Intelligence MEMOS

From: William B.P. Robson

To: Canadians Concerned about Inflation

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Re: Is Inflation Back? In the End, it's a Question of Politics

Suddenly, inflation is in the news. In Canada and abroad, spending is surging and COVID-impaired production is struggling to keep up. Key commodities – oil, lumber and metals – are expensive.

It is front-of-mind in financial markets as well. The yield on the federal government's 30-year bonds, which was below 0.9 percent last August, topped 2.0 percent in March – well above its pre-pandemic level.

Do these headlines and fears represent overreactions to rogue statistics and possible minor tactical shifts by central banks? Or is something more fundamental happening? Will politicians who won't stop spending more dollars than they tax end up forcing central banks to print money to cover the difference?

Current indicators and worries could be blips. Canada's economy, like its US counterpart, is growing faster than expected. So the Bank of Canada and the US Federal Reserve are revising their projections for when inflation will get back to their targets – and bond traders are bringing forward their expectations for increases in the central banks' policy interest rates.

Moreover, higher readings on the Consumer Price Index (CPI) are guaranteed over the next few months – a "base effect" as prices depressed by the pandemic in 2020 boost the year-over-year measures. We will see CPI increases of 3 percent this year. The question is, what next? A return to 2 percent in 2022? Or further increases – to 5 percent or more?

Seriously higher inflation would be quite a reversal. It is 40 years since central banks squeezed inflation down from the double-digit rates of the 1970s to the single-digit rates of the 1980s. Almost 30 years since inflation targets, adopted first by the central banks of New Zealand and Canada, ushered in the era of 2-percent inflation. And more than 10 years since the financial crisis of 2008-09 opened a decade when central banks often undershot their inflation targets. Why might now be different?

Now might be different because politics now is different. Big moves in inflation – up to double digits in the 1970s and down again in Canada and other major democracies, or more extreme examples, such as the hyperinflations in Germany in the 1920s, Greece in the 1940s and Zimbabwe in the 2000s – do not happen because central banks make tactical errors. They happen because of government choices.

When the long postwar boom flagged in the late 1960s, governments reacted to discontent about slower growth by borrowing to boost spending, and central banks reacted to upward pressure on interest rates with easy monetary policy. When the resulting inflation became a political issue, central banks brought it back down. Inflation targets were political: the numerical goals themselves, and elected governments giving central banks the tactical independence they needed to hit them.

Politics now might be different because high inflation happened so long ago that we have forgotten that it is so unpleasant that we endure recessions to end it. Politics now might also be different because of advocates claiming that government deficits financed by central banks can get our economies back to – or even beyond – where they were before COVID-19 hit.

Most economists believe that governments can use their budgets to moderate booms and busts and most economists believe that central banks can affect money growth to the same end. But advocates invoking "modern monetary theory" go further. They claim governments can spend more than they tax, make central banks cover the difference by buying their debt with newly issued money, and stop just before inflation takes off.

Yes, but .... If governments had followed the theory and been willing to cut spending and raise taxes after using their central banks to cover the gap temporarily, the hyperinflations of Germany, Greece and Zimbabwe would never have happened. Nor would less extreme cases, such as Canada's inflation of the 1970s.

The problem is that, at any given moment, closing the budget gap can be more politically painful than leaning on the central bank. Yields on the federal government's bonds are almost double what its Fall Economic Statement – which emphasized that low interest rates make its heavy borrowing affordable – projected for this year. If that continues, which will be louder: calls for the government to issue less debt? Or calls the Bank of Canada to buy more?

In this uncertain environment, the Bank of Canada and other central banks will inevitably undershoot and overshoot their inflation targets at times. But whether inflation of 5 percent or more comes back – the answer to that question is political.

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