Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Canada's Inflation Watchers

Date: September 30, 2021

Re: **WHAT'S NEXT FOR MONETARY POLICY?**

Earlier this month, the Bank of Canada left its target for the overnight interest rate at 25 basis points while maintaining the pace of its quantitative easing (QE) program by continuing to purchase Government of Canada debt at a rate of $2 billion per week.

Markets widely expected that: any major change to tighten or ease monetary policy in the closing days of an election campaign could have been seen as a political statement. But with the economy stalling, inflation spiking (headline inflation was 4.1 percent in August) and federal government stimulus not ending soon, what is next for monetary policy?

We are at an interesting point on the path of pandemic inflation.

One perspective sees it on track. As of July, considering the whole period since the pandemic began, the Consumer Price Index (CPI) increase sits almost exactly at the Bank of Canada's 2-percent target.

A second perspective frets that recent inflation has been well above 2 percent in both "headline inflation" – the target's goal – and "core inflation," which the Bank calculates by stripping out goods with more volatile prices. This has naturally led people to ask whether the current inflation spike will persist.

Prices fell off a cliff in March 2020 as the pandemic hit the economy, causing the CPI to drop at an annualized rate of minus 10.8 percent. It bottomed out a month later as the COVID-induced recession hit its trough, and growth restarted in May. By October of last year, the CPI had caught up to its pre-pandemic level, and it has grown quickly ever since.

If we average the month-over-month changes in the CPI between March 2020 and July 2021, we get 2.04 percent, almost exactly the Bank of Canada's inflation target.

In other words, prices are back on a 2-percent growth path from February 2020. Insofar as monetary policy is responsible for this, the Bank of Canada has acted as a "pure price-level path targeter," to use the jargon, compensating for the initial dramatic drop in prices by allowing headline inflation to temporarily exceed its target as the price level has caught up.

How long will this above-target inflation persist and can the Bank of Canada control it?

That's the million-billion-trillion-dollar question on the minds of Canadian inflation-watchers.

On the demand side, household savings remain high. After peaking at a staggering 27.4 percent in the second quarter of 2020, the household saving rate fell to 13.5 percent in the third quarter and remained high through the second quarter of 2021 (at 14.2 percent). Since the turn of the century, household saving has averaged 3.3 percent of income with a maximum of 6.5 percent (in long-ago 2001), so current levels are very high. A return to more normal levels (i.e., if these extra savings are spent) could lead to demand-fuelled inflation.

On the supply side, the Bank of Canada's policy announcement stressed its judgment that "the Canadian economy still has considerable excess capacity," thus justifying a continuation of easy monetary policy and helping calm fears of persistent high inflation. Output (as of June) and employment (as of August) remain below their pre-pandemic levels. On the other hand, determining the economy's potential output after all the adjustments different sectors have undergone, as well as all the supply chain disruptions and bottlenecks, is difficult.

When an economy goes through a massive adjustment, resources are re-allocated and labour shortages become more likely as businesses and workers have a harder time matching existing skills with those required in expanding sectors.

The bottom line is that high demand and restricted supply could very well keep headline inflation above target for some months. This will put pressure on the Bank to tighten monetary policy. As Governor Tiff Macklem indicated in his speech, in order to keep the level of its balance sheet stable, the Bank will have to buy maturing bonds. But there is scope to reduce the stimulus provided by QE, and that will likely come before interest rate hikes, the Bank's other big policy instrument.

Both major parties in the election pledged – though not in so many words – to continue to inject plenty of stimulus into the economy. If that juices inflation, ending the QE program likely will not be enough. Interest rates will have to go up.

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A version of this Memo first appeared in the Financial Post.