An Extraordinary Time for Canadian Monetary Policy

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June 14, 2022

1. The Bank’s mandate renewal

2. The various causes of inflation

3. What can policy do?

The Punchline in Advance

1. Our current inflation has many, unusual sources.

2. The Bank of Canada can’t address them all.

3. So inflation might persist, even with aggressive monetary policy.

1. The Bank’s mandate renewal

“Core” Wording in the Renewed Agreement

“Consequently, the Government of Canada and the Bank of Canada agree to renew the inflation target on the following basis:

- **The target will continue to be defined in terms of the 12-month rate of change in the total CPI.**
- **The inflation target will continue to be the 2 percent mid-point of the 1 to 3 percent inflation-control range.**
- **The agreement will run for another five-year period, ending December 31, 2026.”**

Beyond the Core: “Word-flation”

Year	Total Words	Word-Flation (A-on-A %)
2001	334	
2006	366	9.6%
2011	431	17.8%
2016	503	16.7%
2021	873	73.6%

Some Unusual Verbiage

“The Government and the Bank also agree that monetary policy should continue to support maximum sustainable employment, recognizing that maximum sustainable employment is not directly measurable and is determined largely by non-monetary factors that can change through time.

Further, the Government and the Bank agree that because well-anchored inflation expectations are critical to achieving both price stability and maximum sustainable employment, the primary objective of monetary policy is to maintain low, stable inflation over time.”

This is all true, but ….

"This renewal of Canada's monetary policy framework is occurring at a time when changes to the economy are complicating the task of monetary policy. The global financial crisis and COVID-19 pandemic have had a significant impact on the global economy and financial system, and major trends such as shifting demographics and new digital technologies are altering the economic landscape. Climate change and the long-term transition to net-zero greenhouse gas emissions will drive structural change in the Canadian and global economies. Also, there is now greater recognition, supported by economic research, that when the benefits of economic growth and opportunity are more evenly shared, it leads to more prosperity for the whole economy. A strong and inclusive labour market helps reduce income inequality and supports robust demand for goods and services."

… is there much the Bank can do about it?

"Monetary policy is well equipped to address some of these challenges, less so for others. Two developments are particularly salient to the conduct of monetary policy:

- Neutral interest rates are likely to be lower than in the past, which means that central banks will have less room to lower their policy interest rates in the face of large adverse shocks to the economy.

- Major forces, including demographics, technological change, globalization, and shifts in the nature of work, are having profound effects on the Canadian labour market. These evolving forces have increased uncertainty about the level of maximum sustainable employment (i.e., the level of employment beyond which inflationary pressures arise)."

What does all of this mean?

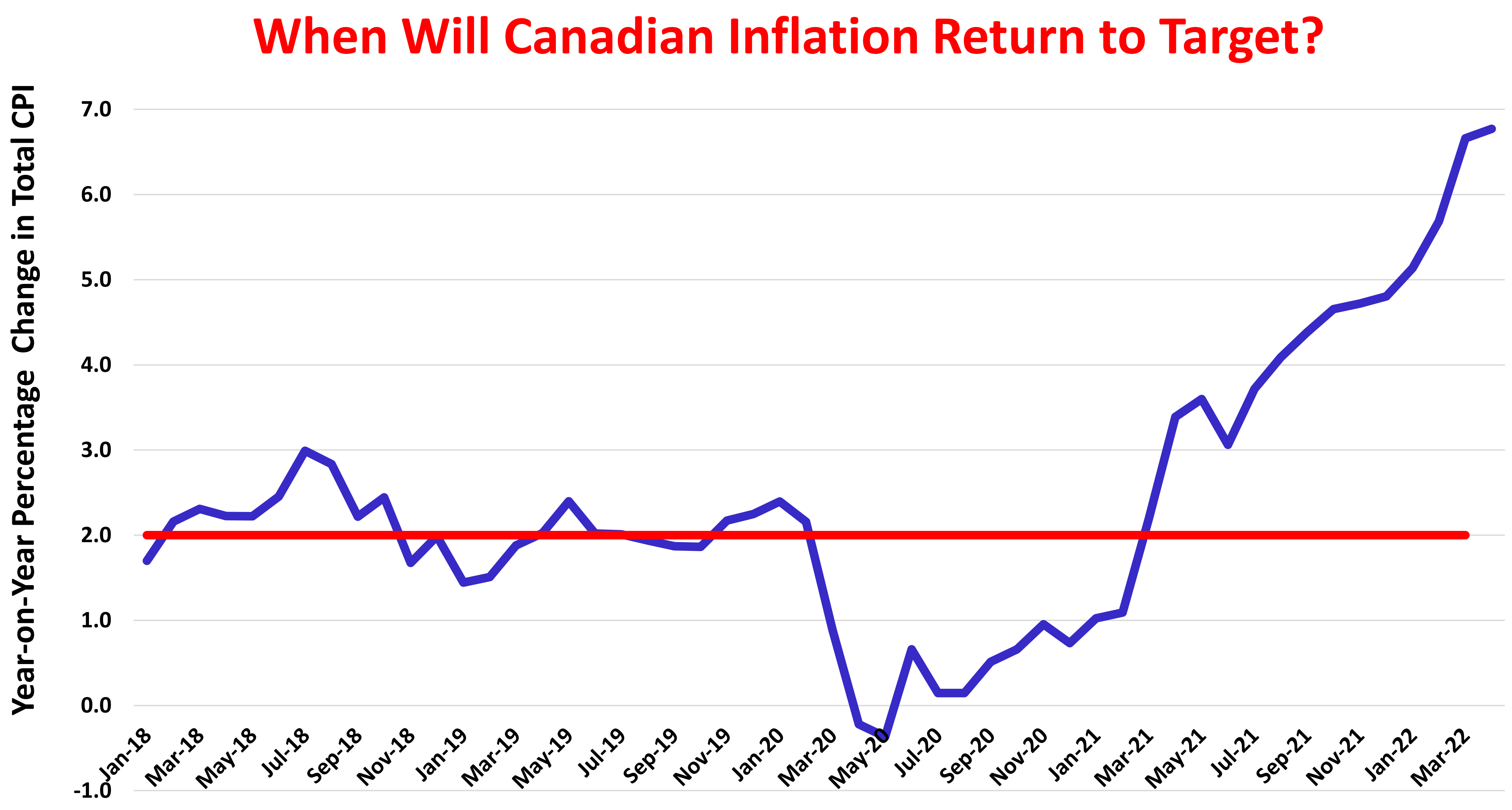
It’s hard to know for sure.

Apparently, this is NOT a dual mandate – according to the official press conference after the mandate renewal was released.

Was/Is there disagreement between the Bank and the Government?

See my essay in **MAX** ***Policy*** for a longer analysis of the language in the renewed mandate.

2. The various causes of inflation


When Will Canadian Inflation Return to Target?
Year-on-Year Percentage Change in Total CPI
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-1.0
Jan-18
Mar-18
May-18
Jul-18
Sep-18
Nov-18
Jan-19
Mar-19
May-19
Jul-19
Sep-19
Nov-19
Jan-20
Mar-20
May-20
Jul-20
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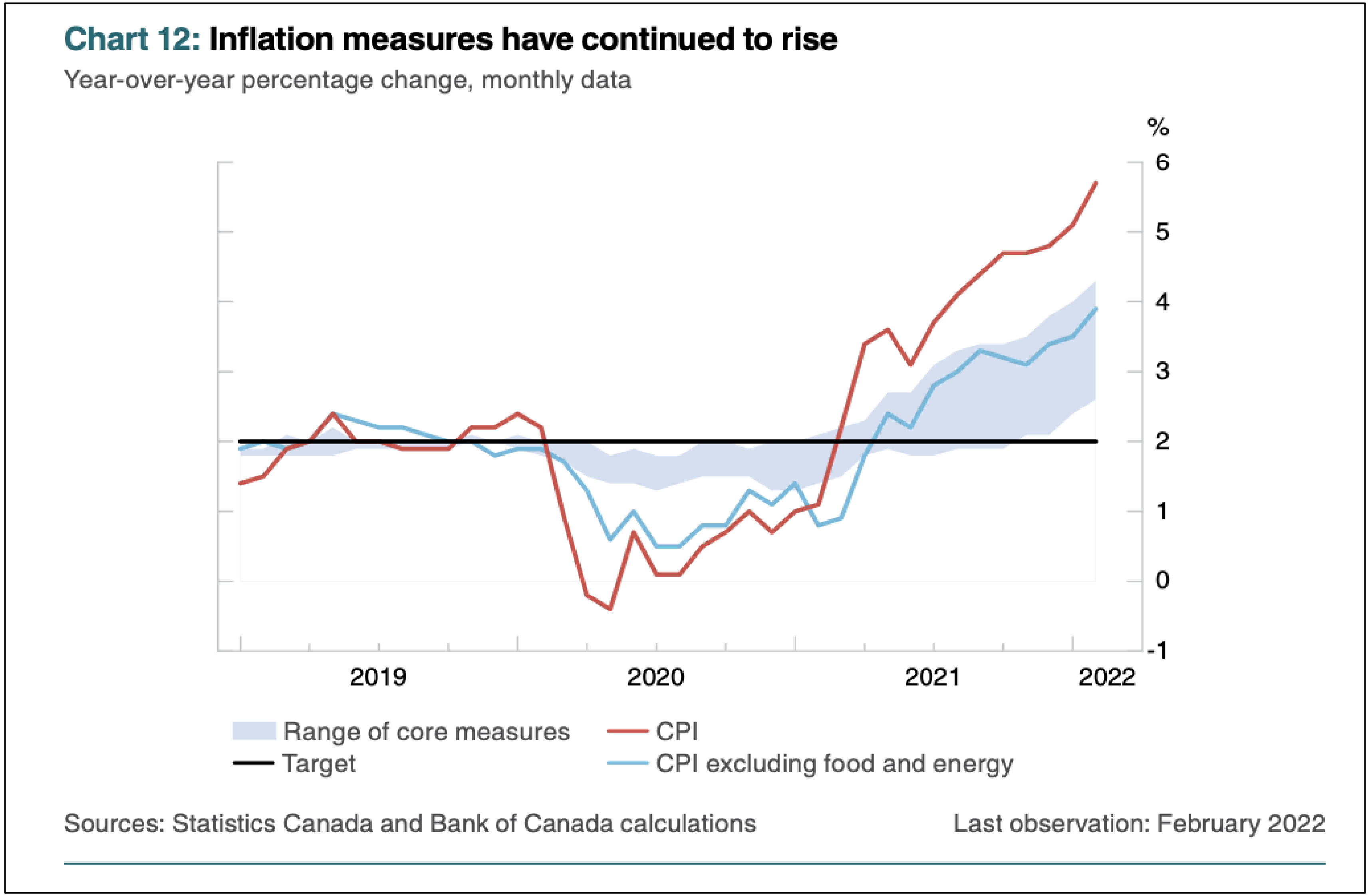
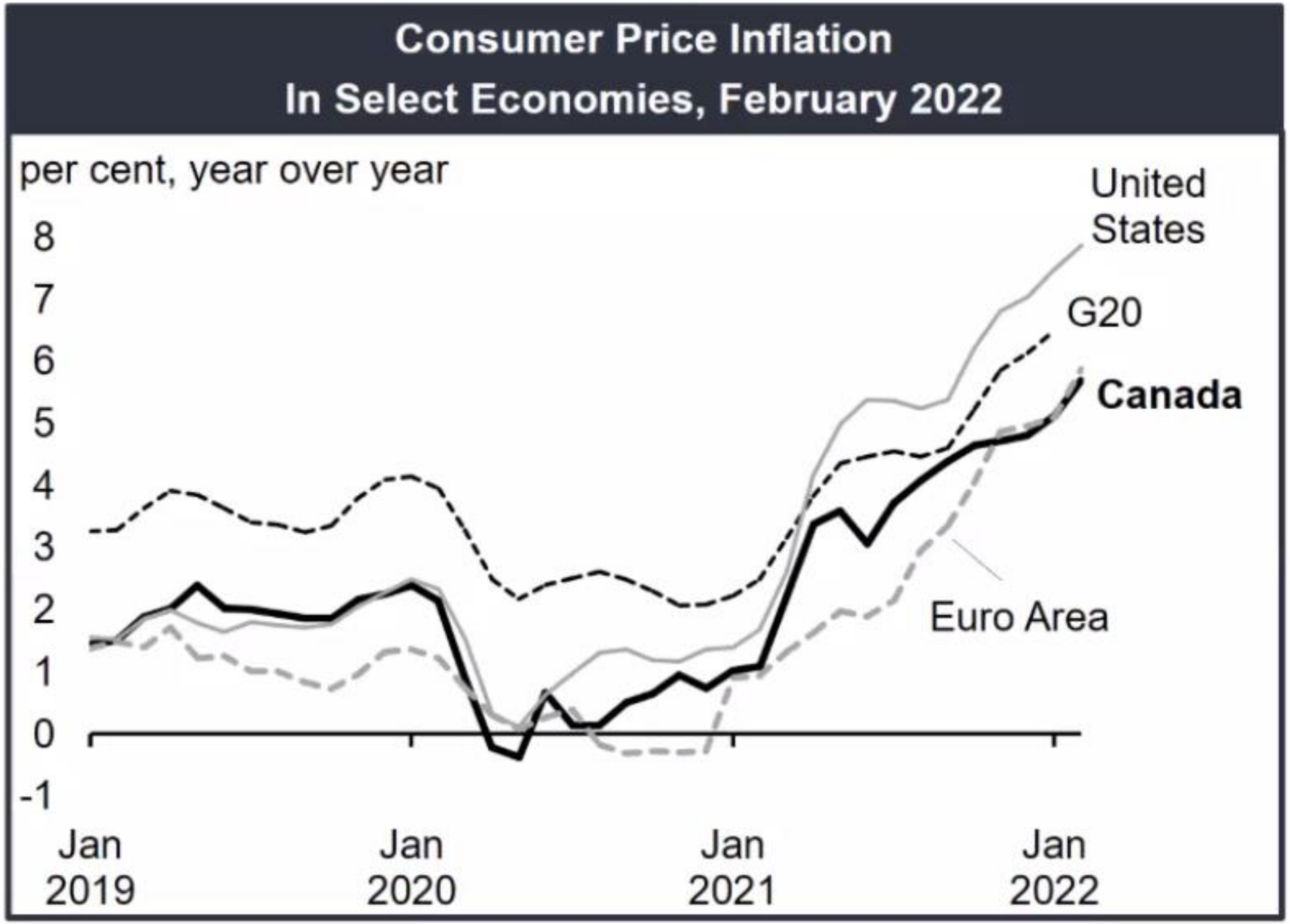
Jan-22
Mar-22

Core Inflation is Rising Too



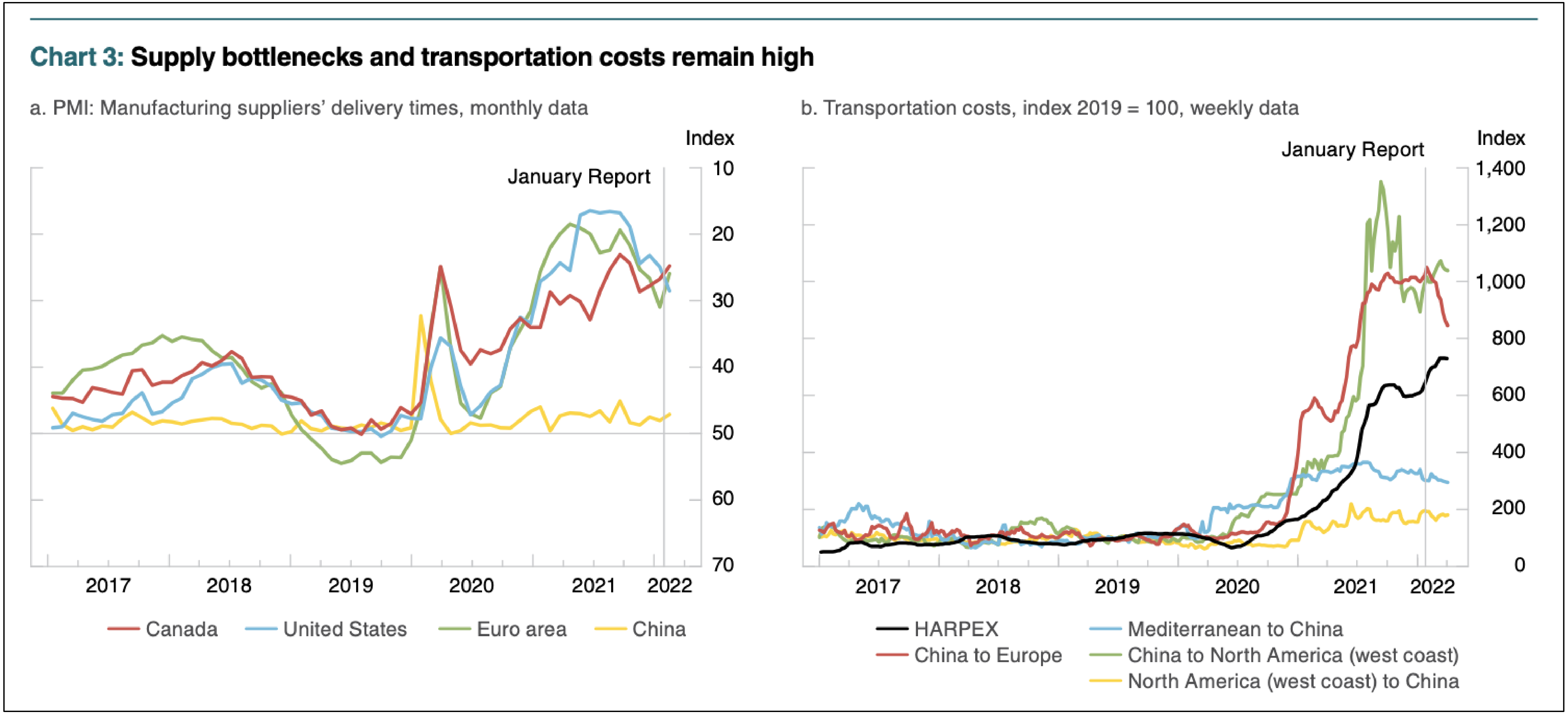
Source: Bank of Canada, *Monetary Policy Report*, April 2022

Canada Is Not Alone



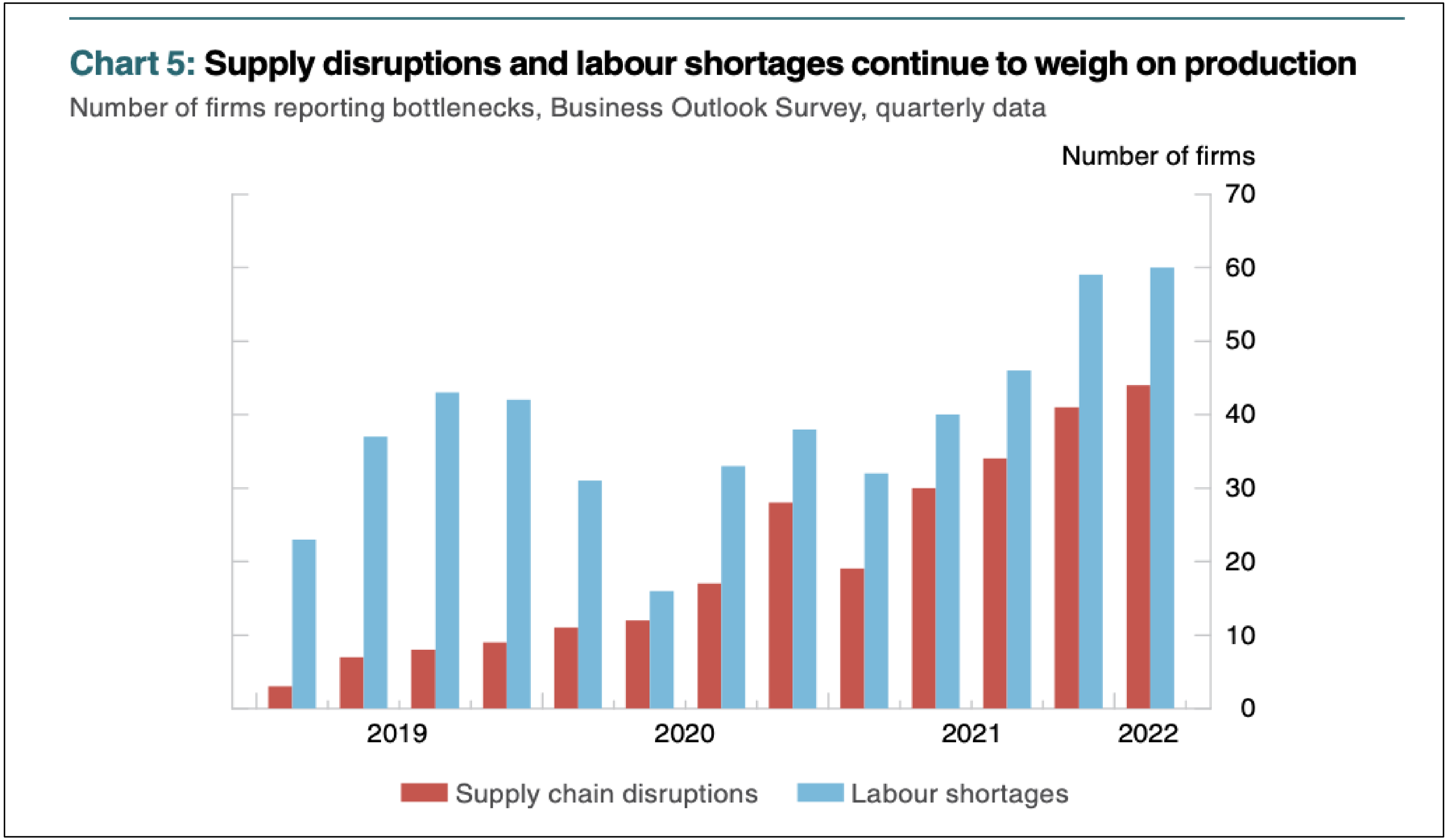
Cause of Inflation	When?
1. Supply-Chain Disruptions	The last ~ 15 months.
2. Pent-Up Demand	The last ~ 12 months.
3. Unleashed Expectations	The last ~ 6 months.
4. Ukraine War	The last 15 weeks.
5. Increase in Monetary Base	Starting soon?

Supply-Chain Disruptions I



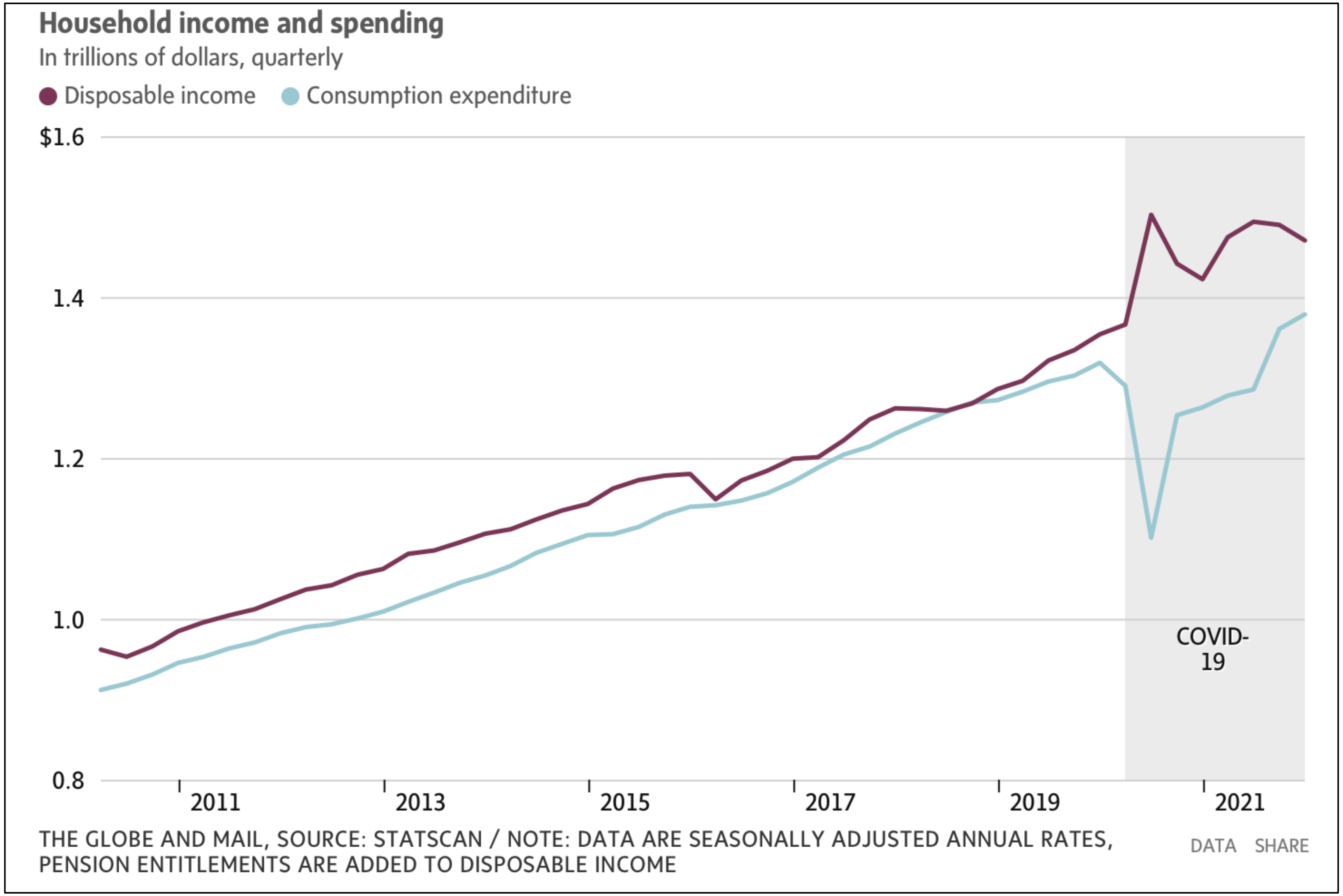
Source: Bank of Canada, *Monetary Policy Report*, April 2022

Supply-Chain Disruptions II

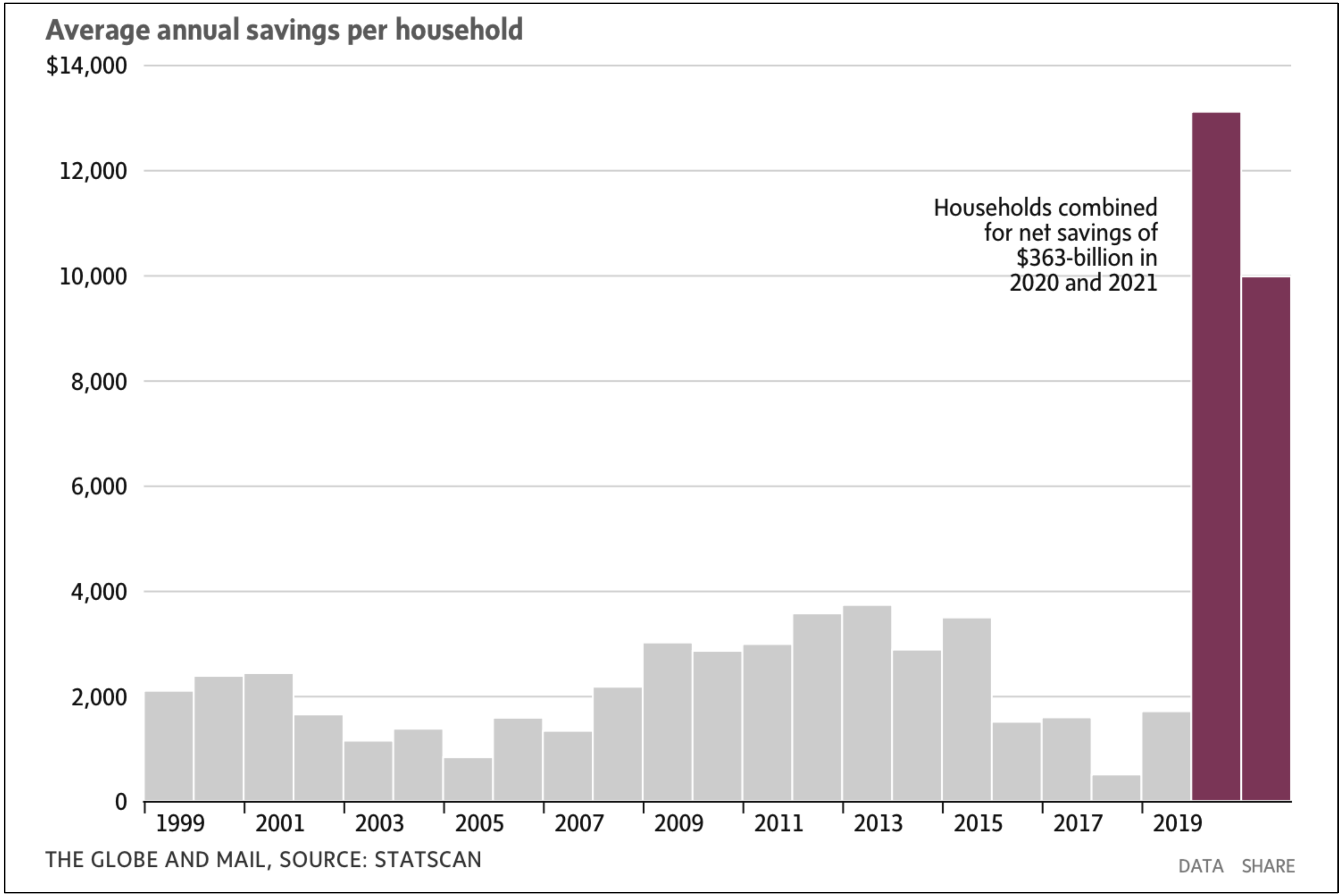


Source: Bank of Canada, *Monetary Policy Report*, April 2022

Pent-Up Demand I



Pent-Up Demand II



Inflation Expectations (Next 6 months)

Expectations **Selected definitions, graphs and historical data**		**2020Q3**	**2020Q4**	**2021Q1**	**2021Q2**	**2021Q3**	**2021Q4**	**2022Q1**
Percentage of firms expecting price increases over the next six months of: Source: **The Conference Board of Canada**	1% or less	45	24	14	7	5	1	0
	2% or less	66	65	39	22	13	9	7
	3% or less	78	80	66	60	33	23	18
	more than 3%	22	20	34	40	67	77	82

Source: Bank of Canada's website, June 6, 2022

Inflation Expectations (Next 2 years)

		2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1
Percentage of firms expecting CPI inflation over the next two years to be: Source: **Business Outlook Survey**	Less than 1%	12	7	2	0	0	0	0
	1-2%	44	60	35	8	10	2	1
	2-3%	28	21	42	51	42	30	26
	more than 3%	11	8	13	35	45	67	70
Expectations implicit in real/nominal bond spread		1.2	1.5	1.7	1.8	1.7	1.8	1.8

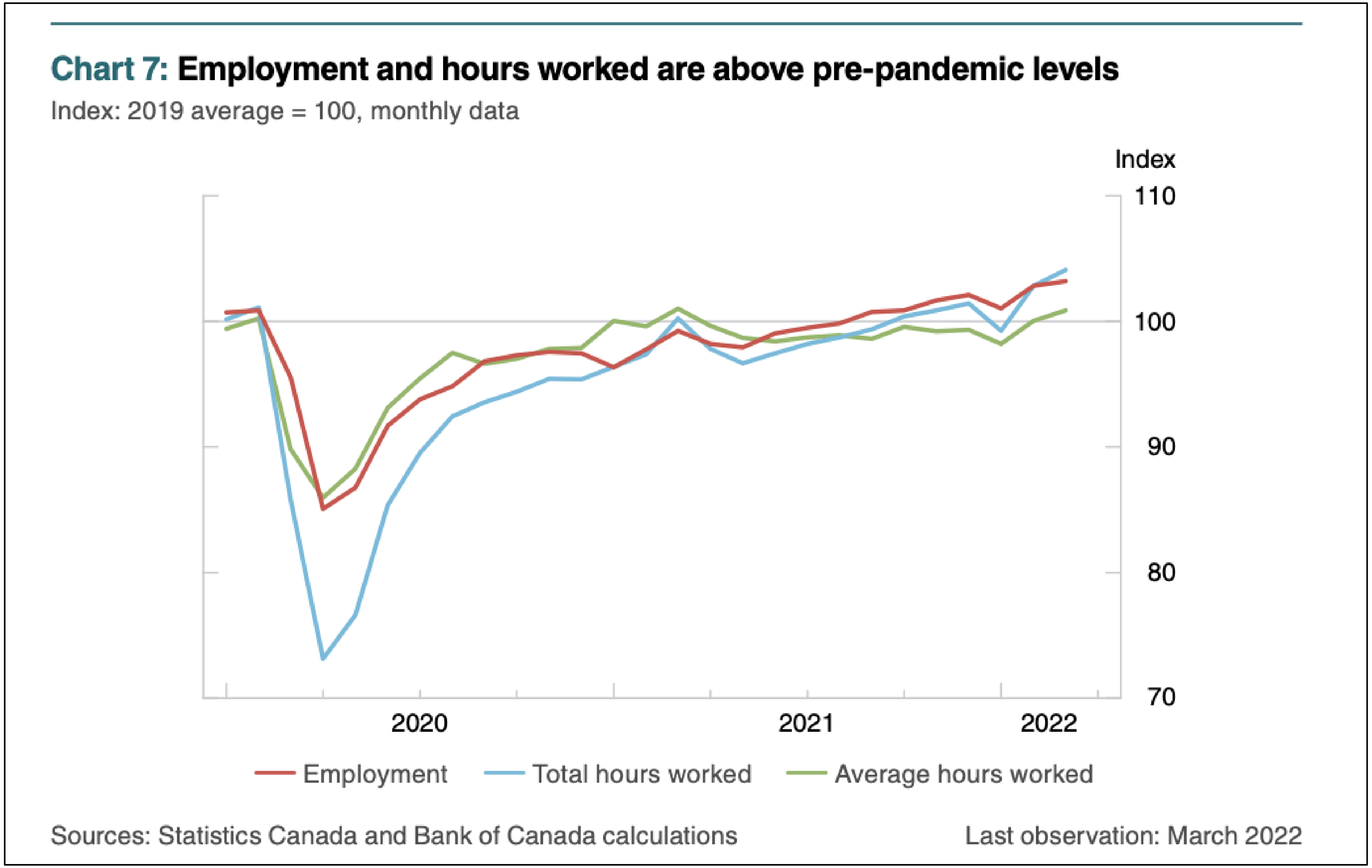
Source: Bank of Canada’s website, June 6 2022

But Only a Hint of Wages Starting to Rise Quickly

Wages and costs (year-over-year percentage change) Selected definitions, graphs and historical data		2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1
Wage-common		4.5	3.7	3.5	1.2	2.0	2.4	
Wage-common inputs	Labour Force Survey – Average Hourly Earnings	6.1	5.3	4.4	-1.2	1.2	2.5	3.0
	Survey of Employment, Payrolls and Hours – Average Hourly Earnings	5.0	4.2	4.8	0.7	2.1	2.2	3.2
	Productivity Accounts – Compensation per Hour	9.1	6.5	1.2	-10.2	0.4	1.2	
	National Accounts – Hourly Wages and Salaries	6.5	4.6	5.2	0.4	1.6	2.5	3.3
Unit labour costs - Total economy (labour income/GDP at market prices)		4.0	3.3	3.3	2.8	5.5	5.5	7.5

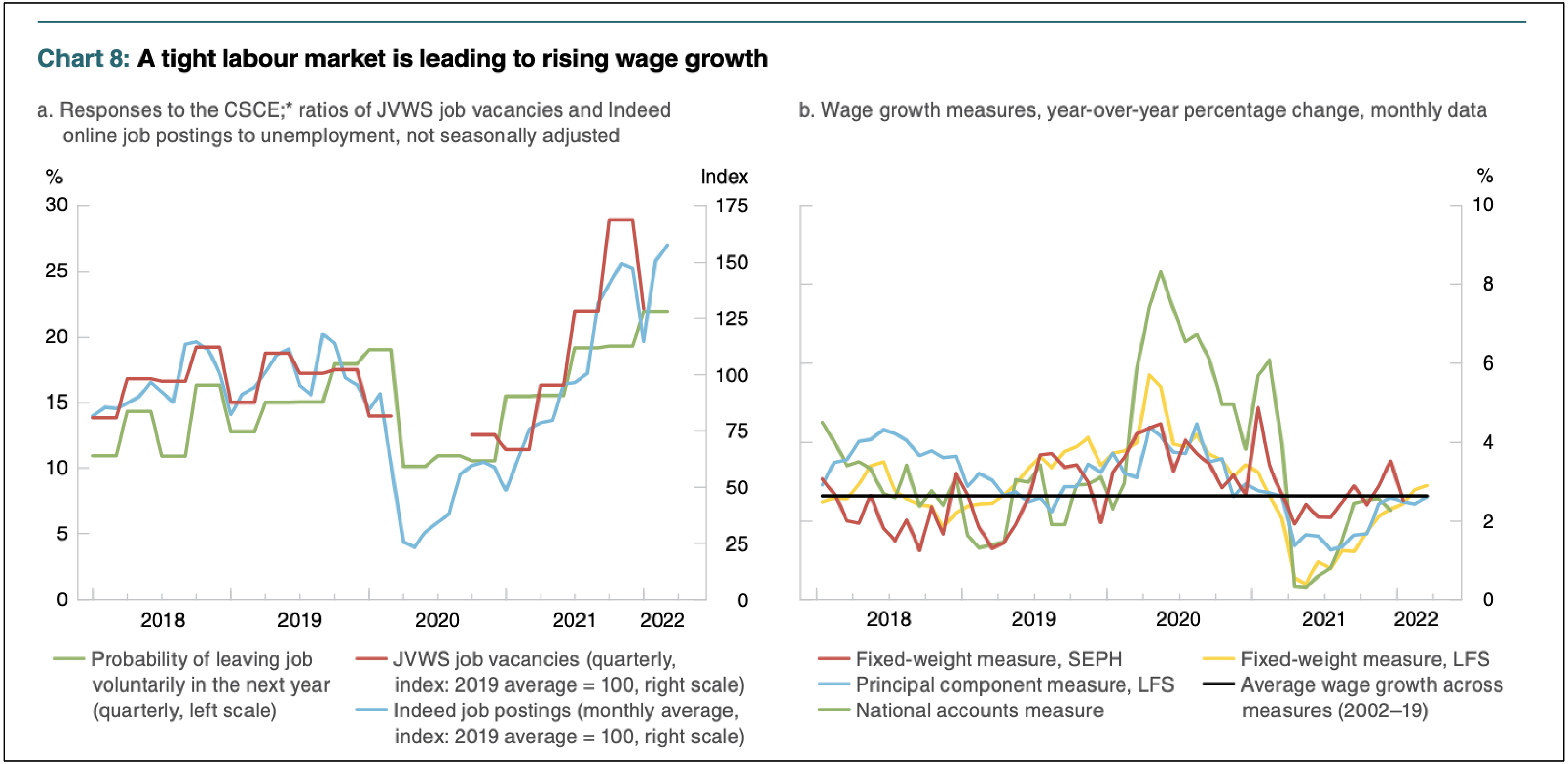
Source: Bank of Canada's website, June 6 2022

Wage Pressures I



Source: Bank of Canada, *Monetary Policy Report*, April 2022

Wage Pressures II

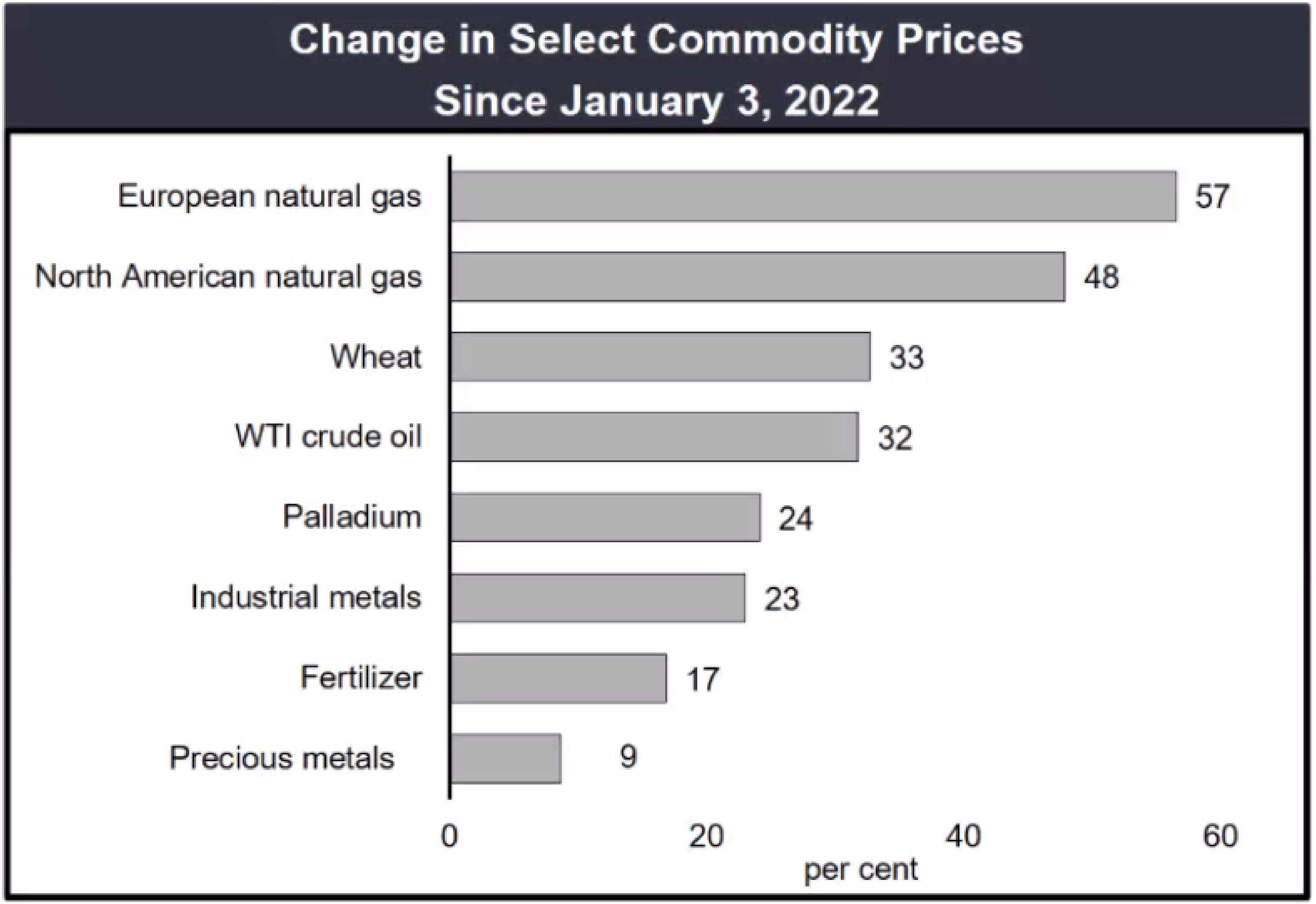


Source: Bank of Canada, *Monetary Policy Report*, April 2022

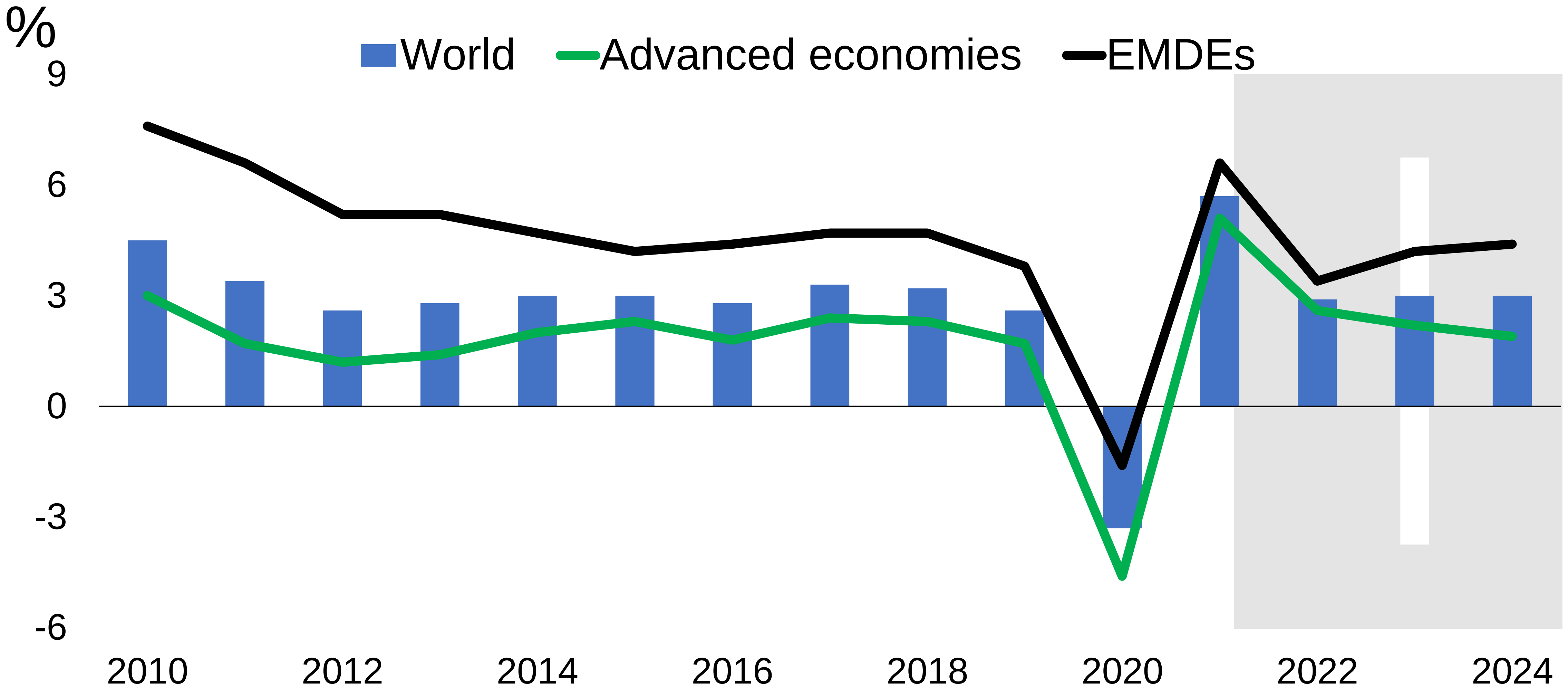
Ukraine War I

Source: Bank of Canada, *Monetary Policy Report*, April 2022

Ukraine War II



Growth in World Real GDP



Source: World Bank

Offsetting Effects for Canada

Table 3-A: The impacts of Russia's invasion of Ukraine on Canadian growth and inflation

Channels		Real GDP	Inflation
Higher commodity prices	Improved terms of trade	↑	↑
	Increased commodity production	↑	↑
	Direct CPI effects	↓	↑
	Higher production costs	↓	↑
More persistent supply chain disruptions	Higher production costs, lower output	↓	↑
Total effects		-	↑

Source: Bank of Canada, *Monetary Policy Report*, April 2022

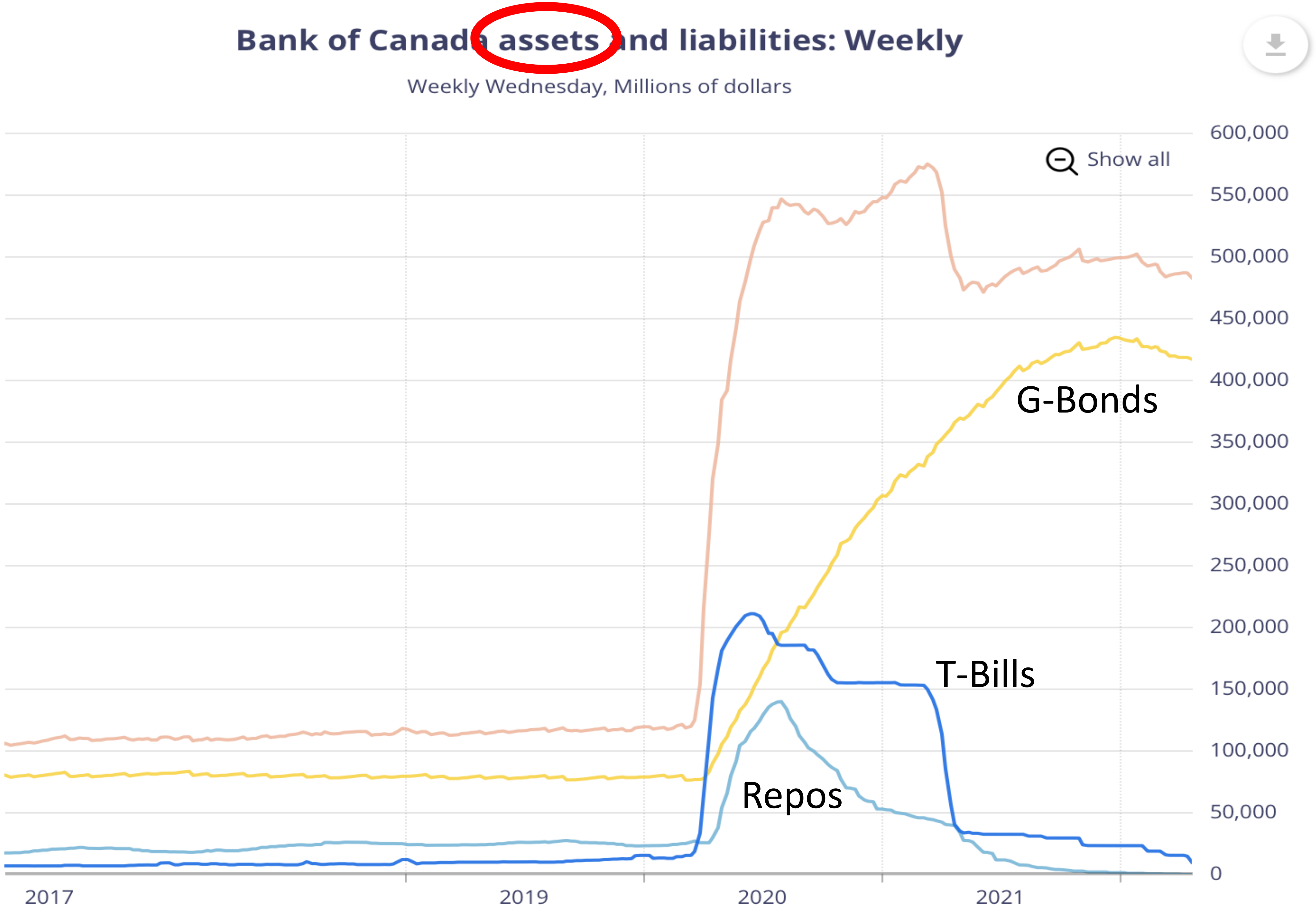
Canada's GDP and Inflation

Table 3: Summary of the quarterly projection for Canada*

	2021		2022			2021	2022	2023	2024
	Q3	Q4	Q1	Q2		Q4	Q4	Q4	Q4
CPI inflation (year-over-year percentage change)	4.1 (4.1)	4.7 (4.7)	5.6 (5.1)	5.8		4.7 (4.7)	4.5 (3.0)	2.4 (2.2)	2.1
Real GDP (year-over-year percentage change)	3.8 (4.0)	3.3 (3.2)	2.8 (2.4)	5.3		3.3 (3.2)	3.8 (4.2)	2.9 (2.7)	1.7
Real GDP (quarter-over-quarter percentage change at annual rates)†	5.5 (5.4)	6.7 (5.8)	3.0 (2.0)	6.0					

Source: Bank of Canada, *Monetary Policy Report*, April 2022

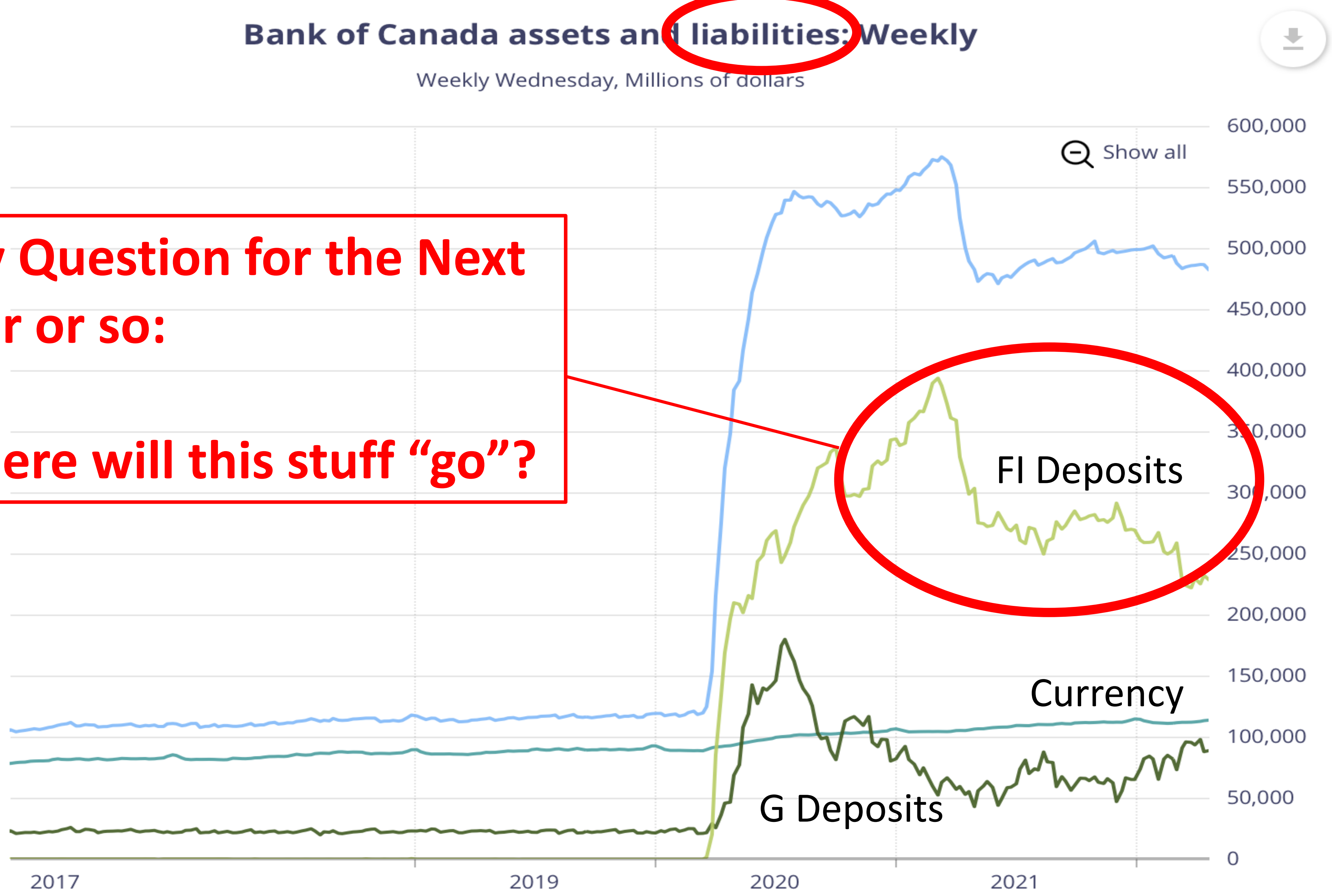
How About Money Growth?



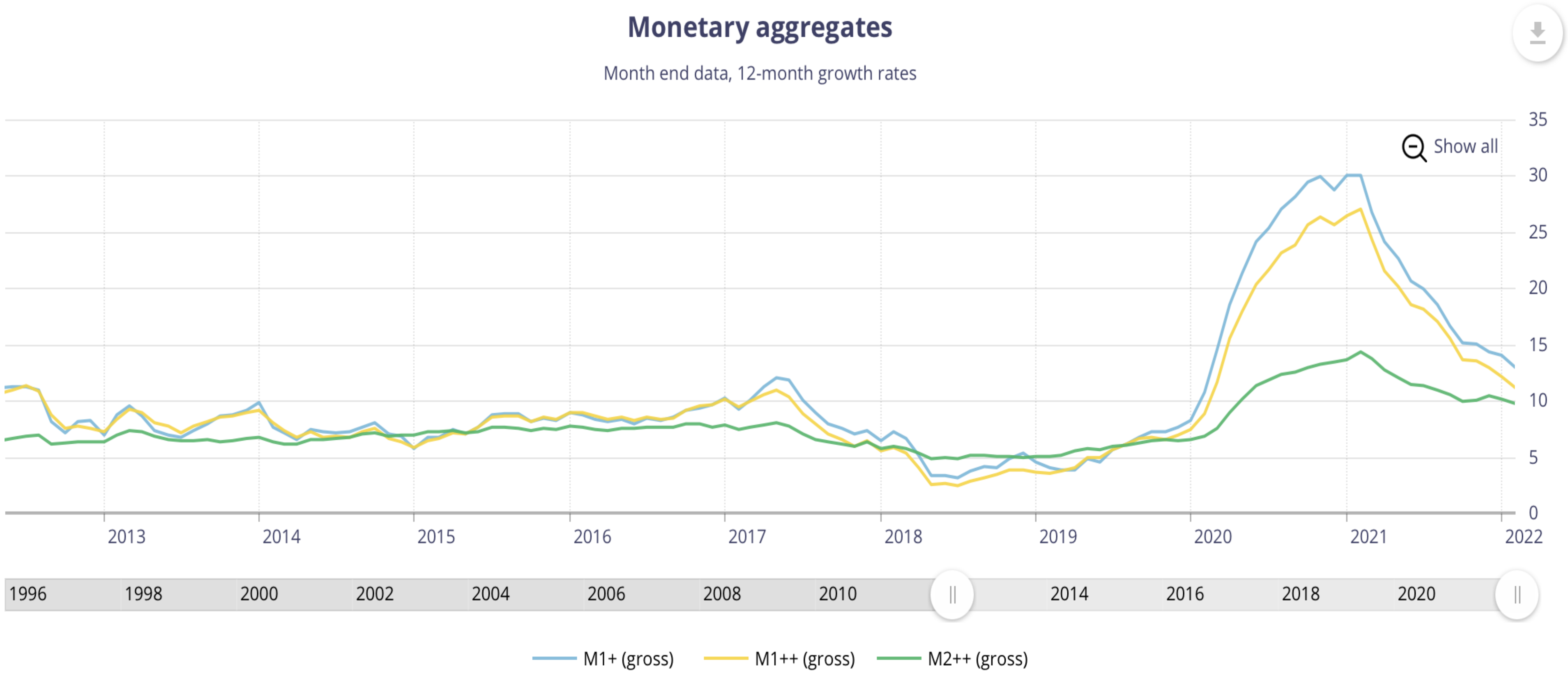
Bank of Canada assets and liabilities: Weekly
Weekly Wednesday, Millions of dollars
Show all
600,000
550,000
500,000
450,000
400,000
350,000
300,000
250,000
200,000
150,000
100,000
50,000
0
2017
2019
2020
2021
G-Bonds
T-Bills
Repos

Key Question for the Next Year or so:

Where will this stuff “go”?



Growth in Broader Money Supply



3. What can policy do?

Cause of Inflation	When?	What the Bank Can Do?
1. Supply-Chain Disruptions	The last ~ 15 months.	Nothing.
2. Pent-Up Demand	The last ~ 12 months.	A little (more on housing).
3. Unleashed Expectations	The last ~ 6 months.	A lot.
4. Ukraine War	The last 15 weeks.	Nothing.
5. Increase in Monetary Base	Starting soon?	A lot.

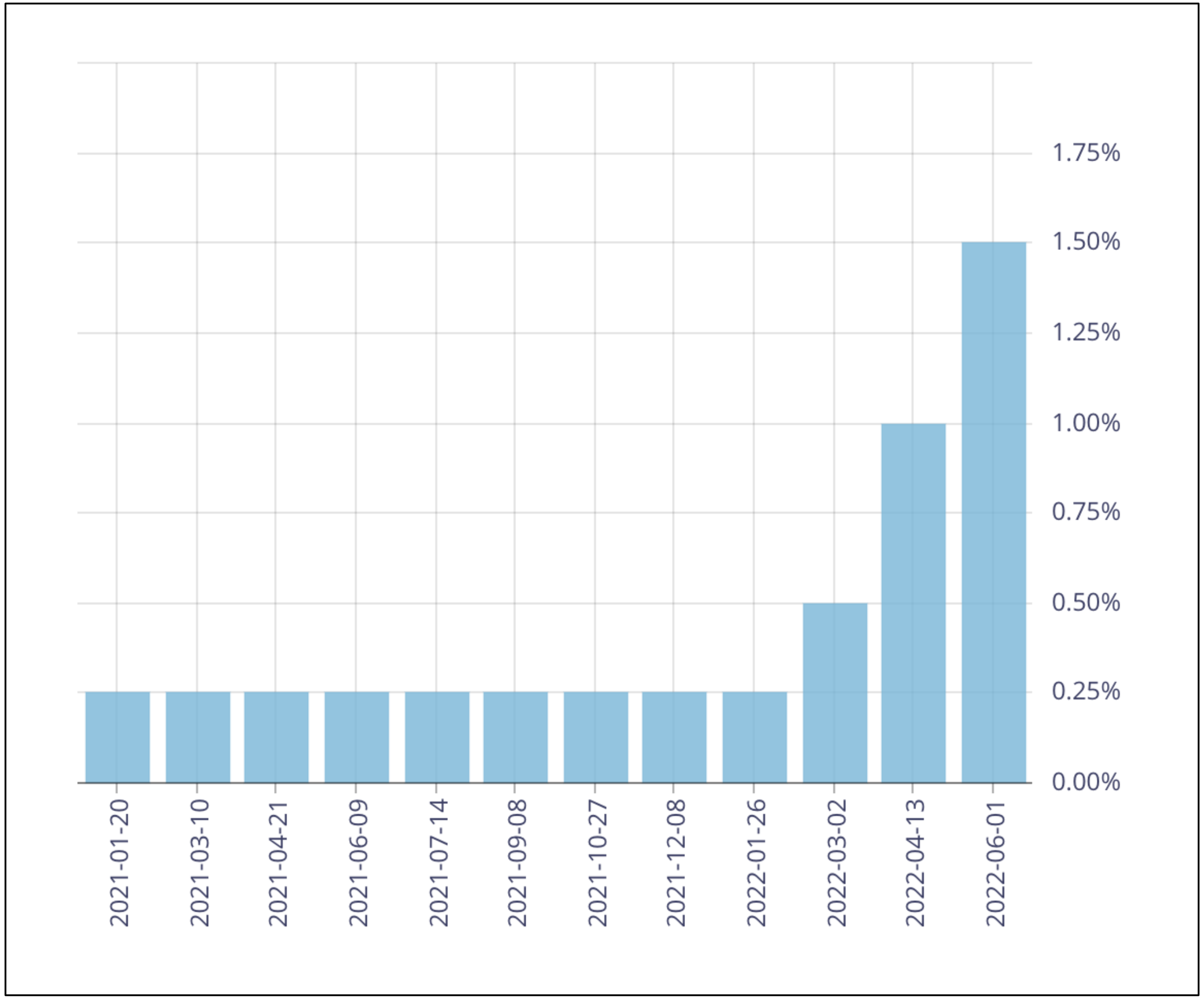
Remember the Limitations of Monetary Policy

1. Todays inflation has several causes. Monetary policy cannot address them all.

2. Monetary policy is best suited to addressing **demand-driven** inflation.

3. The Bank may have been too slow to act, but given the extraordinary circumstances of the past two years, perhaps it can be excused.

The Bank's target for the overnight rate



Source: Bank of Canada's website, June 10 2022

Summing Up

1. Pretty clear that Bank of Canada will be raising rates some more. Maybe 150-200 basis points over the coming year?

2. Will this cause house prices to slow …. or to fall outright? How will the Bank adjust?

3. Will inflation expectations come back to being well-anchored?

4. What does this make you think about the Bank's renewed mandate?

Thanks for listening.