A Cure Worse than the Disease?

Toward a More Balanced Understanding of Inflation and What to Do About It

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Preface

By Bea Bruske

As the voice of workers across Canada, the Canadian Labour Congress advocates for working people to have good jobs and safe working conditions within an inclusive economy that works for everyone. It is a privilege to represent over 3 million unionized workers in both the private and public sector. I get to see up-close, every day, how workers and the unions that represent them play a critical role in Canada's economy.

It is easy to get lost in numbers as we digest all the news around inflation and the economy. But we must never lose sight of how our economy is made up of people, not a series of data points. Rising prices on groceries and soaring interest rates on loans, mortgages and credit cards leave workers and their families feeling the pinch. Low and modest-income families are finding it harder and harder to make ends meet.

Right now, policymakers at the Bank of Canada and in government are faced with serious choices that will directly impact Canadians' wellbeing for years to come. We must address inflation, but also the impact of rising interest rates on people and the economy. As policymakers work to bring down inflation, they must consider the full consequences of these decisions on people.

For too long we have been surrounded by bad-faith narratives being pushed about the causes of inflation. People argue that government spending, that helped people survive the pandemic, is causing inflation. These narratives purposely misdirect. And that is why it feels critical at this juncture to remind policymakers that domestic interest rate hikes cannot help control food prices, gas prices, the challenges created by COVID's strain on global supply chains, or the role played by Russia's unjust war on Ukraine.

On October 26, the Bank of Canada will make its next interest rate announcement and release its Monetary Policy Report. The Bank will announce whether it will continue with rapid rate hikes or choose instead to take time to better evaluate the effects of its actions, and monetary tightening in other countries, before going further. A critical factor in this decision must be a clear-eyed view of the real costs of a policy-induced recession. Already, Canada is in the forefront of raising rates: no G7 country has raised them faster and further. That is why we are arguing that the Bank of Canada should not move stubbornly ahead with even more rate hikes, and cause a dangerous recession, before seeing the full effects of measures already taken. Let's take a pause to save Canadians jobs.

Make no mistake: recession is a dirty word. A recession means hundreds of thousands of lost jobs. It means rising bankruptcies and mortgage defaults. We will see downward pressure on wages – that are still lagging far behind inflation – essentially locking in real wage cuts for workers. If our nation's monetary policy decisions trigger an unnecessary recession, the pain will be felt for years to come; and we know that precarious and low-wage workers, in particular women, Indigenous, racialized, recent immigrant workers, will be hit the hardest. It would be wrong to use a damaging recession as a policy tool to bring down inflation, making everyday Canadians pay the price for a crisis they did not cause.

Policymakers at the Bank of Canada must not turn to a decades-old monetary policy textbook to solve 2022's economic crisis. While workers and families have not created high inflation, the same cannot be said for companies that have taken advantage of their market position to unduly jack up prices, far beyond merely covering higher input costs – and fueling higher inflation for the rest of us. It is regrettable that while Bank of Canada policymakers warn loudly about the dangers of higher wages, they are silent on the impact of corporate profiteering.

The Canadian Labour Congress and the Centre for Future Work are releasing this new economic report to give a clear-eyed view of the state of our economy, outline the real costs of a possible recession and propose policy alternatives to policymakers both at the Bank of Canada and in the government.

Instead of relying on old school monetary policy, Bank of Canada policymakers could look to different, more open-minded, and multi-dimensional approaches to the inflation crisis. Reducing consumer confidence with policies that target the welfare and wellbeing of the most vulnerable is not the pathway to the economy we want to build. When workers prosper, our economy grows and strengthens.

Governments also have an important role to play. We welcome the recent steps taken by the federal government and the NDP to provide targeted help for people, but there is much more work to do.

Government policymakers must swiftly set out social, economic, and labour market measures that can help mitigate the impacts of both inflation and now rocketing interest rates on already struggling families. Governments can also ensure that corporations who have raked in such high profits from the inflation crisis, are finally made to pay their fair share.

The reality is, families already face a double whammy of high prices for essentials and rising interest rates on their debts. Still higher rates that cause a policy-induced recession – with massive job losses and lower wages – will make things even worse. We must now do everything we can to avoid this. Let us instead embrace alternatives that put the wellbeing of people at the heart of our nation's monetary and fiscal policies.

Bea Bruske,
President, Canadian Labour Congress

Introduction

Canada's economy is in the grip of an unprecedented monetary tightening. The Bank of Canada has increased its overnight interest rate five times in six months, by a cumulative total of three full percentage points. The Bank's policy rate has jumped 13-fold (from 0.25% to 3.25%); typical commercial variable mortgage rates have tripled.[1] And Bank officials have made it clear: there's more tightening to come, and they will not stop until the target inflation rate (2%) is reestablished, even if the economy weakens badly or enters recession. For example, the Bank's Governor Tiff Macklem said recently:

"We have taken forceful action to restore price stability. It will take time, but we are going to bring inflation back to the 2% target. Everyone should plan for that."[2]

In August, he was equally blunt:
"Our job is not done yet – it won't be done until inflation gets back to the two per cent target."[3]

In June, Deputy Governor Paul Beaudry put it this way:
"The bottom line is we will get inflation back to two per cent and we'll do what's necessary to get there."[4]

All this tough talk clearly communicates the Bank's intention to continue tightening despite the risk of economic slowdown or even recession. The tough words are also motivated by the Bank's belief (reviewed critically below) that if Canadians' expectations of future inflation can be wrestled back down, those expectations will effectively become self-fulfilling – and inflation will decelerate more painlessly.

The Bank of Canada's goal is to reduce consumer price inflation (which was running at 7.0% year-over-year as of August) back to the 2% target as quickly as possible. Canada has never experienced a disinflation on that scale, or such a large proportional increase in interest rates, without experiencing a recession.[5] So based on historical experience, the likelihood that this tightening will cause a recession is high. And a growing consensus among economists indeed suggests that an economic contraction is imminent, for Canada and the global economy.[6] In fact, many indications (discussed further below) suggest the recession may have already begun.

1. The Bank of Canada's "Estimated Variable Mortgage Rate" increased from 1.29% at the beginning of March to 4.53% on October 6.
2. See "Restoring price stability for all Canadians," Speech Summary, Tiff Macklem, Halifax Chamber of Commerce, October 6 2022.
3. Tiff Macklem, "We're determined to eliminate high inflation and return to our 2% target," National Post, August 16 2022.
4. Don Pittis, "Facing up to a 'polycrisis' that the Bank of Canada may not have the tools to fix," CBC News, June 3 2022.
5. David MacDonald, "Canada's fight against inflation: Bank of Canada could induce a recession," The Monitor, July 5 2022.
6. For Canadian forecasts, see Larysa Harapyn, "Big rate hikes could push Canada into severe downturn," Financial Post, October 9 2022; David Rosenberg, "A Canadian recession is 'all but set in stone'", Financial Post, September 15 2022; and Noah Zivitz, "RBC predicts Canada heading for recession in 2023," BNN Bloomberg, July 7 2022. Globally, the IMF has warned of the weakest economic conditions since 2001; see Stephanie Hughes, "IMF slashes outlook as recession risks grows," Financial Post, October 12 2022.

The rise in inflation as the global economy reopened after COVID has been a worldwide phenomenon. Canada's inflation, while painful to workers and low-income households, has been more moderate than most industrial countries. According to the most recent OECD comparative data[7], Canada's inflation rate was 2.6 percentage points lower than the OECD average (7.6% in the year to July, versus 10.2% across the OECD); Canada had the 11th lowest inflation rate of 38 OECD member countries.

Yet despite relatively lower inflation here, the Bank of Canada has been uniquely aggressive among major OECD central banks in raising interest rates. Along with the U.S. Federal Reserve, the 3-point lift in the Bank's policy rate during 2022 ranks as the largest among G7 and other major central banks (Figure 1). Why is our central bank pursuing its inflation target with such unique zeal, and at risk of an economy-wide contraction that will do more harm than the disease it is supposedly aiming to contain?

Ironically, this dark outlook for Canada's economy comes on the heels of a recovery from pandemic disruptions that can only be described as extraordinarily successful. After enduring the fastest, steepest decline in employment and real output in Canadian history early in the pandemic, a combination of strong health protection measures, generous and timely income supports, unprecedented business and wage subsidies, and fiscal and monetary stimulus supported a rapid and welcome economic rebound. Canada regained pre-COVID levels of employment and real GDP by late 2021, far faster than economists expected. And for various reasons (including restrictions on immigration during the pandemic which limited labour supply), labour markets have achieved very strong outcomes since then, with historically low unemployment and abundant job opportunities for most workers.

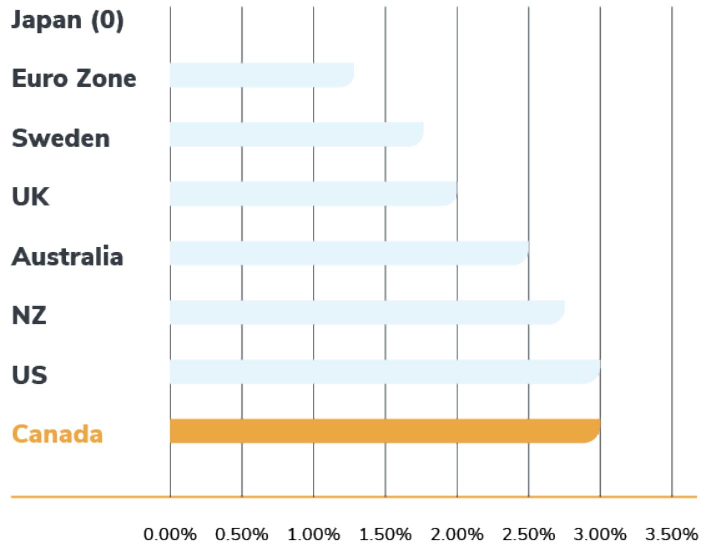

Figure 1. Central Bank Rate Hikes in 2022

Source: Author's compilation from central bank websites.

This success is now jeopardized by deliberate policy actions by one particular governmental agency, intent on pursuing one particular economic goal (reestablishing target inflation) above all others. A recession would impose enormous costs that last for many years: in unemployment, lost incomes, lost output, larger deficits, wasted capacity, destroyed lives. Moreover, given the Bank of Canada's warning that it won't stop its crusade until target inflation is reestablished, it is unlikely that a recession would be short. Perversely, we could well see the Bank continuing to lift interest rates even as the economy contracts. Financial stability is already being tested by the effects of the global interest rate shock (as evidenced dramatically by recent events in the U.K.), so a recession would likely spark deeper ruptures in the financial system, business viability, and confidence.

7. OECD, "Consumer Price Index," Statistics News Release, September 2 2022.

It is not clear that the trade-offs between reducing inflation and other economic goals have been adequately considered. It is not even clear that the Bank of Canada's actions are consistent with its revised mandate, implemented just last year by the federal government, which instructs the Bank to pursue "maximum sustainable employment" along with stable inflation.[8]

The current episode of inflation differs fundamentally from the experience of the 1970s and 1980s that informed the creation of the present inflation targeting regime. There are many reasons to question the current zealous application of policy strategies which were a response to conditions several decades ago. The Bank of Canada's actions should be reviewed and evaluated, including by the government to which it is ultimately accountable; the guise of operational "independence" does not give the Bank free rein to single-mindedly pursue a chosen objective regardless of the collateral damage. As a start, the Bank should pause its monetary tightening: hold interest rates at present levels to evaluate the impact of previous hikes (which typically take one to two years to have full effect), allow the rest of the world to "catch up," and consider and implement complementary measures (including by other arms of government) to reduce inflation, protect Canadians from its effects, and support employment and production. Meanwhile, government must play a more proactive role in addressing the root causes of current inflation (which have little to do with textbook narratives), taking measures that reduce inflationary pressures while supporting the real work and production that are the ultimate determinant of Canadians' prosperity.

This paper reviews the textbook understanding of inflation: that it is caused by excess demand, arising mostly from the labour market, and amenable to control by interest rate adjustments. It presents evidence showing this textbook diagnosis is not well-suited to explaining current post-pandemic inflation, and arguing that policy responses arising from that model are therefore inappropriate. It catalogues the many risks of the single-minded pursuit of an inflation target with higher interest rates. It concludes with a vision of a more multi-dimensional and balanced approach to managing inflation – one that involves other government policy levers (not just the Bank of Canada), and that targets a more beneficial combination of high employment and stable prices.

8. "Joint Statement of the Government of Canada and the Bank of Canada on the Renewal of the Monetary Policy Framework," December 13 2021.

The Textbook Diagnosis:

Inflation's Causes and Cures

The Bank of Canada justifies its aggressive interest rate adjustments on the basis of a textbook understanding of inflation and monetary policy that has guided its actions for the last three decades (since the implementation of Canada's inflation targeting system in 1991). The model is based on the assumption that if economic activity is maintained at an appropriate level, defined as the economy's "capacity,"[9] then inflation will neither rise nor fall. Any number of stable rates of inflation are consistent with the economy operating at its potential; the rationale for inflation targeting is to establish a low, "optimal" inflation rate, and then manage the overall level of economic activity so that rate can be sustained.

In Canada, that optimal rate was arbitrarily set at 2%. Recognizing inherent variability in inflation and economic conditions, the Bank allows for a range of plus or minus one percentage point around that target, but still aims to hit the target on average. Higher inflation is predicted when the economy is pushed beyond its capacity by unduly strong demand for goods and services that outstrips the economy's ability to produce them. In that circumstance, spending power (aggregate demand) must be quickly curtailed (through higher interest rates) to reduce upward price pressures. The Bank hopes that if the expectations of economic agents (firms, consumers, and workers) are maintained (or "anchored") around the target (thanks largely to the Bank's reputation for meeting it), then inflation will return quickly to target after any temporary disruptions resulting from unpredictable economic shocks. But if inflation is allowed to escape the bounds of that target range for very long, economic agents (firms, consumers, workers) will come to expect higher inflation, and that expectation will become self-fulfilling. Even if the economy returns to its proper level of output (so-called "capacity" or "potential output"), inflation will be stuck at that higher (expected) level. This is why the Bank is so anxious both to respond quickly and powerfully to current above-target inflation, and to convince Canadians that its actions will indeed bring inflation quickly back to target. This explains the "front loading" of large interest rate increases, to send a strong signal to Canadians that inflation will quickly come down. Like a "Field of Dreams" story, if Canadians believe lower inflation is around the corner (reinforced by the Bank's active public communication efforts stressing that message), that belief alone will supposedly reduce inflation to target more quickly and painlessly.

Formally, this approach is commonly described through a theory called the "expectations-augmented Phillips Curve."[10] This theory originated in the 1970s, in response to persistent inflation which resulted in part from rapid wage increases, and persisted despite high unemployment (a condition termed "stagflation"). In an earlier postwar formulation, the original Phillips Curve had posited a strong and stable relationship between inflation and the unemployment rate. But that relationship seemed to break down in the 1970s. In response, economists (led by Milton Friedman and Edmund Phelps) began to include expectations of inflation in their theories. They suggested there is a particular unemployment rate (first called the "natural rate" of unemployment, later renamed the Non-Accelerating Inflation Rate of Unemployment or NAIRU) consistent with stable inflation. Inflation will change as a result of a deviation of actual unemployment from its stable-inflation level: accelerating if unemployment is too low, decelerating if it is too high. That stable-inflation level of unemployment came to be considered a kind of "full employment," even though it usually implies substantial unemployed and underemployed labour. Any level of inflation is consistent with that stable-inflation level of unemployment[11], but it is better to have low stable inflation (some modest inflation is acceptable as a lubricant for relative price changes in the broader economy, but economists have never successfully explained why 2% is somehow "optimal").

9. In this understanding, "capacity" does not refer to an actual physical limit on the economy's potential output, but rather on what can be produced (given prevailing institutional arrangements) consistent with a stable rate of inflation.
10. For a typical presentation, see Laurence Ball and Sandeep Mazumder, "A Phillips Curve with Anchored Expectations and Short-Term Unemployment," IMF Working Paper WP/15/39, 2015.
11. Geometrically, the long-run Phillips Curve is a vertical line at the stable-inflation rate of unemployment (ie. the NAIRU).

Expectations of inflation will respond to changes in actual inflation with a lag (assuming that economic agents learn from real experience to adjust their expectations). So the inflation rate at any time (π) will equal the expected rate of inflation (π^e), with an adjustment resulting from a gap between actual unemployment (u) and the NAIRU (u*), plus a random shock or error term (ε):

$$\pi = \pi^e + \alpha\,(u - u^*) + \varepsilon$$

The parameter α indicates how quickly changes in unemployment affect inflation; it is a negative number (since unemployment greater than the NAIRU will reduce inflation).

The theory, empirics, and policy practice of this model have been strongly criticized.[12] Efforts to statistically identify and measure the NAIRU (u*) have never succeeded, and policy-makers' guesses of the level of the NAIRU change constantly – making the concept not very useful for policy purposes.[13] The stickiness of inflation with respect to the unemployment level over sustained periods of time casts doubt on the existence of any magical "natural" rate of unemployment. Instead, it seems that higher or lower l evels of output and employment can be quite consistent with stable inflation. This suggests policy-makers should try deliberately to guide the economy toward an equilibrium with higher (rather than lower) employment.

Learning from these critiques, there is no doubt that central banks became more flexible in their implementation of inflation targeting over time, especially after the global financial crisis of 2008-09. On many occasions the Bank of Canada took actions (including various forms of monetary stimulus, even when inflation was within its target range) that were not obviously justified by the inflation targeting framework.[14] Nevertheless, the core theory of expectations-induced inflation overlaying a real economy that cannot sustainably exceed some optimal NAIRU-like level of unemployment still underpins the approach to inflation management that has been dominant in Canada, and most other industrial countries, over the last three decades. And in the last year, the Bank of Canada (and many, but not all, other central banks) are now once again pursuing the textbook recipe with renewed zeal.

It is important to note that this textbook understanding of inflation (and the inflation-targeting policies which it informs) relies on several critical but unrealistic assumptions:

- Inflationary pressures arise from excess purchasing power (aggregate demand), linked first and foremost to overheating of the labour market.
- Changes in overall interest rates can guide the economy back to its NAIRU level of output.
- In the real economy, competitive markets and flexible relative prices will ensure that resources are optimally allocated and fully employed. This includes the labour market, where flexible wages facilitate an efficient match between labour demand and supply (once expectations of inflation are stabilized).
- Since there is no long-run trade-off between inflation and unemployment, the "best thing" the central bank can do is keep inflation at a low and stable level, and let the real economy adjust to its optimal real equilibrium
- Expectations of inflation merely form a nominal "covering" over the market-determined real equilibrium. Expectations become self-fulfilling, because competitive markets will reestablish the same real equilibrium (with unemployment at the NAIRU) regardless of the rate of inflation. If workers, for example, expect inflation of 5%, they will automatically receive wage increases of 5% – to ensure that real wages remain commensurate with the real supply-and-demand equilibrium determined by the competitive labour market.

12. See, for example, Mark Setterfield, Daniel Gordon, and Lars Osberg, "Searching for a Will o'the Wisp: An Empirical Study of the NAIRU in Canada," European Economic Review 36(1), 1992, pp. 119-136; David Ratner and Jae Sim, "Who Killed the Phillips Curve? A Murder Mystery," U.S Federal Reserve Board of Governors, Finance and Economics Discussion Series 2022-028, 2022; Joseph E. Stiglitz, "Where modern macroeconomics went wrong," Oxford Review of Economic Policy 34(1–2), 2018, pp. 70-106. and David Richardson, Tolerate Unemployment, but Blame the Unemployed: The Contradictions of NAIRU Policy-Making in Australia," Centre for Future Work, 2019.
13. It was shown in the 1990s and 2000s that unemployment could be reduced well below what had been considered its NAIRU level without sparking accelerating inflation; defenders of the theory explained this discrepancy with the circular argument that the NAIRU itself had changed.
14. The Bank argued in a similarly circular fashion that it was aiming to guide the economy toward "capacity" so that the inflation target could be protected in the long run (even if inflation was already consistent with that target).

All of these assumptions are extreme and unrealistic. There are many potential causes of inflation, not just excess demand and an overheated labour market. Inflation can arise from supply-side problems, market power of certain agents, or government regulatory policies. Interest rate adjustments may not be effective in guiding the economy to full capacity or altering inflation – especially if inflation was caused by things other than excess demand. Even with low and stable inflation, the economy will not automatically settle at an optimal level of employment and output. Policymakers thus have a responsibility to actively guide the economy toward a position with higher employment, income, and productivity; market forces alone won't do that. Finally individuals' expectations of inflation, do not automatically give them power to act on those expectations (by demanding and winning wage increases, for example, that fully compensate for expected inflation). For all these reasons, the textbook theory that underpins inflation targeting cannot be trusted – especially at a moment when inflation is clearly caused by other, unique factors (mostly related to the pandemic) that were never mentioned in a textbook.

Advocates of inflation targeting point to its apparent "success" in Canada and other countries through most of the three decades before the COVID pandemic; inflation stayed close to target during most of that period. This may, in retrospect, be the result of factors other than the targeting system itself. The deflationary impact of low-cost merchandise imports from China and other emerging markets, and the ongoing suppression of unit production costs arising from the long-term decline of the labour share of GDP, clearly contributed to lower inflation during this time – but they cannot be relied on to continue playing that role. Moreover, sustained ultra-low interest rates that were maintained for many years after the global financial crisis of 2008-09 highlight the limits of interest rate adjustments in guiding the economy toward "capacity." The economy became dependent on continual very low interest rates, without which aggregate demand was chronically inadequate; in retrospect, other sources of support (including fiscal policy) were needed to stimulate growth and job creation. Moreover, the unintended side-effects of sustained low interest rates (including bubbles in real estate and financial markets throughout this period) cast further doubt on the wisdom of relying on monetary policy alone for macroeconomic stabilization.

The Bank of Canada does not speak explicitly anymore of a NAIRU, but the influence of the textbook model is readily apparent in its statements and actions during the current inflationary episode. While it acknowledges the impact of unusual COVID-related factors in explaining the initial upsurge in prices last year, its statements in recent months have focused on the alleged "overheating" of Canada's economy, an alleged shortage of labour, rising wages, and the risk that Canadians' expectations of future inflation will diverge from the Bank's 2% target. It feels justified in prescribing dramatic and painful medicine, in order to keep expectations (assumed to be self-fulfilling around a self-adjusting real equilibrium) anchored at the desired level. The Bank remains silent on the very unequal distribution of costs and benefits resulting from both current inflation, and the remedies to inflation it is imposing.

A Better Diagnosis:

Understanding Post-COVID Inflation

The COVID pandemic and subsequent public health measures caused unprecedented turmoil in economies around the world, and Canada was no exception. Canada endured the steepest and fastest decline in output and employment in history. Entire industries were shut down to preserve public health. Extraordinary support programs were implemented to prevent wholesale bankruptcies, foreclosures, and evictions. Global supply chains were thrown into chaos by COVID lockdowns, limits on travel and transportation, and shortages of key components. Then, when health conditions permitted a gradual reopening of economic activity, new pressures emerged: including pent-up and restructured consumer demand, disruptions in labour supply (including from limits on immigration), and the unwinding of emergency income, fiscal, and monetary supports.

Is it any wonder at all that, in the course of that chaotic and frightening economic journey, normal pricing and inflation trends might also be disrupted? In the initial months of the pandemic, prices fell. Depression-style deflation was prevented thanks to rapid and powerful fiscal and monetary stimulus. Then, with economic re-opening, prices in some specific sectors began to rise rapidly: particularly those subject to supply disruptions, or benefitting from big swings in consumer demand (such as supercharged demand for building materials and home electronics). A global energy price shock, sparked by the invasion of Ukraine (and amplified by volatile global energy markets), added more fuel to the fire.

Most central banks, including Canada's, expected these initial inflationary pressures to be transitory. They have proven more stubborn than initially expected, and now broader price pressures are affecting a wider swathe of the economy. But this does not mean that the original analysis of the causes of current inflation was wrong – only that it may take more time for them to dissipate. Already there is ample evidence that price spikes for minerals, energy, shipping costs, and many strategic components have been reversed.[15] This supply chain deflation will eventually be reflected in reduced consumer price pressures, too.

Unfortunately, the Bank of Canada and many other central banks have lost patience waiting for these unique COVID-specific factors to resolve. They worry that sustained inflation will create self-fulfilling expectations of longer-term price rises that – in their understanding – will "lock in" inflation at too high rates. So they have dusted off their orthodox textbooks, and are now imposing harsh monetary austerity as a remedy for inflation which they now blame on classic 1970s-style imbalances: overheated demand and unduly tight labour markets. This conclusion is wrong. Here we present several pieces of evidence to show the Bank's diagnosis is incorrect, and will lead to inappropriate and damaging policy responses:

15. A useful catalogue of deflating input prices, from gold to building materials to oil to the Baltic dry index, is provided by Catherine Wood, "ARK Extends An Open Letter To The Fed," ARK Invest, October 10 2022.

Inflation Was Not Caused by Wages

The timing of the acceleration of inflation early in 2021 confirms it cannot be ascribed to an overheated domestic labour market or rising wages. Inflation first broke through the Bank of Canada's 2% target in March 2021. From that point continuously to the present, the year-over-year growth of average hourly wages has lagged behind price inflation, by an average of almost 3 percentage points. As illustrated in Figure 2, nominal wage growth has picked up some momentum in recent months, but has plateaued at about 5% since June. That remains well below CPI inflation, despite the moderation of headline inflation in July and August.

In fact, this 5% growth rate likely overstates the true strength of recent wages. Statistics Canada's measure of hourly wages is a simple average of all wages paid across the labour market; it is thus influenced by changes in the composition of employment. Those changes were dramatic through the pandemic, as a result of lockdowns and then reopening of low-wage sectors like retail and hospitality. Brendon Bernard, economist with the Indeed employment website, calculates a "fixed weight" index of wage growth which attempts to control for those changes in employment composition. His measure suggests that wage growth has been even more modest than the unweighted data suggests: around 4% on an annualized basis in recent months.[16] For most workers, therefore, nominal wages have lagged far behind inflation – resulting in an erosion of the real purchasing power of their incomes.

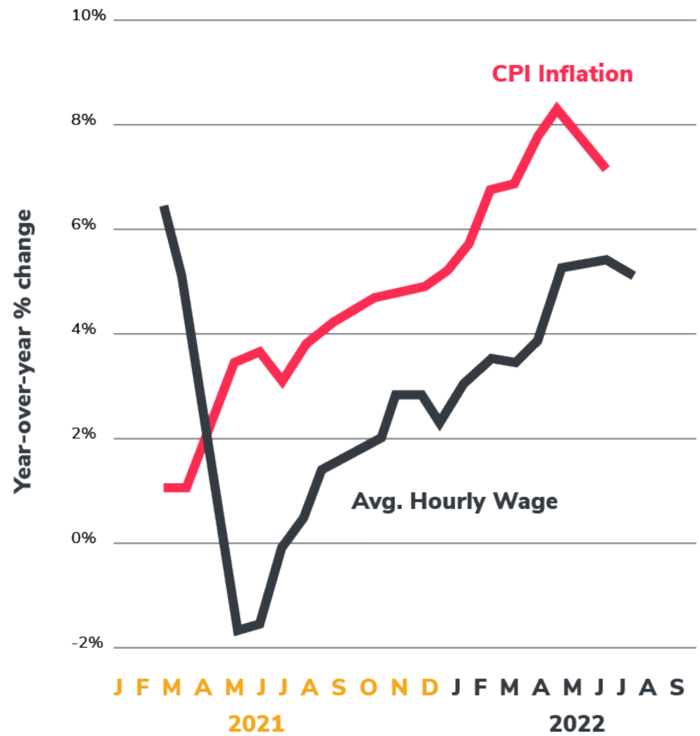

Figure 2. Growth in Prices and Wages

Source: Author's calculation from Statistics Canada Tables 14-10-0063-01 and 18-10-0004-01.

16. See Brendon Bernard.

As confirmed by Figure 3, average real wages have declined rapidly in Canada since the initial COVID lockdowns. In March and April 2020, average wages spiked temporarily, as a result of the lay-off of hundreds of thousands of workers in low-wage retail and hospitality sectors (due to health restrictions); that meant that average wages for those who remained on the job (including professional and managerial staff who were able to work from home) seemed higher. That effect was reversed, however, when industries reopened and most former retail and hospitality staff returned to their jobs. So the temporary spike in apparent wages that occurred during the lockdowns should be discounted.[17] But even since early 2021 (when most industries had re-opened), average real wages have declined by another 6%, and they are now lower than they were before the pandemic hit. Worse yet, there is no doubt that real wages will continue to decline for months or years to come, since nominal wages cannot accelerate fast enough in the near term to match elevated inflation.

Other measures confirm that labour costs are not the cause of the recent upsurge in prices. For example, the labour compensation share of total output in the business sector has fallen by 5% since 2019, confirming that wages have lagged behind output prices.[18] And the share of labour compensation in total GDP has also declined since before the pandemic, by 2 percentage points (discussed further below). By any estimation, real compensation and workers' share of total output have declined since the pandemic. This is the opposite of the experience in the 1970s, when real wages and labour's share of GDP were both increasing markedly.

Labour costs cannot have caused the surge in inflation; to the contrary, falling real wages and eroding compensation have moderated inflation during this time. Workers are the victims of recent inflation, not its cause. And saddling workers with unemployment and dislocation in a self-inflicted recession will amount to a double (and painfully unfair) burden.

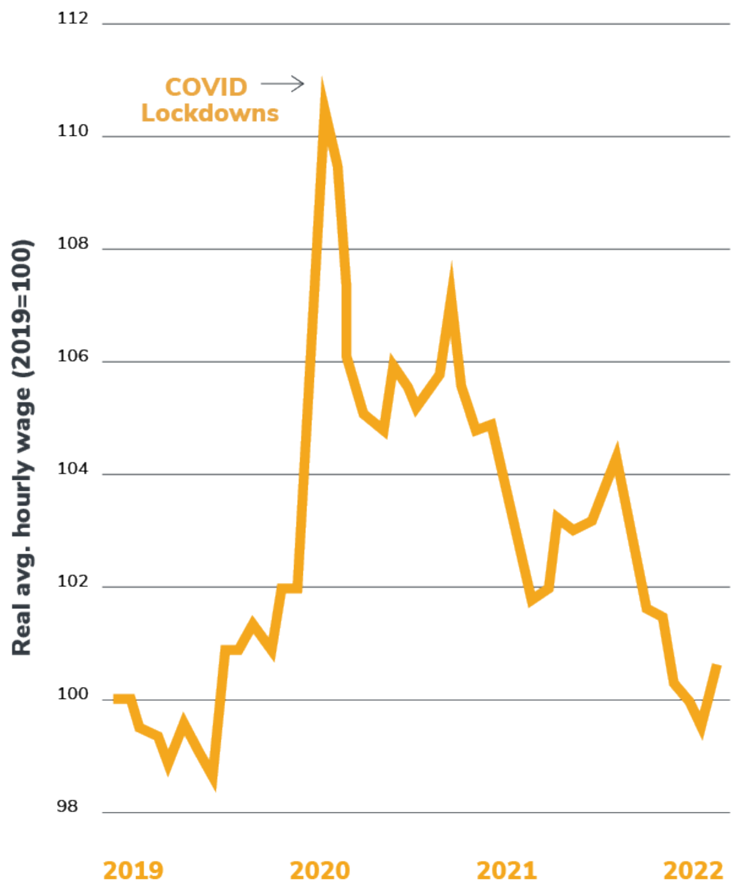

Figure 3. Real Hourly Wages

Source: Author's calculation from Statistics Canada Tables 1 4-10-0063-01 and 18-10-0004-01.

17. The slight rebound in real wages at the right side of Figure 3 reflects the absolute decline in the CPI in July and August due to falling gasoline prices; that will likely be reversed in coming months.
18. See Statistics Canada Table 36-10-0206-01.

Domestic Demand is Not "Overheated"

The Bank of Canada's repeated assertion that domestic spending is too strong and this is the primary cause of continuing inflation, is especially puzzling. There is little evidence that domestic spending is unusually strong at all. Real wages are falling, restraining consumer spending. To be sure, there is some desire for "catch-up" among consumers to make purchases deferred during the pandemic – financed by the unusual volume of savings accumulated since 2020. Despite a recovery in spending, however, household savings rates remain well above traditional patterns: households saved 6.2% of disposable income in the second quarter of 2022, almost three times the average saving rate during the five years prior to the pandemic, and this further moderates consumer spending.[19] And consumer spending, while regaining momentum, still lags behind the trend that prevailed before the pandemic (see Figure 4). If this relatively low pace of consumer demand seems strong relative to available supply, perhaps more attention should be paid to lifting supply – rather than assuming that demand is the problem and needs to be cooled off.

A one-sidedness is apparent in the Bank's depiction of aggregate demand conditions. Consider, for example, its announcement of a 75 basis point interest rate increase in September. The Bank repeated its now-familiar refrain that inflation is caused by an overheated domestic economy and labour market: "The Canadian economy continues to operate in excess demand and labour markets remain tight."[20] As supporting evidence, it cited Statistics Canada's second-quarter GDP report, highlighting two particularly robust components of domestic demand: total household consumption (up 9.5% annualized in the quarter) and business investment (up 12%). But the Bank did not mention other components of domestic demand, documented in that same Statistics Canada release, that were very weak: including residential investment (down 28%), consumer durables (down 12%), government capital spending (down 8%), and public sector current consumption (no growth)[21]. Overall domestic demand grew just 2.9% on an annualized basis in the second quarter – far from "overheating," by any definition. This obviously important bottom-line outcome was ignored entirely by the Bank's statement. This very unbalanced selection of economic data seems dishonest: perhaps aimed at justifying a predetermined narrative (namely, that domestic overheating requires monetary cooling), rather than honestly interpreting economic reality. This bias is concerning, and undermines confidence in the Bank's credibility.

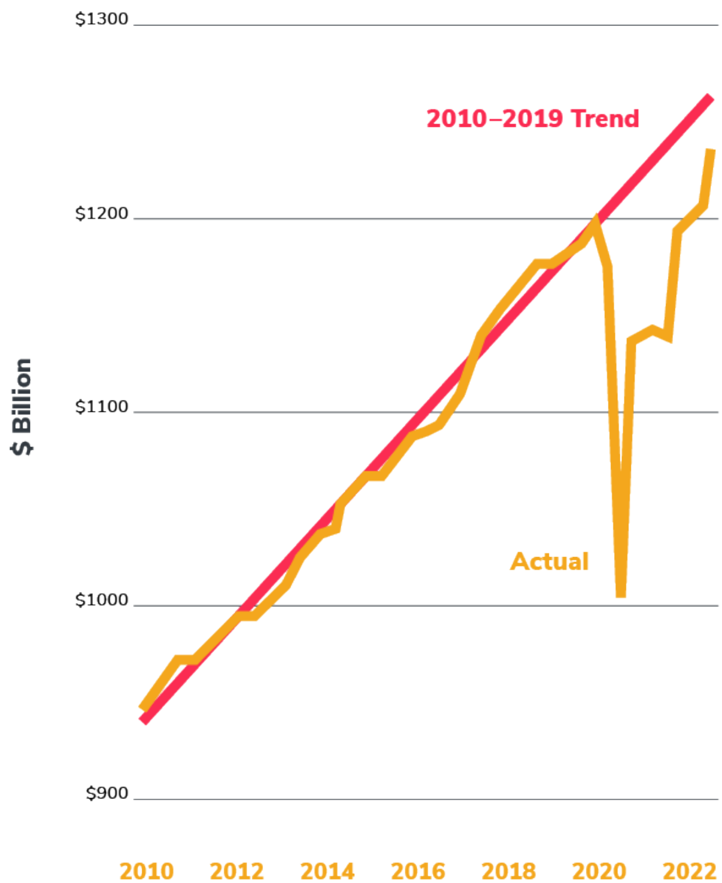

Figure 4. Actual and Trend Consumer Spending

Source: Author's calculations from Statistics Canada Table 36-10-0104-01.

19. Author's calculations from Statistics Canada Table 36-10-0112-01.
20. "Bank of Canada increases policy interest rate by 75 basis points, continues quantitative tightening," September 7 2022.
21. See more discussion in Jim Stanford, "Slowing Economy Should Give Bank of Canada Pause … But It Won't," Centre for Future Work, September 6 2022.

The Real Economy is Not Operating Beyond its Capacity

Canada's economy experienced the fastest, deepest decline in real output in its history during the early months of the pandemic. Held back by health restrictions and the full-scale shutdown of several industries, real GDP fell 17% in just two months (from February to April 2020). Some 3 million jobs disappeared in the same time – and even that shocking statistic doesn't tell the full story. Thanks to the federal government's wage subsidy program, millions more Canadians retained their jobs even though they were not actively working.

Thanks to the powerful rescue mission launched by the federal government, the Bank of Canada, provincial governments, and public health agencies, that unprecedented drop-off in economic activity was quickly reversed. As illustrated in Figure 5, real GDP rebounded dramatically, regaining its pre-COVID level by late 2021. Employment regained its pre-COVID level about the same time. Both output and employment continued to grow after that – although that progress was undermined by the Bank of Canada's premature monetary tightening.

It is a trite truism that inflation is caused by "too much money chasing too few goods." The important question is whether that imbalance results from "too much money" or "too few goods". That is, are firms increasing prices because of a shortage of supply, or excessive demand? It is clear that real output and income in Canada, despite the impressive rebound from the initial pandemic, have yet to regain the pre-COVID trajectory that should be expected given population growth, productivity, and capital accumulation. Relative to its pre-COVID trend, real GDP in July (most recent data) was some 2.25% below what would have been expected without the pandemic. What's worse, the gap between actual and trend GDP has been widening since April – right after the Bank of Canada began tightening.

If an imbalance between demand and supply results from a supply constraint, then suppressing demand to reduce price pressures will lock in unduly low supply conditions. Firms see declining demand, and abandon plans to increase capacity. And since high interest rates (aimed at reducing demand) make business capital spending more expensive, this further discourages the investments which would help to ease the fundamental cause of the imbalance. The Bank's actions force a damaging convergence between sub-optimal supply and suppressed demand.

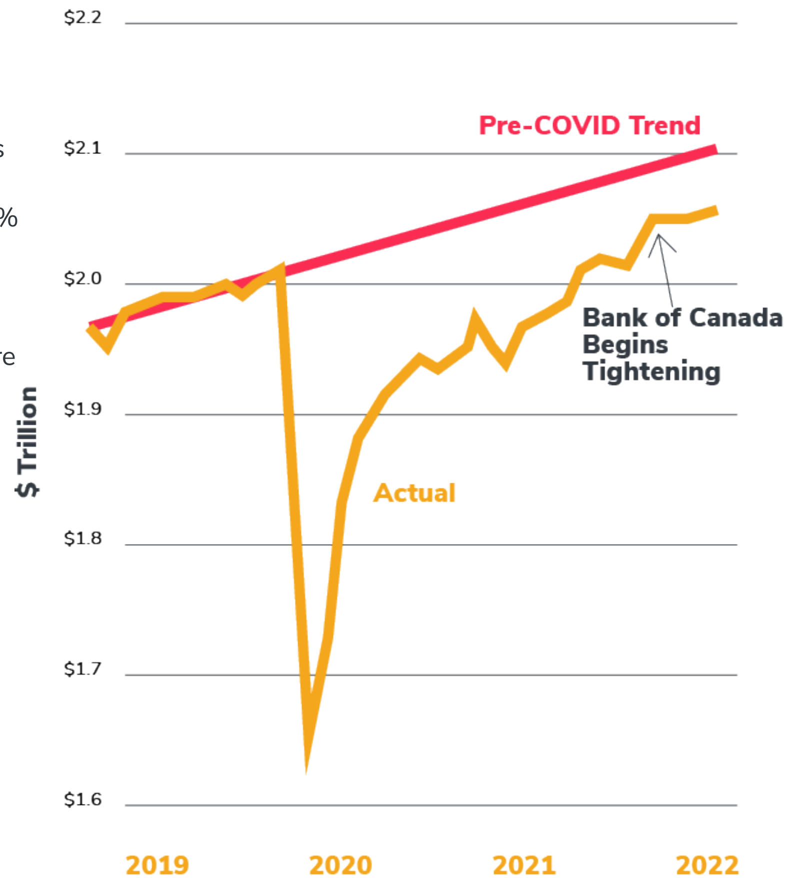

Figure 5. Actual and Trend GDP

Source: Author's calculations from Statistics Canada Table 36-10-0434-01.

Will this reduce inflationary pressures? Likely, eventually. But at the cost of locked-in under capacity that will undermine output and living standards for years to come.

It is not true that the Canadian economy is operating beyond its capacity. To the contrary, more work is needed to repair the supply-side damage that remains from the pandemic, and catch-up to our true economic potential. And while the unemployment rate is historically low, there are still over 1 million Canadians officially unemployed, and millions more underemployed or not in the labour force, even though they would like to work. The Bank's premature crusade to suppress demand, while the economy is still operating well below its true potential, will short-circuit further post-COVID recovery and undermine future production possibilities. Through a process of "hysteresis," the idling of human and physical capacity becomes "baked in" to long-term economic conditions.

Not All Expectations Can be Acted on

As noted above, the emphasis on "anchoring expectations" which shapes the Bank of Canada's actions is based on an unrealistic faith in the efficiency of underlying market outcomes in the real economy. The assumption is that competitive markets will ensure that available resources (including people) are optimally engaged in production. Relative prices, determined by real factors like productivity, technology, and consumer preferences, are fundamentally fair and efficient. Inflation expectations merely determine the nominal packaging which overlays that underlying real equilibrium.[22] Since supply and demand takes care of that real equilibrium, inflation expectations are self-fulfilling. They merely determine what particular rate of inflation is realized coincident with that stable-inflation level of employment and output. If workers expect 5% inflation, employers will have to lift their wages by 5% – because otherwise the wage will be too low to get workers to agree to work.

In the real world, this is not how wages and prices are set at all, as any worker can immediately attest. Prices and wages reflect institutional forces (like regulations, collective bargaining, and social norms). Markets are not perfectly competitive: concentrated power in some sectors allows influential firms to influence or even dictate prices for things they sell (monopoly or oligopoly) and things they buy (monopsony or oligopsony). Unemployment and underutilized resources are normal outcomes of the economy – even in the absence of shocks, rigidities, or market failures. Therefore, the economy is not usually supply-constrained; aggregate demand matters to real output, not just nominal price levels.

This more realistic understanding of how markets and prices function, leads to a more realistic understanding of the role of expectations in explaining inflation. At one extreme, the fact that retail gasoline prices in Canada doubled between November 2020 and June 2022[23] is hardly the result of "expectations" of higher gasoline prices among Canadians – layered on top of some presumably efficient real process by which gasoline prices reflect the clearing of a competitive market. That massive and costly increase in the price of gasoline – the largest single contributor to recent inflation – is obviously the result of something other than "market forces". Gasoline prices doubled because of the actions of a global cartel, speculative behaviour in a financialized futures market, and the oligopolistic power of large energy-producing firms – who have been given authority (under Canada's current energy policy) to unilaterally and dramatically increase prices even though the cost of producing gasoline in Canada has hardly changed at all. The resulting massive profits pocketed by energy producers is a payoff to their oligopolistic power, not some efficient and fair return to the real productivity of their operations.

At the other extreme, health care workers and other staff in the broader provincial public sector in Ontario have had their wage increases capped at 1% per year for the last four years – and the provincial government is trying to impose similar wage restrictions (far below inflation) for more years to come. Does this muted wage response reflect "anchored expectations"? Of course not. Nurses, teaching aides, and other public sector workers fully expect inflation much higher than 1% – but they do not have the power to protect themselves against it. By ignoring the structural, institutional, and power dimensions of wage and price outcomes in Canada's economy, and assuming that the underlying real economy functions efficiently and in some sense fairly on its own, the Bank of Canada ascribes an undue and undiscriminating importance to the role of self-fulfilling expectations in determining future inflation.

Yes, expectations do matter. There is evidence, for example, that firms can leverage consumer expectations of inflation to impose price hikes above and beyond what is justified by higher input costs alone.[24] But the assumption that expectations will determine the future course of inflation is wrong. And the resulting policy conclusion – namely, that wages must be suppressed below inflation to prevent higher expectations being "locked in" – is both unjustified and deeply unfair. Every Canadian may have certain expectations of future inflation, but their ability to protect themselves accordingly varies greatly depending on their place in the economic and social pecking order. Any strategy for managing inflation expectations that ignores this unequal reality is misplaced and biased.

22. For an important critique of this simplistic understanding of inflation expectations, see Jeremy Rudd, "Why do we think that inflation expectations matter for inflation? (And should we?)," Review of Keynesian Economics 10(1), 2022, pp. 25–45.
23. Author's calculations from Statistics Canada Table 18-10-0001-01.
24. See, for example, Daniel Kahneman, Jack L. Knetsch and Richard Thaler, "Fairness as a Constraint on Profit Seeking: Entitlements in the Market," American Economic Review 76(4), 1986, pp. 728-741, and Paul Krugman, "Wonking Out: Rockets, Feathers and Prices at the Pump," New York Times, July 8 2022.

Not All Canadians Are Hurt by Inflation

The Bank of Canada makes an equally naïve claim that all Canadians are harmed by inflation, and hence reducing inflation to target is a universally beneficial goal.[25] This claim is also self-evidently false. Some groups of Canadians have profited immensely from the acceleration of inflation. In fact, for the business community as a whole, profits have never been better. Since decisions by businesses to increase prices are the proximate cause of inflation, it should be obvious that understanding inflation, and learning how to combat it, must involve investigating the nature of business price decisions and profitability. Strangely, however, the role of business in explaining (and profiting from) recent inflation is largely ignored in Canadian monetary discussions, including by the Bank of Canada.

As indicated in Figure 6, after-tax corporate profits have surged by over 5 percentage points of GDP since before the pandemic. Excess profits have been concentrated in various non-financial sectors of the economy,[26] including energy firms, housing developers, and some retailers.

Businesses have taken advantage of the unique conjuncture of circumstances after the pandemic – including supply disruptions, healthy household spending power (reinforced by emergency COVID income supports), and strong market power in some sectors – to increase prices well above input costs. The result has been a swelling of profit margins, even as Canadian consumers struggle to make ends meet. Firms' pricing decisions are the immediate cause of inflation. But most discourse on inflation takes for granted that firms will charge whatever the market will bear. A parallel assumption is that current elevated profit margins are somehow sacrosanct, since it is assumed that any future increases in wages (perhaps resulting from workers trying to regain lost real incomes) must automatically be passed on in higher prices. An alternative would be to fund higher wages from a reduction in profit margins back toward normal levels.

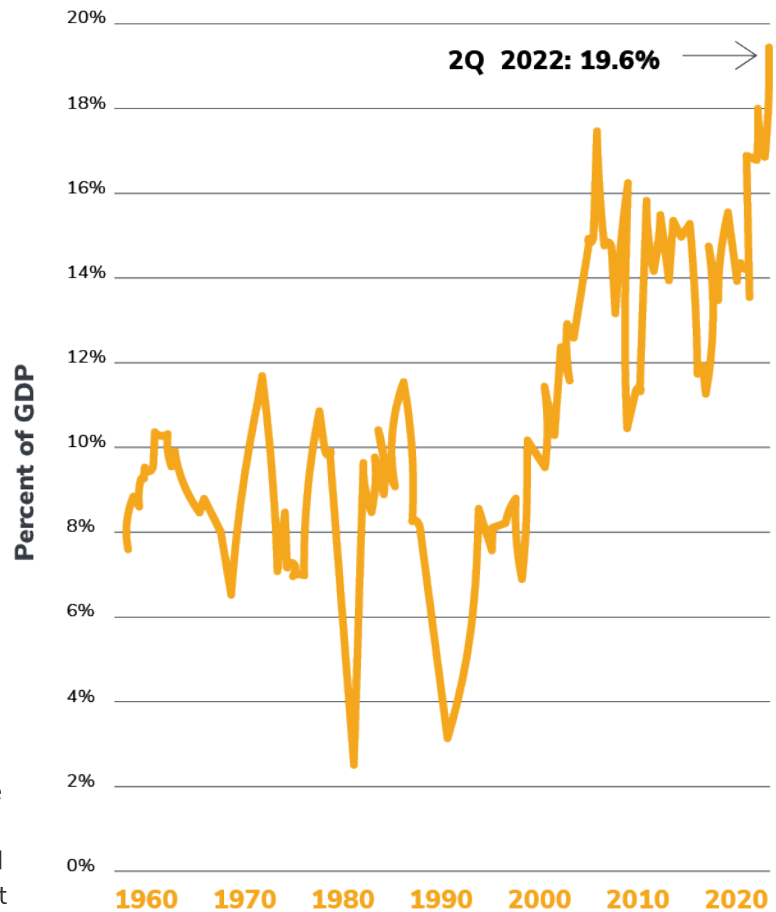

Figure 6. After-Tax Corporate Profit Share

Source: Author's calculations from Statistics Canada Tables 36-10-0103-01 and 36-10-0117-01.

25. See, for example, https://twitter.com/bankofcanada/status/1557357117128036352.
26. Profits of financial corporations have not increased relative to GDP during the recent rise in inflation.

The lucrative profits earned by some Canadians from the recent surge in inflation makes it all the more inappropriate for the Bank of Canada to concentrate so single-mindedly on controlling wage growth in its anti-inflation crusade. Not one of the most recent speeches by senior Bank officials even mentioned the word “profit”;[27] nor did the most recent Monetary Policy Report. Yet the Bank’s research and communications materials abundantly discuss rising wages, and the risk of a wage-price spiral like the 1970s[28] (even though the role of wages and labour costs in the current circumstances differs so fundamentally from that earlier period). Governor Macklem even urged business leaders to restrain wage offers as part of the effort to reduce future inflation.[29] Curiously, he did not ask business leaders to restrain future growth in their prices – even though it is prices set by business which are the actual cause of inflation. Again, the right of businesses to set prices at whatever the market can bear is taken for granted. This one-sided approach to understanding and controlling inflation fails to recognize and confront the actual causes of the current problem, and undermines the Bank’s credibility as a public institution.

27. Including speeches by Governor Macklem in Halifax October 6; Deputy Governor Paul Beaudry in Waterloo September 20; and Senior Deputy Governor Carolyn Rogers in Calgary September 8, based on remarks posted here.

28. In contrast, the July 2022 Monetary Policy Report mentioned the phrase “wage-price spiral” 13 times and featured a special box (on p. 25) detailing the Bank’s fears of how such a scenario could unfold.

29. See Vanmala Subramaniam, “Union leaders frustrated by Bank of Canada’s advice for companies not to adjust wages to inflation,” Globe and Mail, August 17 2022.

Fiscal Policy is Also Currently Contractionary

Some have blamed current inflation on overspending by the federal government during the pandemic (purportedly facilitated by Bank of Canada bond market interventions). And in a narrative which blames inflation on excess domestic demand (as the Bank now does), then curbing government spending might seem like an appropriate response. It was on these grounds, for example, that some economists criticized recent modest federal measures (including expanded GST credits and subsidies for low-income renters) as causing inflation – rather than being welcomed as an effort to protect the most vulnerable Canadians against its effects. However, blaming government spending is not convincing as an explanation for the current inflationary episode. The rise in inflation since the pandemic has been experienced across virtually all OECD economies, and there is no correlation between national levels of government spending and national rates of inflation. Some countries with larger public deficits and debts (such as Japan) are experiencing slower inflation; while other countries with smaller deficits and debts (like Netherlands, Portugal, or Poland) are experiencing faster inflation.

A more important point is that current fiscal policy in Canada is strongly contractionary, as a result of the phase-out of most of the extraordinary measures put in place during the pandemic. Federal program spending in the current fiscal year is shrinking by almost $50 billion, on top of a $135 billion reduction recorded in 2021-22.[30] As a share of GDP, federal program spending will shrink by over 3 full percentage points of GDP this year alone – a remarkable contraction in the real economic footprint of government, by any standard. Program spending is set to decline still further (but more gradually) as a share of GDP over the next 5 years. Provincial government spending is also shrinking in absolute and relative terms, in most provinces. Manifestations of this fiscal retrenchment include reduced income supports (such as the elimination of eased qualification rules for the EI program), continued restraint in funding for public services (even health care in some provinces), and continued restrictions on compensation for public sector workers.

If government spending caused inflation (either directly, as some extreme critics allege, or as one component of broader excess demand), then inflation should be disappearing. The fact that it is not reaffirms that both the causes of inflation, and the solutions, are more complex than simplistic anti-government narratives imply. Worse, this trajectory of fiscal retrenchment will exacerbate the damage from a future recession if it is not quickly reversed. Governments must be ready to expand fiscal supports again, if current monetary tightening does indeed push the economy into contraction.

30. See A Plan to Grow Our Economy and Make Life More Affordable, Federal Budget 2022, Table A1.4.

The Consequences
of Mis-Diagnosis:

First Do No Harm

The preceding discussion clearly suggests that the textbook diagnosis of inflation – that it arises from excess demand, first and foremost from the labour market, and can only be solved by suppressing demand through monetary tightening – does not fit the reality of Canada's post-pandemic economy. Inflation since early 2021 was obviously led by unique, largely temporary, and largely global factors related to pandemic supply disruptions and subsequent reopening: supply shocks, a reallocation of consumer demand away from services and toward merchandise, and a global energy price shock. Domestic demand and supply both remain below pre-COVID trends. Labour markets retain significant cushions of unutilized capacity, and real wages are falling sharply.

By forcing the round peg of post-COVID inflation into the square hole of a decades-old stereotype of the causes and nature of inflation, the Bank of Canada is misdiagnosing the problem. Worse yet, this misdiagnosis risks doing great and lasting damage to the patient. Signs of an imminent and destructive economic contraction are mounting, in Canada and internationally. Here are some of the potential consequences that should prompt an urgent rethink by the Bank.

Recession

Canadian employment declined by almost 100,000 jobs from May through September. Almost all of the jobs lost were full-time. The only times in the past when equivalent numbers of employment were lost over a four-month time horizon, was when the Canadian economy was in recession (including recessions in the early 1980s, the early 1990s, the 2008-09 financial crisis, the 2015 oil price shock, and the COVID pandemic).

The latest quarterly GDP report from Statistics Canada reports on the second quarter of 2022 (April through June). Headline annualized growth in that quarter seemed decent, at 3.3%. But this is misleading. Firstly, most of that growth reflected the lagged effect of growth that occurred in the latter half of the first quarter. Within-quarter annualized growth was likely about 1.5% (less than half the headline number).[31] More concerningly, GDP growth in the second quarter was entirely due to an unprecedented build-up of private business inventories: which swelled by $46 billion (by far the biggest inventory increase ever). Without that inventory expansion, real GDP in the quarter would have contracted. Rising inventories usually signal a slowdown in sales.

Monthly GDP data provides a more timely indicator of economic developments within each quarter. According to this series, real GDP grew just 0.2% between April (after the Bank began tightening) and July (most recent data). In other words, the economy almost ground to a full stop three months ago. Conditions have certainly worsened since then.

Statistics Canada will not report third-quarter GDP results (for the July to September period) until late November. But based on falling employment, weak momentum leading into July, and negative shocks to consumer and business confidence in recent weeks, it is entirely possible that real GDP contracted in the third quarter. If followed (as likely) by another contraction in the fourth quarter, then the recession has already begun.[32]

31. For more explanation see Jim Stanford, "Slowing Economy Should Give Bank of Canada Pause … But It Won't," Centre for Future Work, September 6 2022.

32. A recession is conventionally defined as at least two consecutive quarters of declining real GDP.

Inequality

Economic downturns usually result in a widening of inequality. Those who lose work, of course, see their economic position decline in both absolute and relative terms. Even those who retain employment experience weaker job security and capacity to bargain for better wages – undermined by the presence of a large group of unemployed people desperate for work. The negative impact of recession on government finances spurs some governments to cut back income support payments (as the federal government is already doing with the EI program), further undermining incomes for those who need help most.

In another sense, an imminent recession would cement the recent increase in inequality between workers and the businesses they work for. As noted above, business profits have risen strongly in Canada through this inflationary episode – reaching their highest share of GDP ever (almost 20% on an after-tax basis). Meanwhile, workers' share of GDP has been eroded by falling real wages and the growing gap between labour productivity and labour compensation. As indicated in Figure 7, workers have lost a 2 percentage-point share of GDP since COVID hit (relative to pre-pandemic factor shares in 2019). 2 percent may seem small: but it represents $56 billion of lost compensation, or some $3000 per worker per year. That $3000 would certainly help cover the costs of higher groceries. Meanwhile, corporations have gained 4 percentage points of GDP in before-tax gross surplus, and 5 percentage points in after-tax profits. Small businesses also lost a small share of national income, more modestly than workers.

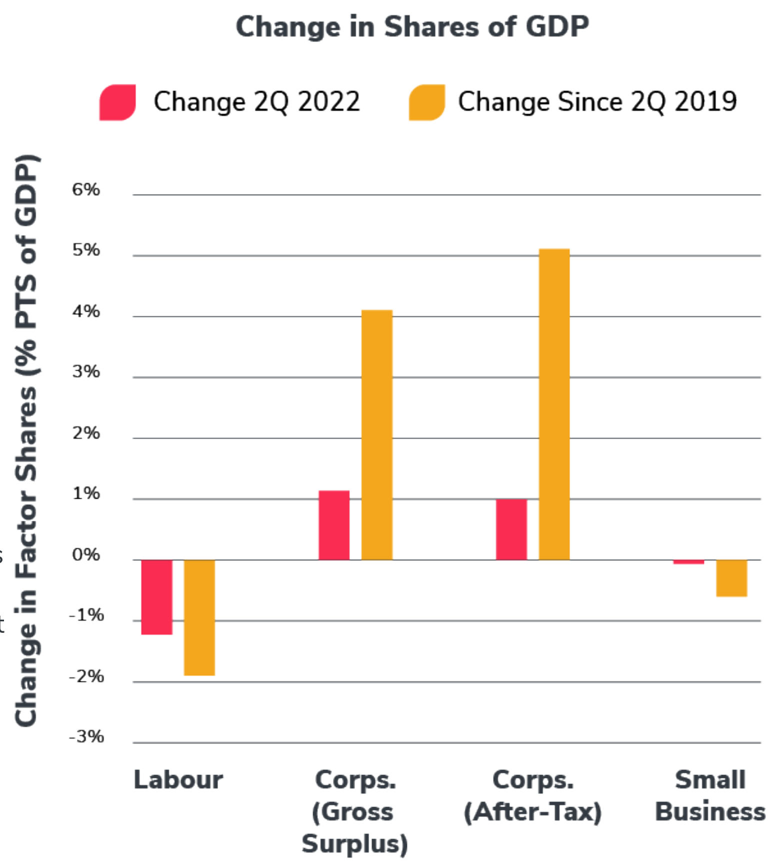

Figure 7. Changes in Factor Income Shares

Source: Author's calculations from Statistics Canada Tables 36-10-0103-01 and 36-10-0117-01.

The Bank of Canada has strongly opposed wages keeping up with inflation. This implies continued erosion of real wages and workers' share of GDP in coming years. To rebuild their share of GDP, workers would need to win wage increases that not only match inflation, but exceed it. In fact, because productivity growth reduces unit labour costs, nominal wages can grow by the sum of inflation and productivity growth without altering unit labour costs or workers' share of GDP.[33] Wages would have to grow even faster than that to increase workers' share of GDP back to pre-COVID norms. The Bank of Canada's position that wages must grow more slowly than prices until target inflation is reached, will effectively lock in the regressive shift in income distribution from workers to corporations that has occurred since the pandemic. This will permanently widen inequality even further.

Financial Rupture

Recent events in the U.K. have demonstrated that the global interest rate shock is creating intense fragility in financial markets. Rapid shifts in asset prices and liquidity are leaving investors and institutions precariously exposed. U.K. pension funds were driven to the edge of failure by margin calls related to leveraged debt instruments, in the context of rapid declines in bond prices. An emergency rescue from the Bank of England (reversing course on monetary tightening, and relaunching a major new bond-buying initiative) bought the funds some time, but underlying conditions remain fragile. At time of writing liquidity conditions for U.K. government bonds had deteriorated to the worst in the G7 (worse even than perennially troubled Italian bonds).[34] Other asset classes facing potential panic and collapse include emerging market debt, cryptocurrencies, and higher-risk corporate debt. Continued global interest rate increases will undoubtedly spark more financial ruptures and crises in coming months. A potential replay of the 2008-09 global financial crisis could be the legacy of current worldwide monetary austerity.

33. This is equivalent to real wages increasing at the same pace as labour productivity.

34. See Robin Brooks, Institute of International Finance.

Political Extremism

Another potential risk of an imminent, self-inflicted recession is the fuel it would provide to the further growth of extremist and anti-democratic political trends that have emerged in many industrial countries – including Canada. Opposition to public health measures during the pandemic fostered social fragmentation and misinformation. The attempted overthrow of elected government in the U.S. in 2021 confirmed that even established democracies are at risk from extremists exploiting fear and hardship to challenge established democratic norms. With the rise to power of anti-democratic far-right movements in several countries (including Hungary, Italy, and the Philippines), this threat is now global in nature. If a painful recession is added to this worrisome and volatile mix, it is likely that challenges to democracy would become more urgent. Conspiracy theorists will have a heyday fomenting outrage and rebellion about a self-inflicted recession that could quite legitimately be described as deliberately engineered.

As the first principle of their training, medical students are taught to do no harm to their patient. The zealous monetary tightening being pursued by central banks around the world, with the Bank of Canada leading the way, threatens to do exactly that. The global interest rate shock is pushing economies around the world to the edge of recession, and some financial institutions to the breaking point. And the damage has only just begun. Even rate hikes already in place will cause greater damage in coming months. Further rate hikes in this context would constitute reckless malpractice.

A Better Treatment Plan:

A Comprehensive and Balanced Anti-Inflation Strategy

A Better Treatment Plan

Central banks have misdiagnosed the unique, global, and largely transitory surge in inflation that accompanied economic reopening after the pandemic. Their rote application of textbook inflation theories and policy responses, developed for a different time and very different circumstances, threatens to throw the economy into a needless and painful recession. The standard assumption that inflation arises from excess domestic demand, and particularly from overly tight labour markets, is not relevant in the current situation. Both supply and demand in Canada remain mired below potential; recovery from the initial pandemic and recession in 2020 is not yet complete. To now decide that demand must be further suppressed to control inflation that clearly originated from supply-side and global conditions, will lock in that underperformance for many years to come – and impose needless harm on working Canadians who have already suffered too much.

Disputing the Bank of Canada's approach to this problem is not to deny that inflation imposes significant costs and stresses on Canadian households. Household budgets for millions of Canadians are squeezed between falling real wages and rising prices; rapidly rising interest costs are now making matters even worse. Canadians need relief from inflation, and also from other factors contributing to the broader cost-of-living crisis (like the housing crisis, and an energy system tied dangerously to speculative fossil fuels markets). But throwing the economy into recession, and throwing hundreds of thousands of Canadians out of their jobs, is hardly the solution.

A more nuanced and evidence-based diagnosis of the sources of recent inflation can inform a more balanced and effective treatment plan. Here are six key elements in an anti-inflation strategy that won't kill the patient:

1. Balanced, Targeted Monetary Policy

Monetary policy is obviously a vital element of managing inflation. The ultra-low interest rates which prevailed in Canada (and other countries) since the 2008-09 financial crisis must eventually be normalized. At the same time, however, the Bank of Canada should not be allowed to pursue its inflation target as a pre-eminent or exclusive goal. The pursuit of stable inflation must always be considered in the context of the overarching need to attain and achieve maximum productive potential of the economy and labour market. The recently renewed 2021 framework agreement between the Bank and the federal government attempted to define a more multi-dimensional mandate for the Bank (which includes pursuit of "maximum sustainable employment"). But the language around that reform was obviously not adequately specific: the Bank's actions this year, and statements by its leaders that they will do "whatever is necessary" to reduce inflation back to 2%, clearly indicate that this hoped-for balance has been lost.

The Bank should be provided with more specific terms of reference that elevate full employment as its pre-eminent mission. Its pursuit of price stability must always be operationalized within the context of ensuring that every willing Canadian has an opportunity to work, produce, generate income, and pay taxes. That is the core requirement for a prosperous economy. Stable inflation alone, even if realized, is no guarantee at all that that goal will be achieved.

In addition to balancing inflation control with other, more important macroeconomic goals, the Bank should also explore pursuing its monetary policy interventions with more targeted and flexible policy tools. The overall interest rate is a blunt instrument that does not necessarily achieve optimal results: lifting that rate, for example, can suppress productive investments that help to reduce future inflation, while cutting general interest rates can stimulate unproductive activity (such as real estate or financial speculation) that undermines general welfare. With the more pro-active and targeted use of supplementary policy levers (such as macroprudential regulation, mortgage lending regulations, and controls on certain types of financial activity), monetary policy could do a better job of stimulating credit for useful purposes, but restraining its availability for undesirable activities.

2. An Active Role for Fiscal Policy

Counter-cyclical fiscal policy fell out of favour during the inflation targeting era, because of the assumption that interest rate adjustments alone could reestablish an optimal macroeconomic equilibrium (facilitated by the efficient operation of market forces in the real economy). Fiscal policy was seen as too cumbersome, slow, and politicized. Real-world experience, however, proved this simplistic preference for monetary policy wrong. In many cases monetary policy was ineffective in managing aggregate activity. Through many years of weak growth after the 2008-09 global crisis, for example, ultra-low interest rates lost their power to stimulate real economic growth – contributing instead to damaging asset price inflation. Discretionary fiscal policy, meanwhile, proved its worth in spades: first during the 2008-09 crisis, and then even more so during the COVID pandemic. The recent habit of assigning macroeconomic stabilization in general, and anti-inflation policy in particular, solely to the central bank should be abandoned.

Fiscal policy is more effective in stimulating job creation and real activity in weak economic conditions. It puts money directly to work in the real economy: whether in income transfers (preferably targeted at low and middle-income households which are more likely to spend them), public service delivery, or real capital spending. Less of the stimulus is dissipated in personal savings or unproductive financial speculation. When the economy is strong, fiscal policy can also stabilize output and inflation conditions: through discretionary taxes (preferably targeted at high-income households for distributional fairness), or counter-cyclical spending programs (such as infrastructure investment systems which accelerate new projects when the broader economy is weak, but delay them when the economy is stronger).

3. Government Actions to Address True Causes

Government spending, investment, and regulatory levers can also play a direct role in reducing inflationary pressures, by ameliorating some of the actual causes of higher prices, and/or directly reducing other prices that also appear in the overall consumer basket. One example of using government spending to address the true causes of recent inflation would include accelerating investments in affordable and non-market housing, to reduce inflationary pressure in this largest single component of overall consumer spending. Another example would be accelerating the roll-out of renewable energy systems and energy conservation measures (such as building retrofits, public transit, and others). These would reduce the extent to which Canada's economy is subject to inflationary pressures based on the whims of far-off fossil fuel futures markets.

Governments also possess power to directly limit inflationary pressures through price regulation in vital sectors of the economy. This already happens in many areas. Many provincial governments impose limits on rent increases, for example; these will have a significant impact in reducing the inflation of rental costs which is a counter-productive byproduct of the current monetary tightening. Prices for most forms of energy (but not gasoline and other refined petroleum products) are already regulated in Canada, and so are some agricultural prices. Price regulation could be extended to other products: particularly strategic commodities used as inputs in many other industries (like energy). Excess profit-taking at the wholesale and retail stages of supply chains can also be challenged with regulatory levers. The current Parliamentary investigation into elevated profits in grocery retailing[35] will shed light on the extent to which oligopolistic structures in this industry have contributed to food price inflation.

Complementary inflation-reducing actions can be taken by reducing the prices of some government-controlled elements of the overall consumer bundle. The current roll-out of $10-per-day early child education services will have a modest but measurable impact in reducing overall price inflation. Similar effects could be achieved by reducing user fees for other public services, from supplementary health care (including dentistry) to public transit.

35. See Jake Edmiston, "House committee to probe big grocers' profits, prolonging industry's PR struggle," Financial Post, October 5 2022.

4. Redistribute Excess Inflationary Profits

A specific dimension of fiscal policy that would be especially valuable in combatting the effects of current inflation would be the use of redistributive measures to shift spending power from groups which have profited unduly from the acceleration of inflation, to those whose living standards have been seriously harmed by it. This could happen through the imposition of new taxes on corporate sectors that have recorded excess profits (the main culprits include the petroleum industry, housing developers, and some retail segments), and then redistributing the resulting revenues through targeted transfers or subsidies for low- and middle-income households. This set of policies would be neutral in fiscal terms, as well as in its impact on inflation (if excess domestic demand was considered to be contributing to inflation – which is not generally true at present).

5. Negotiation and Planning in Labour Markets

The textbook theory of inflation which underpins the inflation targeting regime, suggests that a certain desired level of unemployment (the NAIRU) must be maintained to protect a stable and low inflation rate. Unemployment any lower than that rate, it is alleged, will cause undue wage pressure to break out, and inflation to accelerate. Some version of this theory is clearly embedded in the Bank of Canada's current alarming warnings about labour shortages and rising wages. The fact that real wages have fallen, not increased, and that the recent uptick in wage growth was clearly later and slower than the rise in inflation, does not deter the Bank from pursuing this textbook narrative.

Canada is far from genuine full employment, and wages are not the cause of current inflation. But in the long run, attainment and maintenance of very low unemployment could be assisted by the adoption of stronger industry and economy-wide structures and practices to regulate wages on a logical and sustainable basis. Systems of broader-based collective bargaining (at sectoral, occupational, regional, or national levels) would allow wage growth to be managed in a steady, sustainable manner in relation to fundamental determinants (like inflation, productivity growth, and equity objectives). Wages would thus continue to increase steadily even in weak macroeconomic conditions – thus providing a spur to stronger consumer spending and hence economic growth. By the same token, wage growth in strong macroeconomic times would retain their relationship to those fundamental determinants, eliminating the risk of the much-feared "wage-price spiral".

Several other countries, especially in Europe, and also Asia and Latin America, have implemented structures and policies that allow for coordinated, planned wage negotiations on a sector-wide or economy-wide basis. Economic evidence confirms that countries with coordinated collective bargaining systems tend to achieve superior employment and income outcomes – compared to either countries with weak collective bargaining, or strong but uncoordinated bargaining. Considering reforms in labour law and labour market planning to allow this sort of rational, steady, sustainable wage determination would complement efforts to achieve and maintain true full employment – rather than accepting the NAIRU as the best the economy can hope for.

6. Patience

The preceding discussion has shown that current inflation emerged as a result of disruptions and pressures associated with the COVID pandemic, restrictions and shutdowns, and subsequent economic reopening. It is natural that those unprecedented shocks should be associated with some disruption in normal price and inflation outcomes. The broader economy has not fully recovered from the shock of the pandemic. So those price disruptions are likely to continue for a while yet.

It is reasonable to expect that Canadians will simply have to endure current inflation, until some of its more transitory causal factors abate (as is already occurring). Mid-single-digit inflation need not be an economic catastrophe, so long as Canadians (particularly low-income and working Canadians) are protected from its worst effects: through wages and social benefits that keep up with inflation, and targeted supports to help the most vulnerable cope with a higher cost of living. So long as measures are taken in the meantime to ameliorate the true initial causes of the inflation (including addressing challenges in supply chains, the energy system, and housing markets), this waiting need not result in "locked in" inflation. The Bank of Canada's extreme assumption that expectations of higher inflation on their own can cause higher inflation, is based on unrealistic assumptions about how the underlying real economy works – and is blind to the huge inequalities in bargaining power that characterize Canada's economy.

Conclusion

After three years of dealing with both the health and the economic consequences of an unprecedented pandemic, the last thing Canadians can tolerate is another recession – less than three years after the last one. This prospect is all the more maddening given it would be a self-inflicted downturn, not the result of some uncontrollable external shock. Working Canadians have already seen their real wages fall substantially, and their share of total economic output shrink notably, since the pandemic hit. The costs of a needless recession would only add to that unfair burden.

The Bank of Canada should pause its schedule of interest rate increases. It has pledged to hike its policy rate further, not stopping until inflation slows to the target – and most financial investors (as evidenced by the bets they place on financial derivatives) expect them to follow through on that pledge. But as data accumulates attesting to the weak state of both the Canadian and global economies, the Bank should hold off. It should take time to examine the impacts of previous rate hikes on real output, employment, and income distribution. It should wait to see the final effects of the rapid disinflation already occurring in some of the most important initial sources of inflation (including global energy, commodity, and shipping costs). It should ascertain the course taken by other central banks, rather than charging ahead as it has done so far. As a small open economy, it makes little sense for Canada to be unilaterally aggressive in lifting interest rates, so the Bank's "leadership" in this dubious race is ill-advised and counter-productive. For all these reasons, at a minimum the Bank of Canada should hold off on any further rate increases, at its October 26 meeting and for the rest of the year. And it should be prepared to unwind previous rate increases quickly if it is confirmed that Canada's economy has begun to contract.

At the same time, recognizing that managing inflation cannot be wholly assigned to the central bank, the federal and other levels of government need to take complementary measures to address and ameliorate the true causes of current inflation, protect Canadians against its effects, and put in place structural reforms that better insulate the economy against the market-driven shocks (like fossil fuel and housing prices) which have so exacerbated recent inflation. Proactive fiscal policy is as important as, or even more important than, monetary policy in smoothing out economic cycles – both when the economy is weak, and when it is strong. Taxes and transfers have a vital role to play in better sharing the costs and benefits of inflation control.

Finally, governments at all levels need to be ready to step in quickly and powerfully to protect jobs and incomes, and stimulate investment and spending, if the Canadian economy does indeed enter imminent recession. The infatuation with reducing inflation and deficits that currently dominates macroeconomic policy must be replaced with a more balanced, patient, and humane emphasis on enhancing Canadians' ongoing capacity to work, earn, and live well. That, not hitting arbitrary numerical targets, should be the ultimate goal of economic policy.

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