Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Canadians Worried About Inflation

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Re: **Will Ending Supply Bottlenecks Solve Inflation?**

Last week's Bank of Canada policy rate announcement once again stressed supply chain bottlenecks as the source of the high and increasingly persistent inflation facing Canadians.

So then, inflation should come down smartly once these supply chain bottlenecks disappear. A closer look at the data indicates that this is not the case, and the supply-driven inflation will simply give way to demand-fueled inflation.

That means the Bank may not be able to keep the overnight rate at its current level for as long as it might like.

To see why, we need to consider the output gap, the difference between actual output and the economy's potential. When actual output is lower than potential there is slack, which puts downward pressure on inflation and interest rates. When the opposite occurs, there is upward pressure on inflation and interest rates.

What do the data tell us about the output gap today, where it might be headed, and what that means for monetary policy?

Spending in sectors most affected by pandemic shutdowns grew very quickly. Spending on semi-durables was up 14 percent (quarter over quarter), and on services by 6.3 percent. Breaking this down further, spending on clothing increased 26.8 percent, on transport by a whopping 40.3 percent, while spending on food, beverages and accommodation was up 29 percent. On the other hand, real expenditure on less-affected durable goods fell by 1.4 percent.

This uneven distribution, with a mild overall increase in GDP, led to third-quarter inflation of 3.7, 4.1, and 4.4 percent, rising to 4.7 percent in the first two months of the fourth quarter.

While supply chains are part of the high inflation story, demand remains ready to run hot, borne out by the high household savings rate (11 percent), a far cry from its 2.7 percent average in the five years before the pandemic.

Some of these savings have been channeled into financial assets, but households have parked much of it in the form of money balances. Narrow money (principally chequing accounts) grew by 16.7 percent year-over-year in September, while broad money (which adds in savings accounts) grew by 10.5 percent. This ballooning of monetary aggregates has led to a crash in different measures of the velocity of circulation (which measures how often money changes hands as it is spent). For example, M1 velocity fell by 27 percent between the end of 2019 and the end of the third quarter of 2021. A return (even partial) to historical values of velocity will push nominal spending even higher. Real output would have to respond to the higher demand. If this is not possible, prices will have to rise.

This raises the question how much slack remains in the economy. The Bank's rate announcement forecast excess capacity will persist until the middle quarters of 2022.

We are unconvinced. Uneven growth in demand across sectors has led to a reallocation of labour. Some of this may be permanent, dampening productive capacity at least temporarily.

The Bank of Canada's Business Outlook survey for the third quarter showed labour shortages equal to late 2018 levels, with the intensity of those shortages higher than any time since the financial crisis. The overall unemployment rate was 6 percent in November. This was slightly higher than the 5.7 percent unemployment rate in the fourth quarter of 2019, but given the reallocation of labour across sectors this remains indicative of a tight labour market. The November survey by the Canadian Federation for Independent Business had its members predicting a 3.1 percent increase in wages over the following 12 months, up 0.6 percentage points from October.

This rate of wage increase may not seem high with headline inflation above 4 percent, but Canadian productivity growth has been sluggish, again pushing the economy up against its productive capacity. Labour productivity fell 5.4 percent in the third quarter and unit labour costs were up 6.2 percent on the previous year. Business fixed capital formation, which fell by 4.8 percent in the third quarter, will certainly not help productivity growth.

It's a story of booming demand confronting supply constraints, even without the varied supply-chain troubles of the moment.

The Bank's latest rate announcement may be too sanguine, both with respect to economic slack and to how much inflation will ease in the second half of 2022. It is not surprising that market expectations of a rate increase by the Bank have gradually crept towards the early part of 2022.

The next couple of rate announcements will tell us whether the Bank will be willing and able to stick to its guns, holding the overnight rate at its current level. Our bet is it will not.

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