Intelligence MEMOS

From: William B.P. Robson

To: Canadian Federal Parties

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Re: **NOW WOULD BE A GOOD TIME TO REMIND CANADIANS OF MERITS OF LOW INFLATION**

Statistics Canada's latest gross domestic product release contained at least two surprises. The first was that real GDP fell at an annualized rate of 1 percent in the second quarter. That made headlines. With all the stimulus and rising optimism about recovery from the COVID recession, why the setback?

But a second surprise was that nominal spending – measured in the dollars that actually changed hands, before adjustment for price changes – rose at an 8 percent annualized rate. That raised eyebrows. The difference between a 1-percent real fall and an 8-percent nominal rise is 9-percent higher prices.

Real activity slipped a little. The value of our money slipped a lot.

We already knew that consumer prices were up 3.7 percent over the year to July – way above the Bank of Canada's target of 2 percent. The Bank has been keeping short-term interest rates close to zero and buying government bonds to hold down long-term interest rates. Does the GDP report show that fiscal and monetary policy are combining to push inflation higher?

Anyone worried that recent price increases aren't just temporary will find cause for worry in the report. The 9 percent annualized increase in prices was not a one-quarter story. Prices in the second quarter of 2021 were up by the same amount – 9 percent – from the same quarter of 2020. Over those 12 months, no surprise to shoppers, prices of goods bought by households rose more than 4 percent. Prices in the housing sector, boosted by low interest rates, government supports and working from home, rose an eye-popping 17 percent.

Not everything in the report was that bad. Prices of services bought by households rose less than 2 percent over the year. Prices paid by businesses investing in equipment and intellectual property products actually fell and so did the price of goods and services consumed by governments, which had surged early in the pandemic.

Other elements of the report are ambiguous. A fall in real GDP typically signals weak demand, which prefigures lower inflation. But this time the decline in output partly reflects supply constraints – for instance, microchip shortages that are hurting automobile production. That sort of thing signals higher inflation. The 9-pe cent rise in the GDP price index owed much to strong export prices. That improvement in Canada's terms of trade boosted our incomes – fuel for further recovery, which is nice, but also for higher inflation, which is not.

Stepping back, the big picture from the GDP release is not reassuring. A single quarter of declining output and leaping prices does not yet constitute "stagflation." But it is the exact opposite of the expanding real output and negligibly rising prices that, except for the US-centred financial crisis and recession in 2008-9, Canadians have enjoyed through the three decades since the establishment of inflation targets in the early 1990s.

The productive capacity of our economy is suffering lingering effects of COVID-19, ranging from disruptions for specific goods like microchips to more general shortages of safe workspaces and labour. Demand stoked by government transfers and easy money is pushing up against those supply constraints. Hence the disappointingly weak reading on output volumes and the alarmingly strong reading on prices.

Election campaigns tend to feature facile slogans and populist posturing – not ideal for a detailed discussion about monetary policy or the merits of a central bank that can act independently of elected politicians to preserve the value of money. The rising cost of living is already an election issue, however, and the ominous combination of campaign promises that would increase federal borrowing with continued buying of federal bonds by the Bank of Canada has the close attention of increasing numbers of economists and central-bank watchers.

The Bank of Canada and the new federal government are due to review the Bank's 2-percent inflation target before the end of the year. Now would be a good time for both the federal parties and the Bank of Canada's leadership to remind Canadians of the merits of low inflation and how the Bank's independence is crucial to achieving it.

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