Intelligence MEMOS

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From: Steve Ambler and Jeremy M. Kronick

To: Canadians Worried About Inflation

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Re: **THE BANK THAT DIDN'T BARK**

The Bank of Canada kept its overnight rate target steady at 25 basis points last week, which was a surprise to markets that had already priced in a rate increase. Despite that ample cover for a first post-pandemic increase, it didn't happen.

With inflation rising at home and abroad, we believe this was a missed opportunity.

Steady increases in inflation and inflation expectations had led markets to believe the bank was set to increase its target. Headline inflation was up to 4.8 percent in December, all of the bank's core inflation measures had increased – with two of the three at or above 3 percent – and its December Business Outlook Survey revealed that two-thirds of firms expect inflation to remain above 3 percent for the next two years.

The Bank's view that recent high inflation readings were temporary has evolved as inflation has crept upwards. And continued government spending – justified in the early pandemic days, harder to justify today – has added an unhelpful push to prices, with overall spending now outpacing our current production capacity.

Unfortunately, the same policy decisions have been made abroad, leading to the same inflationary response. Australia had 3.5-percent inflation in December, the Euro area 5 percent; the U.K. 5.4 percent and the US a whopping 7 percent. In each country, headline inflation was up from November. Yes, inflation is a worldwide phenomenon, but mainly because almost all countries are following the same inflationary policies.

With prices continuing their rise, however, the world's central banks have become significantly more hawkish. The Bank of England raised its policy rate in December for the first time since the beginning of the pandemic (albeit to only 25 basis points). The Federal Reserve has said it will begin raising its policy rate in March and will start to trim its balance sheet.

In the long run, the inflation rate in any economy with a flexible exchange rate is determined by that country's monetary policy. On the other hand, inflation abroad can exacerbate the difficulties we face taming prices at home.

Before the pandemic, Canada's inflation rate had remained chronically below the 2- percent target. Explanations for this phenomenon abound. The Bank's own research has identified low world inflation as one of the main causes for the Bank's difficulties in hitting its target, largely because global inflation is driven largely by energy and food prices, which make up a big part of Canada's typical consumer market basket. This remains true today, as any grocery shopper or gas station customer can attest.

Unhelpful shifts in global demography may also lead to continued increased prices at home. In their 2020 book *The Great Demographic Reversal*, Charles Goodhart and Manoj Pradhan outlined how temporary demographic factors have biased world inflation downward in recent years.

The integration of China and Eastern Europe into the world economy combined with the wave of Chinese internal migration from rural areas to coastal cities produced the largest increase in labour supply in history.

The resulting labour glut lowered production costs for most manufactured goods. But the world's population is aging and growth in its working-age population is rapidly slowing, which increases production costs.

On top of huge monetary and fiscal responses to the pandemic around the world, these changes have led and will continue to lead to higher inflation and that inevitably will push interest rates up.

Higher global inflation will also make it harder for the Bank to bring down Canadian prices. Our very open economy relies on imports of both final and intermediate goods. Higher prices abroad will soon mean higher prices here.

Interest rate hikes are coming. The Bank's announcement last week said as much. With the Fed also beginning to act, most advanced-economy central banks are likely to start tightening monetary policies. If they succeed, that will help moderate what Canadians pay for imports. Its effect on global demand is less certain. Higher interest rates are likely to slow global consumption.

This is one of the many problems with an inflation fever; if it takes hold, it is hard to break. Yes, interest rate medicine can be hard to swallow, as the Bank of Canada showed last week, but it does not go down any more easily if you put it off.

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