

Intelligence MEMOS



From: William Robson
To: Canada's Inflation Watchers
Date: January 25, 2022
Re: CANADA NEEDS TO TAKE ITS ANTI-INFLATION MEDICINE EARLY

We have not seen inflation this high in Canada for decades. With it has come a resurgence of arguments not heard for many years, both about the causes of inflation and whether we should reduce it.

These arguments will be fierce. Getting inflation back to the Bank of Canada's 2-percent target will mean tighter monetary policy, including higher interest rates. That will hurt – but inflation hurts more.

The sooner we settle on what to do about it, the easier reducing it will be.

Disagreement about what causes inflation matters. After all, if inflation were not related to monetary policy, asking the central bank to fix it would make no sense. Higher prices at stores or in Statistics Canada reports often seem related to news events – clogged ports, bad harvests or COVID shutdowns, for example. Fingers are pointed at greedy suppliers, unions or speculators.

Governments often pick up on those themes, to deflect blame from their own policies. But bottlenecks happen, and self-interested behaviour is nothing new. Inflation was high in the 1970s and 1980s, and low after the early 1990s. The change was not in bottlenecks or human nature – it was in monetary policy.

Nor does it help to say, as the federal government did in its fall economic and fiscal update, that “inflation is a global phenomenon,” as though it has somehow seeped into Canada from abroad. Inflation is like ours, in mid-single digits, in the United States and Britain. It is higher, in double digits, in Argentina and Turkey, and above 1,000 percent in Venezuela. It is lower, below 2 percent, in Japan and Switzerland. Inflation is high where monetary policy has been inflationary, and low where it has not.

We can make Canada's inflation low again.

Should we?

The debate is intense because there are no happy choices. Inflation is high because spending is outrunning our economy's ability to produce goods and services. Fixing the situation means we'll need higher interest rates. Higher interest rates will lower the price of assets, including housing. That hurts. And if the momentum of rising prices is strong, slower nominal spending is likelier to mean a recession and lost jobs, as happened when the Bank of Canada reduced inflation in the early 1980s and early 1990s.

The desire to avoid the pain of reducing inflation reinforces arguments for letting it stay high, or even increase. But advocates for high inflation underestimate how much people dislike it when the purchasing power of their dollar shrinks.

Money is a unit of transaction and measurement that makes life easier in myriad ways. Its value can change, but we are much happier when it stays the same.

When we step on a scale, measure flour for a recipe, or check the temperature before deciding what to wear, we take for granted that the measurements for kilograms, cups or degrees will maintain their reliability from one day to the next.

Imagine how much harder building or renovating a house would be if the distance for a foot or an inch changed over time. The frustration of cooking if cups and teaspoons varied. How impossible managing your electricity consumption would be if the watts you will use tomorrow represented less energy than the watts you used yesterday.

We empower governments to regulate these measures to ensure they are reliable, and we feel the same way about the value of our money. That is why, after inflation rose in democratic countries in the 1970s and 1980s, people supported the governments that reduced it. The cure was painful, but the disease was worse.

Inflation in Canada is up because of macroeconomic excess – spending outpacing what we produce. If we are to return to the Bank's 2-percent target, we will need tighter monetary policy. Higher interest rates will pinch, and the desire to avoid pain will give extra energy to arguments that we cannot and should not reduce inflation.

We can reduce inflation. We have done it before, and we can do it again. As for whether we should – the fact is that people hate inflation. Sooner or later, governments that foster inflation lose to governments that contain it. The faster the Bank of Canada moves to reduce it, the less momentum it will gather, and the quicker and easier getting back to target will be.

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