about a recession.

However, if the shock is persistent and inflation remains high, the danger with leaving rates unchanged would be that high inflation becomes baked into inflation expectations. The trust households and businesses have in the Bank's willingness to do what's necessary to hit the 2-percent target would be under threat. This would encourage firms to increase their prices at a faster rate and also encourage a more rapid increase in wages and salaries.

The Bank will likely be forced to thread the needle between not exacerbating a downturn caused by an increase in shipping costs while at the same time not letting inflation expectations become unanchored.

For now, we would recommend a wait-and-see attitude in response to this supply-side shock. The way to prevent any de-anchoring of expectations – in which people start to believe inflation above 2 percent will continue for a long period of time – is through clear and transparent communication. The Bank should get ahead of the curve. Its next announcement should not only address this as an upside risk, but also make clear that it will look through any resulting increase in inflation as long as it is temporary – defining what that means – and explain why.

This could include presenting and explaining the kind of breakdown of inflation into demand-driven and supply-driven components calculated by **Sonja Chen and Trevor Tombe** and regularly updated by the **C.D. Howe Institute**. The Bank could explain from one announcement to the next how the breakdown changed, what factors were responsible – in this example, the conflict in the Middle East – and whether they expect the shock to be sufficiently temporary to leave rates unchanged.

Supply-side shocks complicate the lives of central bankers. The Bank must walk the tightrope between looking through the events over which it has no control, such as geopolitical tensions, and not losing the credibility of hitting its 2-percent inflation target. For now, best for the Bank to leave rates unchanged.

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