Intelligence MEMOS

From: William B.P. Robson

To: Canadians Concerned about Inflation and Recession

Date: July 28, 2022

Re: **Inflection Points for Inflation and the Economy**

Two economic headlines a week apart – the Bank of Canada's 1 percent hike in the overnight rate and last Wednesday's 8.1 percent year-over-year Consumer Price Index increase – make clear that we are at a major turning point.

The Bank has underlined its determination to get inflation, which it admits it underestimated, back to its 2-percent target. Canadians can look forward to lower inflation, and also need to be ready for the recession that will precede it.

Although the Bank's hike was larger than most forecasters expected, the June CPI report validated the big move. Canadians too young to have experienced inflation like this before are discovering what older Canadians already knew: inflation is bad. It erodes savings, increases tax burdens, complicates buying and selling, exacerbates labour disputes – and does all this damage, and more, in an insidious and nontransparent way. The sooner inflation gets back to target, the faster these problems will disappear.

Canadians old enough to have experienced inflation also know that reducing inflation is not painless. Just as it takes an economy running hot to push inflation up, it takes an economy running cold to push inflation down.

The projections for real GDP in the Monetary Policy Report that accompanied the Bank's overnight-rate announcement do not show a recession. They do, however, show the year-over-year increase in the CPI falling to 2 percent in late 2024. Nothing unusual in the Bank's projections ending with inflation on target – hitting the target is its job. But a fall in inflation that far that fast would be unusual.

Getting inflation to 2 percent by late 2024 implies a sudden fall in the inflation rate – as much as 5 percentage points between the end of this year and the end of 2023 alone. As the Figure shows, declines that sharp have happened before, but they are rare. Since the mid-1950s, we have three instances when the year-over-year change in the CPI fell more than 4.5 percentage points: in 1976, 1983 and 1992.

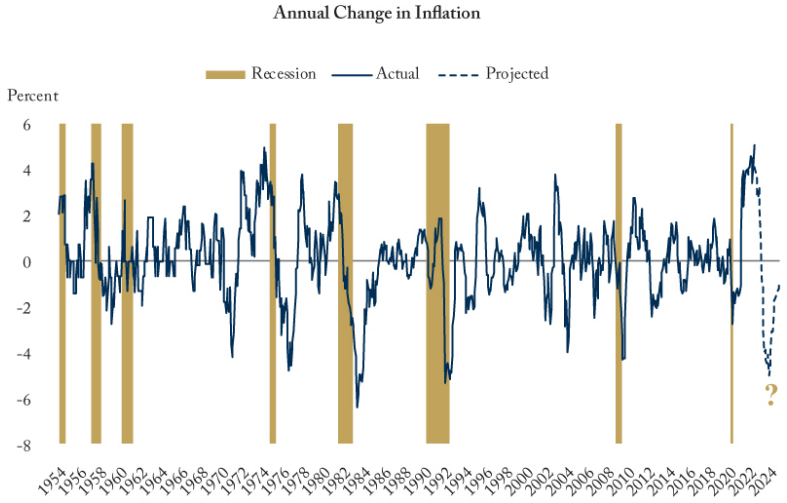
Canadians old enough to have experienced inflation will recall that those declines followed the economic slumps of 1975, 1982 and 1991.

How likely is a slump this time? The core of the case for at least a couple of quarters of falling real GDP is that demography and chronically low business investment are holding back growth in Canada's potential output. That means the Bank has to push spending down more aggressively than ever to get some slack in the economy. That said, we have reasons to hope the slump will be less severe than those that preceded the 1976, 1983 and 1992 disinflations.

One reason: productive capacity, in Canada and abroad, is still rebounding from COVID-19. As supply comes back on stream, and as monetary and fiscal excesses in the United States and elsewhere unwind, a better global environment will make the Bank of Canada's job easier.

Another reason: we have a better understanding of monetary policy and inflation since those earlier episodes. In the 1970s and 1980s, too many people – including people in central banks – thought inflation was not something monetary policy could control. They blamed businesses, or unions, or foreigners for inflation, and responded with measures such as wage and price controls, while monetary policy was irresolute. That meant that inflation expectations stayed high even as the economy weakened. This time, a quarter century of successfully targeting low inflation is fresh in memory, and agreement that monetary policy can and should bring inflation back down is more widespread. That will ease the transition.

There is a third, if paradoxical, reason for optimism: expectations – not just of disinflation, but of a slump – are spreading. Many Canadians have been spending their government transfers and COVID-19-related savings too freely, and buying and renovating houses too enthusiastically. Governments have been spending and borrowing too much. Some businesses have become too used to easy credit. If a dimmer outlook induces more caution across the board, the Bank of Canada's upcoming interest rate increases will be smaller, and the cycle will end sooner.



The Bank of Canada has signalled its determination to get inflation back to target, and the CPI has signalled the size of that task. Canadians should get ready for a softer economy, and the lower inflation that will follow.

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