Intelligence MEMOS

The C.D. Howe Institute put out a call late last year for Intelligence Memos from next-generation policy leaders. The purpose of the program is to provide a platform for new or soon-to-be graduates to raise their profiles, showcase their ideas, and build their professional networks. This week we are releasing the work of the top three participants.

From: John D. Baker

To: The Bank of Canada Governing Council

Date: June 1, 2022

Re: **MONETARY POLICY AND INEQUALITY IN CANADA: A NEW CHAPTER**

High inflation and recessions are two leading causes of inequality at short horizons, and they disproportionately harm workers at the lower end of the income distribution.

Keeping inflation low and promoting macroeconomic stability helps. However, while the long-running inflation mandate has recently been renewed, there are louder calls for central banks to expand into more socially oriented issues, including income inequality. These are important causes, and while the central bank is not the best institution to address them, providing more transparency on monetary policy's unintended consequences would be helpful.

Following unprecedented COVID-19 induced monetary stimulus, central banks are under greater scrutiny about economic inequality and the possible intersection that disparities in wealth (especially concerning the post-stimulus effect on boosting asset prices) and income may have with expansionary monetary policy. This trend predates the pandemic and lends credence to the thought that the effect of monetary policy on inequality does not simply net out over the business cycle.

In a September 2020 speech, the Governor of the Bank of Canada sought to mitigate these concerns, remarking: "We're going to be there, creating the conditions for all boats to rise, through the full length of this recovery. . .

"You can think of monetary stimulus and the recovery like the tide coming in . . . when the tide comes in, it creates the conditions for all boats to rise. That's what monetary stimulus does."

But does monetary stimulus raise all boats?

The answer, as with most in economics, is "it depends."

On the one hand, COVID-related stimulus – both monetary and fiscal – has played a role in stabilizing the massive labour market peril initiated by the onset of the pandemic. Mitigating instability in the labour market inevitably benefits those on the lower end of income distribution, as this group was much more negatively influenced by COVID-19 shutdowns.

At the same time, however, one must also consider the fact that expansionary monetary policy boosts asset prices, which are disproportionately held by Canada's most well-off households. From the March 2020 lows through to December 2021, the Toronto Stock Exchange rose 58.6 percent and house prices have risen by 40.6 percent at the national level. On the labour side, over this same period, although unemployment was approaching its pre-pandemic level and the labour market started to tighten by the end of 2021, average real wages declined by 1.2 percent.

These statistics suggest that wealthier individuals have benefited more from the recovery. This is also compounded by the fact that white-collar workers were far less likely to lose jobs in the first place, or to be negatively affected by public health measures that followed thereafter. While the asset-endowed Canadians saved and invested over this period, many low-wage workers in sensitive industries like retail and hospitality faced tremendous labour income uncertainty.

Of course, not all of the appreciation in asset prices can be attributed to loose monetary policy. However, it is indisputably a contributing factor. Take for example the case of house prices. **Communications** from the central bank often emphasize a lack of supply and "extrapolative expectations" as the reasons driving imbalances in the housing market. While these factors play a big role, the friendly lending environment that has fueled unprecedented demand from investors and repeat-home buyers relative to first-time buyers has played **no small part**.

At this point, one might interject that between contractionary and expansionary policy, any long-run influence on inequality will simply net-out over time. **Recent research** comparing contractionary versus expansionary monetary policy suggests that the effects on income inequality are asymmetric.

Beyond these considerations, it is not clear that monetary policy is the best tool to address these frictions. Fiscal channels are better equipped to handle issues of redistribution, and if economic inequality is determined to be abnormally high by the general public, then the democratic process can be used to elect government(s) with policy platforms that target inequality.

Instead, it is important for the central bank to have an open dialogue on these concerns, and more generally, to communicate a greater awareness on the externalities that arise from maintaining a given policy stance. Amid the post-COVID worries of rising inequality – not to mention persistently high inflation – it is essential for Canada's central bank to continue its tradition of transparency with the public.

John D. Baker is a PhD Candidate in Economics at the University of Waterloo.

To send a comment or leave feedback, email us at blog@cdhowe.org.

Read the winning submission for the C.D. Howe Institute Competition for Intelligence Memos here.