Intelligence MEMOS

From: Steve Ambler and Jeremy Kronick

To: Canadians Worried About Inflation

Date: March 10, 2022

Re: **The Upward Rate March**

The Bank of Canada's decision this month to start raising its target for the overnight rate of interest reflects its recognition that inflation has turned out to be higher and more persistent than expected.

Slack in the economy has been absorbed faster than predicted and supply-side factors are in play: Poor harvests and higher transportation costs, and, now, higher energy and food-related commodity prices resulting from the invasion of Ukraine.

Beyond that, there is another, often-neglected, demand-side factor that will maintain upward inflation pressure: the extraordinary surge in money that has occurred in Canada since the pandemic began.

The combination of pandemic related constraints on spending over the past two years and government income support has driven household savings to unprecedented levels. And as restrictions ease, some of the money pooling in Canadians' bank accounts will begin circulating, boosting spending.

The kinds of money that matters most for spending and inflation is the kind that people and businesses can easily spend. Economists categorize different monetary aggregates, like M1, M1+ and M2++, according to how liquid they are, with the higher number (and additional plus signs) indicating the inclusion of less and less liquid assets.

Growth rates of virtually all these monetary aggregates shot up starting in February 2020, and peaked a year later, with year-on-year growth of M1+ exceeding 30 percent in January 2021.

These aggregates ballooned because tens of billions of COVID-related emergency transfers were going into Canadians' bank accounts and also because of low interest rates, which encouraged borrowing. When a bank lends, the loan shows up in the borrower's bank account as a deposit, which increases the money supply.

The household savings rate in the second quarter of 2020 reached an unprecedented 28.2 percent, and remains high today relative to recent norms.

Some of that money has already supported spending. Many households decided to buy a new house or renovate an old one, contributing to rapid run-ups in the prices of housing and building materials. But much of the rest they parked in liquid assets, including components of the money supply, to await the day when spending on things like restaurants and travel became either easier or feasible at all.

Money growth has slowed from its peak a year ago but remains robust. And with pandemic uncertainty declining, this big pool of money is now beginning to move.

Over the last few decades, the velocity of money's circulation – the rate at which a given stock of money moves through the economy – has gradually but steadily trended downward, in large part because low global interest rates have reduced the opportunity cost of holding more liquid assets. Then, during the pandemic, the demand for liquid assets soared and velocity plummeted as people willingly built up their bank account balances.

Velocity is now slowly beginning to return to pre-pandemic trends. As it does, and with the economy operating at capacity, either the over-sized money supply is going to have to fall or prices will go up, which will stoke inflation and the growing inflationary psychology.

The economy's big liquidity overhang suggests we may be in for more nasty inflation surprises in the near future. The Bank of Canada's monetary tightening has likely only begun.

Steve Ambler, a professor of economics at the Université du Québec à Montréal, is the David Dodge Chair in Monetary Policy at the C.D. Howe Institute, where Jeremy Kronick is associate director, research.

To send a comment or leave feedback, email us at blog@cdhowe.org.

A version of this Memo first appeared in the Financial Post.