Intelligence MEMOS

From: Miville Tremblay

To: Canada's Inflation Watchers

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Re: # The False Choice Between Inflation and Employment

One cannot choose a combination of employment and inflation the way we shower with our mix of hot and cold water.

So, if the Bank of Canada wants to maximize employment in a sustainable way, it must first tackle inflation, its primary mission.

In the US, where the Federal Reserve actually has an official dual mandate of stabilizing prices and maximizing employment "in a sustainable manner," the employment objective plays second fiddle to the fight against inflation.

Employment cannot be increased by low interest rates when inflation is high, and saying so is simply an empirical observation, not an ideological choice. Such a policy path is inherently unstable, causing even more inflation, which ends in a severe recession and rising unemployment.

In "maximizing employment in a sustainable way," the key word is "sustainable," because the low unemployment of an overheating economy is a ticking time bomb.

On the other hand, when inflation is under control, and the economy is still operating below its maximum capacity, a central bank can promote employment in this moment of grace – called **divine coincidence** – where the two variables are addressed by the same policies.

Yet the crude tool of interest rates quickly hits its limits, unable to train the workforce to fill available jobs or increase the number of skilled immigrants. That's why you need a panoply of microeconomic policies to complement the macroeconomic policy of the central bank.

A refresher on Inflation 101: It increases when demand for goods and services exceeds supply, or the production capacity of the economy, as it does now. Conversely, it usually decreases when demand is lower than supply.

By raising interest rates, central banks aim to moderate demand so it equals supply. Landing softly is tricky, however, when inflation is as high as it is now.

Rate increases immediately hit consumers and businesses, who borrow less to spend or invest, but any rate increase takes up to two years to deliver its full inflation benefits.

This delay is why it's so hard to tell when the Bank's increases will be sufficient to pull inflation back to 2 percent by 2024, as projected in its latest Monetary Policy Report.

Too much sparks a severe recession, not enough threatens credibility.

And credibility plays a critical role beyond the mechanical effects of rate hikes. A central bank that lets inflation run wild with insufficient rate hikes risks unmooring public and market expectations of a return to 2 percent and fueling an out-of-control spiral. These expectations can too easily become a self-fulfilling prophecy.

Last year, the federal government and the Bank renewed their formal 2-percent inflation target – the best contribution of monetary policy to the well-being of Canadians is to continue to focus on price stability" – that has now been in effect for three decades.

The new mandate agreement includes a goal of a "maximum level of sustainable employment," even if the Bank does not have all the tools for this task.

This new mention of employment does not change anything concrete, except for providing more transparency to its existing efforts when demand is too low.

The government co-signed the mandate and must now respect the operational independence of the Bank, so it can take the necessary decisions, however unpopular. History teaches that politicians rarely have that courage.

Defeating inflation is the challenge of the hour. It erodes the purchasing power of workers, whose wage increases can't keep up, and hits low-income people the hardest.

Financial markets, addicted to low interest rates, are taking the global monetary tightening very badly. They nervously scrutinize the words of the central bankers to guess the moment of a possible pivot, which will mark the beginning of a pause, then a relaxation, conducive to investments.

Yet if they thought central banks were losing their fight against inflation, they would react negatively, writing risk premia into bond yields, which would translate into higher mortgage rates.

Bank of Canada Governor Tiff Macklem says monetary policy tightening is not over, but is winding down, suggesting further hikes may be less steep. Fed boss James Powell didn't go that far.

Complicating matters is the confluence of crises: The residual effects of COVID-19, the war in Ukraine and its shock on energy prices, global warming and the decarbonization of the economy, tensions with China and the redeployment of supply chains, the rise of populism, not to mention the risks to the stability of the financial system posed by widespread indebtedness.

The inflation battle is not won.

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