Slaying the Inflation Dragon

What More Can We Do?

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Key findings

- Month-to-month inflation in Canada has slowed to about 3 per cent on an annualized and smoothed basis. We expect inflation to continue decelerating in 2023, but much is involved in achieving this outlook.
- The Bank of Canada has acted aggressively to contain inflation in the past year. Their role now is to ensure Canadians understand why the moves were necessary—by doing so they can prevent pushback on interest rate increases and the assumption that inflation will be permanently higher.
- Governments can contribute by limiting spending, enacting targeted inflation relief measures, and where possible, increasing the availability of goods, services, and people.
- Businesses can play a critical role in both limiting the price increases they enact and upping their investments to increase capacity and improve productivity.
- At present, large cost-of-living adjustments will contribute to inflation and deliver limited real gains in income. This means it will take time for people to recover their lost purchasing power. In the meantime, they can mute the impact of inflation by being more deliberate in their spending choices.

Inflation: The economic story of 2022

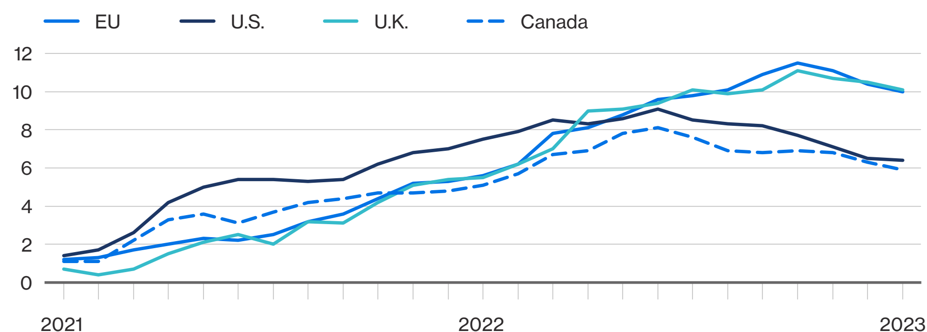
Inflation has been the biggest economic story for the past eighteen months. According to Google Trends, data searches related to inflation more than tripled in Canada in 2022, and they remain elevated today.[1] With consumer inflation peaking at 8.1 per cent in June 2022, a nearly 40-year high, the interest has been warranted.

Many of the factors that contributed to higher inflation were global in nature and were a "hangover" from the pandemic. For example, many goods and services have experienced large swings in both demand and production as economies moved through periods of lockdowns over the past three years. As well, monetary and fiscal stimulus reached unprecedented levels as policy-makers sought to offset the effects of lockdowns on individuals and businesses. Just as these effects were waning, a new inflationary tsunami appeared, in the form of the Russian invasion of Ukraine and the resulting impact on key commodity prices such as wheat and energy.

As a result, Canada has not been alone in experiencing high inflation. Indeed, many regions and countries saw inflation rates reach even higher peaks, including the eurozone (11.5 per cent), the U.K. (11.1 per cent), and the U.S. (9.1 per cent). (See Chart 1.)

Chart 1

Inflation in Canada peaked early and slowed quickly
(year-over-year change in inflation, per cent)



Sources: Eurostat; U.S. Bureau of Labor Statistics; Statistics Canada; U.K. Office for National Statistics; The Conference Board of Canada.

1 Bank of Canada, "Summary of Governing Council deliberations."

Higher interest rates are the policy prescription for high inflation, and central banks have delivered. The Bank of Canada raised rates by a cumulative 425 basis points between March 2022 and January 2023, an unusually large and fast increase. The tone of their rate announcements changed in January, however, with the bank expecting to "hold the rate at its current level while it assesses the impact of cumulative interest rate increases."[2] Indeed, notes from the January meeting indicate there was deliberation about not increasing rates, and the Bank did not raise rates at its March policy announcement.[3]

With the Bank of Canada now taking a pause, the critical question is, "Have we slain the inflation dragon?" In February, year-over-year inflation fell to 5.2 per cent, a clear deceleration, but not back to the Bank's target range of 1 to 3 per cent. However, a look at the monthly changes in prices supports the Bank's decision to pause.

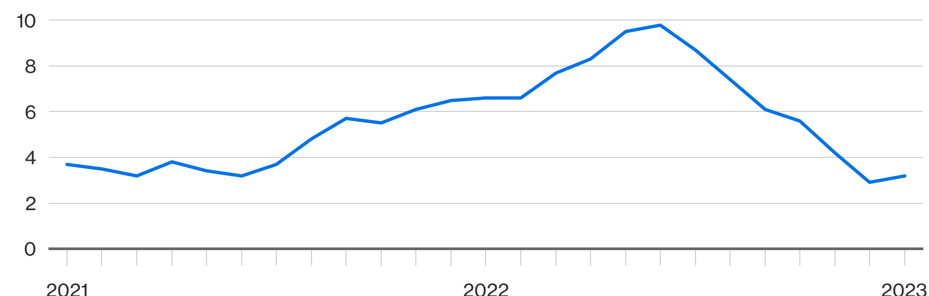
On an annualized and smoothed basis, monthly inflation in Canada has fallen to about 3 per cent.[4] (See Chart 2.) While still at the top of the target range, inflation is decelerating, and it makes sense to pause and assess whether rate increases to date have been sufficient.

At this critical moment of transition, all of us can play a role in "slaying the beast," and that inflation completes its return to 2 per cent, the midpoint of the target range.

Chart 2

Inflation pressures have slowed considerably

(six-month moving average of annualized month-to-month change in all-items CPI, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

2 Bank of Canada, "Bank of Canada Increases Policy Interest Rate."
3 Bank of Canada, "Summary of Governing Council deliberations."

4 Here we use the six-month moving average of the annualized month-to-month change in the seasonally adjusted all-items Consumer Price Index.

Critical juncture for the Bank of Canada: Communication is key

Although they have been the right thing to do, the interest rate increases have not been without costs. Perhaps the most obvious has been a sharp rise in mortgage rates, with five-year fixed mortgage rates reaching their highest level since 2008.

The rise in mortgage rates has also triggered a drop in home prices. Canadian resale prices are now down 15 per cent from their peaks on a seasonally adjusted basis.[5] This has real implications for people, both in terms of their monthly mortgage payments and a loss of personal wealth. For example, increased borrowing costs contributed to a year-over-year decline in average disposable income for people in the lowest income quartile in the third quarter of 2022.[6]

The rise in interest rates has also dramatically increased the risk of recession. According to our own recession risk indicator, there is now a 94 per cent probability of recession, and our forecasts include a mild recession in 2023.[7]

The outcomes associated with higher rates are not in question. Indeed, they are part of the mechanism by which higher rates reduce inflation. Put another way, these are the side effects of the prescribed medicine to combat high inflation. At this point, the Bank of Canada needs to ensure that everyone has a good understanding of why it is taking these actions. Using our analogy, people need to know that the disease is worse than the cure.

5 Canadian Real Estate Association, “National Statistics.”
6 Statistics Canada, “Distribution of Household Economic Accounts for Income.”
7 Ristovski, “Will Canada Slip Into a Recession Within the Next 12 Months?”

Today’s pain is tomorrow’s gain

Canadians deserve to understand why we are trading off pain today for benefits tomorrow. They also need clarity around why 2 per cent is the preferred inflation rate longer term. That the target is not arbitrary, but is set using a detailed and recurring analysis of the pros and cons associated with that target.

The Bank of Canada has been regularly sharing its intentions to raise rates and reduce inflation over the past year through the standard means—policy statements, media engagement, speeches. These statements have been largely focused on explaining what they are doing and providing guidance on what they intend to do. But, until very recently, the why has been missing.[8]

Explaining the why will require simplified messaging for multiple audiences across multiple channels. The Bank of Canada’s communications are primarily aimed at audiences that understand the complexities of how monetary policy is set. Reducing the complexity will go a long way to helping people understand the need for interest rate increases, how they bring down inflation, and why 2 per cent inflation is preferred.

Ensuring Canadians understand this is critical to preventing pushback on the rise in rates so far, and against any future required rate increases. It will also be important in preventing assumptions that higher inflation will be the new normal.

8 Bank of Canada, “Our Commitment to 2% Inflation.”

Governments have multiple tools at their disposal

Beyond monetary policy, all levels of government can play a role in getting inflation back to a low and stable rate. They can play an outsized role in three ways: through fiscal policy, targeted relief for those most affected by inflation, and measures to increase the availability of goods and services that are in short supply.

Tighten fiscal policy

By raising interest rates when the economy is overheating, the Bank of Canada is smoothing out the ups and downs of the economic cycle, known as counter-cyclical monetary policy.

Governments can do the same with fiscal policy, raising taxes and reducing spending during good times and doing the opposite during bad times. If governments do not coordinate their actions with their central banks, however, they risk offsetting the intended effects of changes in monetary policy.

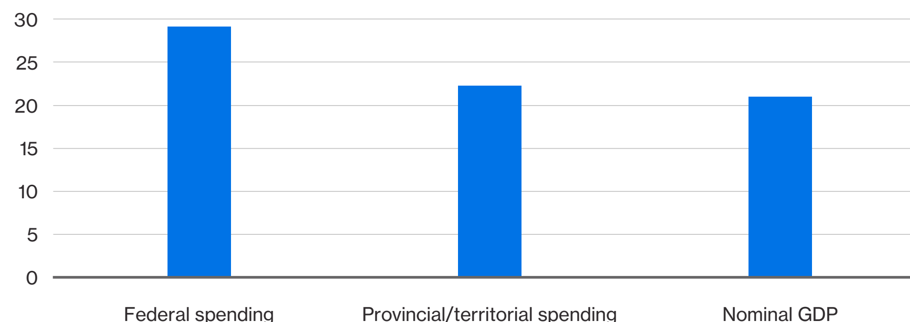
At first blush, governments do appear to be cutting back. Combined federal, provincial, and territorial government spending is expected to be down by 8.7 per cent in the year ending March 2023, compared with the peak in fiscal year 2021.[9] However, remember that government spending, particularly at the federal level, surged during the pandemic, and not all of that increased spending has been unwound.

9 Based on government budget and economic update announcements.

In fact, federal spending in fiscal year 2023 will be up nearly 29 per cent from its pre-pandemic level, and combined provincial and territorial spending will be up 22.7 per cent. Growth in the broad economy, meanwhile, will be about 21 per cent over the same period. (See Chart 3.) This suggests that governments could be doing more to tighten spending.

To minimize the inflationary effects of government spending, all levels of government will need to be more restrained in their spending over the next 12–24 months. If priorities change and require increased spending in one area, that should be offset by reductions elsewhere whenever possible.

Chart 3
Governments can limit inflation by tightening spending
(change between FY2020 and FY2023, per cent)



Sources: Government budgets; Statistics Canada; The Conference Board of Canada.

Targeted inflation relief measures may be warranted

Inflation has had a real impact on people's purchasing power. This is particularly true among lower-income households and young people, who generally have fewer financial resources to cushion the effects of higher prices. Indeed, recent surveys by Statistics Canada have highlighted how rising food and housing costs are impacting households. For example, more than half of people between the ages of 15 and 34 reported being very concerned about their ability to afford housing or rent.[10]

Food inflation remains high, with food prices up 9.7 per cent year-over-year in February. One of the outcomes of this is that demand at food banks has surged. The number of people served at food banks rose by 134 per cent in 2022, and a further increase of 60 per cent is expected this year.[11] At a minimum, food banks need to be funded sufficiently to ensure that people in crisis can access food when they need it. However, more systemic solutions would be preferred.

Canada has various programs in different jurisdictions designed to help those in need, but those are generally meant to supplement income. In essence, they provide money to people and allow them to determine how to best spend it. Targeted programs that are needs-based, such as direct subsidies for low-income individuals to purchase food, could ensure that all Canadians have access to essentials, like nutritious food every day.

Another potential area for exploration is competition policy. Groceries are, in general, a low-margin business, but margins at food and beverage stores have risen since the beginning of the pandemic. Between 2010 and 2019, net profit margins at food and beverage stores averaged 1.5 per cent. In 2022 they averaged 2.7 per cent.[12] Understanding why this change has occurred may help to address some of the food price inflation we are seeing. The grocery sector market study the Competition Bureau announced in October 2022 could provide relevant recommendations.[13]

Creative solutions to address housing affordability are also needed. Partial rent control already exists in some jurisdictions in Canada, but extending these policies is not ideal. The negative effects of rent control, including reduced mobility for renters, conversion of rental apartments to condominiums, reduced building maintenance, and reduced construction of low-income rental units, are well documented.[14] As well, given that rental vacancy rates are near record lows, subsidies are likely to only raise rents further.[15]

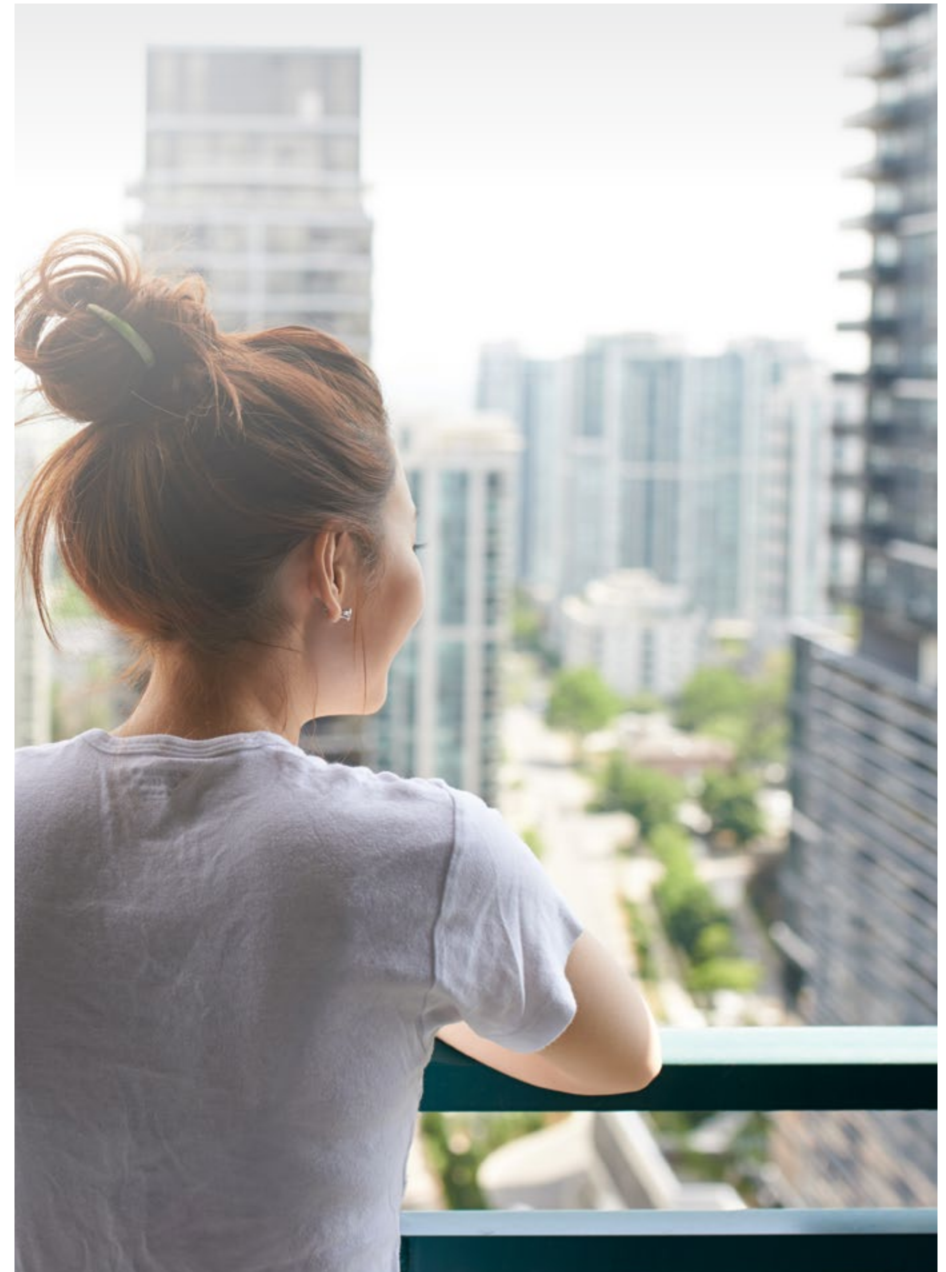
10 Statistics Canada, "One in Four Canadians."
11 Second Harvest, "Canada Needs a New Year's Resolution for Food Insecurity."

12 Statistics Canada, Table 33-10-0225-01.
13 Competition Bureau of Canada, "Competition Bureau to Study Competition in Canada's Grocery Sector."
14 Diamond, R, "What Does Economic Evidence Tell Us About the Effects of Rent Control?"
15 Canadian Mortgage and Housing Corporation, *Rental Market Report.*

Governments can influence available supply

Supply-side measures are likely to be the most effective way of addressing rental affordability. Governments have an array of policy tools available to them, from changing zoning and planning regulations, to reducing development charges, to accelerating approvals. Another possibility would be targeted reform of existing regulations. For example, the recent ban on foreign purchases of residential property has inadvertently stalled construction financing for some residential apartment structures.[16] Although it will take time to address rental shortages through increases in supply, it is likely the best option given how tight Canadian rental markets currently are.

Government policies can also help increase the availability of other goods, services, and people, which should place downward pressure on prices. For example, the federal government's commitment to bring in 1.5 million permanent immigrants over three years, coupled with large increases in non-permanent migration, has likely contributed to bringing down job vacancy rates since they peaked in May.[17]



16 Bula, F, and Younglai, R, "Canada's Foreign Home Buyer Ban Slows Rental Housing Construction."
17 Statistics Canada, "Payroll Employment, Earnings and Hours, and Job Vacancies."

Businesses have a role to play

Keep a lid on price increases

Many of the factors that drove the initial spike in inflation are dissipating. For example, many commodity prices have dropped considerably from their peaks, and global shipping costs, as measured by the Baltic Dry Index, have fallen by about 80 per cent from their 2021 peak. Businesses were typically quick to pass on these higher costs to consumers, but evidence of price cuts has been less common, despite the recent corrections.

In fact, after-tax corporate profits as a share of GDP in Canada rose to a record high in 2021 and, although they have started trending down, remained elevated last year.[18] This would suggest that Canadian businesses have some ability to absorb any further cost increases and to pass on price declines to their customers.

Invest more

The other key thing that Canadian businesses can do, particularly given their healthy profit situation, is invest more in machinery and equipment, software, intellectual property, and research and development. Limited business investment, and the associated poor productivity growth, has been a long-standing challenge in Canada.

And no better time than the present to address it. This is particularly true in the current environment, where labour markets are tight and labour-saving investments could reap large dividends. Additional investments would also expand our economic capacity and reduce supply constraints.

18 The Conference Board of Canada, *Dialing Down*.

Consumers can play a part

Make deliberate spending choices

In the face of higher prices, consumers do still have choices. One of the easiest ways for people to manage price increases is to "vote with their wallet." In essence, choosing carefully what you buy and where you buy it. For example, if you're at the grocery store, this may mean buying a different brand or product, or even going to a different store. This is easier to do with some expenditures than others, but being more deliberate in your purchase decisions can reap significant savings.

It will take time for incomes to adjust to higher prices

Another key consideration for consumers is how quickly their incomes will rise to offset the increase in the cost of living. Understandably, most people want quick adjustments in their pay, but that may be self-defeating.

What would happen if employers suddenly agreed to pay everyone 3 per cent more? To demonstrate this, we modelled an extra 3 per cent increase in Canada's average hourly earnings in 2023 beyond the 3.4 per cent we currently expect. We found that inflation was pushed up by another 2.4 per cent, meaning that four-fifths of the wage gain was eaten up by price increases.

Given how capacity-constrained the economy is right now, large increases in pay will fuel even larger increases in prices, effectively negating most of the benefits of wage gains. In essence, we will just have more money chasing the same amount of goods and services, which is a recipe for additional inflation.

In practical terms, this means that consumers will need to be patient. It will take time for them to fully recover the purchasing power they have lost since the beginning of 2022.

This too shall pass

People are clearly still worried about persistently high inflation. In our most recent consumer confidence survey, 55 per cent of respondents expected inflation to average greater than 3 per cent over the next three years.[19] This is down only modestly from the peak of 61 per cent in May 2022. It is worth noting that people generally perceive inflation to be higher than it actually is.[20] However, reducing people's expectations remains a critical component to resolving the recent spike in inflation.

Recent high rates of inflation will not persist. The Bank of Canada has clearly demonstrated over the past year that it will act to reduce inflation. If governments, businesses, and consumers all play their parts, inflation will slow and the Bank of Canada will likely not need to raise rates further. This is an important point, as expectations for higher inflation influence the decisions that people make.

19 The Conference Board of Canada, "Consumer Confidence Rises for a Second Consecutive Month."
20 Bank of Canada, *Monetary Policy Framework Renewal.*

Concluding thoughts

We currently expect inflation in Canada to decelerate over the course of 2023, and average 2.4 per cent in 2024. This will bring inflation back within the Bank of Canada's target range and allow for interest rates to begin dropping early next year. We all have a part to play in making this a reality. If we collaborate, the inflation dragon will be slain that much sooner.

Appendix A

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