Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Inflation Watchers

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Re: **The Bank of Canada's Welcome Inflation Blink**

The Bank of Canada's decision last week to leave its target for the overnight interest rate at 25 basis points and end its quantitative easing (QE) program was the right call given what now seems to be persistent underlying inflation.

From now on, the Bank will only purchase government bonds to replace ones that mature. Its balance sheet – more than quadrupled by pandemic bond -buying – will stay high compared to its usual level but, in theory, will not grow further.

Tightening monetary policy to deal with inflation above target can now come in only one of two forms: shrinking the balance sheet by selling or not replacing maturing government bonds or, more likely, hiking the overnight rate, though probably not until at least the middle quarters of 2022.

Both have economic consequences, and if inflation continues to be more persistent than the Bank originally thought, it will have to act.

The big question, then, is the extent to which the spike in inflation is more than transitory.

The case for a blip rests on two arguments.

First, prices fell sharply in the early days of the pandemic, so most of what we have seen to date is catch-up growth. Between February 2020 and this past July, the consumer price index (CPI) rose at an annual rate almost exactly equal to the 2-percent inflation target. But prices have now moved above that path, with headline inflation above 4 percent in both August and September.

The second is that the well-documented global supply chain disruptions are largely due to lockdowns, and factories, warehouses, and ports will catch up with demand. But as the Bank acknowledged in its announcement last week, the bottlenecks are tighter and more persistent than it had anticipated.

With the transitory case seemingly on thin ice, why might the case for more persistent inflation seem the stronger of the two?

First, the Bank's measures of core inflation, which strip out the most volatile components of headline inflation, have also been increasing as the all-in CPI has spiked. The three most commonly cited are running at 3.4 percent, 2.8 percent and 1.8 percent year-over-year.

This is in sharp contrast to the last time headline inflation exceeded the top of the Bank's 1- to 3-percent target band. The CPI spiked to 3.7 percent in May 2011, but that same month all three measures of core were at or below 2 percent. Within 10 months, headline inflation had fallen to below target, thus confirming the predictive power of the core inflation measures. But these tried and (that time) true indicators are now flashing: "Inflation."

Second, inflation expectations are becoming a problem. Expected inflation influences actual inflation in a couple of ways. Firms that adjust their prices only periodically will set higher prices if they expect inflation to be higher. Also, higher expected inflation will translate into faster increases in wages, which in turn put pressure on firms' costs. In the Bank of Canada's most recent Survey of Consumer Expectations, household expectations of inflation one year down the road spiked by 1.5 percentage points. True, expectations for two and five years ahead remained stable, but the spike is worrying, especially since the Bank's latest Business Outlook Survey found that almost half of firms surveyed expected inflation to remain above 2 percent over the next two years.

A third reason to think inflation may not abate quickly is that demand pressures have increased. Saving has been well above average since the start of the pandemic, much of it parked in liquid assets like chequing accounts. But households now seem poised to start buying again and that will put upward pressure on prices.

Finally, bottlenecks aside, the economy's supply side gives pause. Energy and other commodity prices have risen sharply, increasing firms' costs and giving them an incentive to raise their prices more rapidly. The one bright spot on the cost side is wage growth, which has remained moderate despite the increase in expected inflation. But how long will that last? The Business Outlook Survey showed that more firms are facing hiring constraints that are putting upward pressures on their wage plans, with heightened wage pressures expected to last beyond the next 12 months.

Given all this, it is no surprise that markets are now pricing in almost four 25 basis-point rate hikes by the Bank in 2022, compared with almost nothing two months ago. The market should also prepare for the possibility that the Bank might start shrinking its balance sheet.

The case for persistence seems to be winning out.

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