Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: The Bank of Canada Governing Council

Date: March 9, 2018

Re: **Stagflation: the Trade-Driven Elephant in the Room**

As expected, the bank left the overnight rate target unchanged this week. The message was simple: growth remains broad-based, and the economic outlook will likely result in future interest rate hikes, but for now trade uncertainty is the elephant in the room. Among the many trade-related concerns, we view as perhaps the most significant for monetary policy in Canada, ones that could lead to rising inflation with a stagnating economy.

How could this occur?

Much has been written on the different outcomes of a NAFTA collapse, but let's assume it results in, at best, a Canadian economy stuck in neutral. Let's also assume the US walks away from the Canada-US Free Trade Agreement, NAFTA's predecessor. Without a formal trade agreement, and short of trade liberalization with all other WTO countries, Canada and the US will then both have to increase tariffs to get back to WTO levels under the so-called "most favoured nation" rules.

Now, this could simply be a one-off increase in prices, which would have no impact on medium-term inflation, or it could result in a trade war where tariffs continue an upward march leading to more sustained inflation. The latter scenario would give a positive impetus to inflation at the same time as the disintegration of NAFTA weakens the real economy.

This would create a dilemma for monetary policy the likes of which Canada has not seen since the 1970s. And we know that story: a decade of weak economic growth and rising inflation. Canada has a much stronger monetary policy framework in place now to avoid the worst aspects of 1970s stagflation, but an end to NAFTA will still pose significant challenges.

Inflation may also face increasing pressures from a depreciating dollar as a result of interest rate differentials should the Fed hike rates three or four times, as predicted over the next 12 months, with the Bank of Canada raising rates only twice.

The question then is how should the bank respond to this 'bad' inflation scenario, coupled with a weak economy, should it come to pass?

First, it was reasonable to hold rates steady at this announcement, given the degree of uncertainty. Second, the focus should continue to be on communication. For example, at 1.25 percent, the overnight rate is far from the neutral range of 2.5-3.5 percent, consistent with inflation at target and the Canadian economy operating at capacity, of which it appears to be near. Uncertainty is a good reason to keep the overnight rate stimulative despite the economy approaching its production capacity. However, crucial for markets is understanding how the Bank's reaction function will evolve as events become clearer.

And lastly, if the 'bad' inflation scenario does come to pass, the Bank may have to tolerate a period of inflation above target in order to lean against weakness in the real economy. It has tolerated inflation below target for the last few years. This 'bad' scenario would give the Bank a chance to show markets how it truly feels about the other side.

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