Intelligence MEMOS

From: William R. White

To: Finance Minister Chrystia Freeland

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Re: **People Get Ready: An Era of Shortages Is Going to Replace Our Era of Plenty**

Is inflation decelerating? Will the Bank of Canada soon be able to moderate further tightening and eventually pivot towards easing rates?

Will your ministerial life be made easier?

Similar questions are being asked all around the world, with divergent answers generally reflecting opposing views about how quickly recent supply shocks will dissipate (reducing inflation) and fears of a wage-price spiral (raising inflation).

Sadly, this debate has largely ignored the growing likelihood of a number of future, negative supply shocks set to transform our Era of Plenty to an Era of Shortages.

These shocks will raise prices, reinforce the need for tighter monetary policy, and put greater strains on already strained Canadian government finances.

Let us count the ways.

First, Canada's COVID-19 recession was severe, albeit short lived. Severe downturns always leave scars and this one seems particularly likely to do so. Companies must restructure supply lines, reducing "efficiency" to improve "resilience," with China's zero-COVID policies posing an additional challenge. In Canada and elsewhere, the supply of workers has been hit by deaths, long COVID and other pandemic-linked problems.

Second, commodity prices were already rising before the Ukraine invasion and these forces will persist. A still-rising global population is putting food security at risk. Fossil fuel and metal production will suffer from recently low investment levels and the previous exploitation of promising production sites. In addition, higher prices for fossil fuels seem unlikely to lead to more investment, while a newly discovered mine site can precede production by a decade.

Third, climate change will push up costs in at least three ways. Mitigation implies stranding of existing fossil fuel reserves. If renewable energy supply is inadequate to meet still-rising demand, then energy prices must rise. Adaptation will involve stricter building standards and many other costs. Finally, climate change will reduce the future supply of food and other commodities, could render significant parts of the world unsuitable for production, and is already causing heavy damage from extreme weather.

Fourth, the global supply of workers is in sharp decline, pushing up wage costs everywhere. While countries like Canada can partially offset this through immigration, this will initially put still more pressure on overstretched infrastructure, the housing stock and our healthcare system.

Fifth, the full costs of misallocated capital, generated by years of easy monetary policies, remain unseen. Zombie companies, whose interest payments exceed profits, and firms that subsidize prices to gain market share have proliferated in recent years. Should financing conditions tighten and these companies disappear, prices will rise directly.

Sixth, geopolitical tensions affecting global supply chains are rising sharply. This threatens higher prices in the short term and will slow the pace of future technological progress.

The effect of higher energy prices on inflation in the 1970s was self-limiting. Money spent on energy was unavailable for other consumer expenditures. In contrast, many of the supply shocks described above suggest the need for substantially greater investment spending, particularly by governments.

Public health systems need resources to prepare for future pandemics. Climate change will demand enormous investment spending for mitigation, adaptation and replacing damaged infrastructure. Labour shortages and higher real wages will encourage capital substitution. Finally, geopolitical tensions will demand higher spending on the Canadian military, with continental defense once again a priority.

In short, aggregate demand could rise even as aggregate supply falls. This is a recipe for stronger inflationary tendencies and "higher for longer" interest rates than markets currently seem to expect.

Higher for longer could prove particularly troublesome for the Canadian private sector, since both household and corporate ratios of debt to income are among the highest in the developed nations. Determined efforts to restrain spending as debt service rises could provoke a serious recession. Nor would already highly indebted governments be immune.

Recognizing future expenditure pressures on governments, provincial credit spreads could widen. Indeed, fears that the Bank of Canada might, in a recession, be called on to finance larger federal deficits could prevent sovereign rates from falling or even cause them to rise.

Pre-empting such possibilities would seem highly prudent. In particular, governments need to take measures to increase labour-force participation rates, productivity growth and thus the tax base. Further, given the urgent need to support both public and private investment, governments will need to find other ways to reduce their deficits in order to reassure troubled global financial markets of Canada's commitment to fiscal responsibility.

In the face of persistent inflationary pressures, the government deficit reduction would also reduce the need to rely on domestic monetary restraint with its potentially dangerous side effects. Having both fiscal and monetary policies pointing in the same direction might also help anchor inflationary expectations, another welcome benefit.

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