Intelligence MEMOS

From: Paul Jenkins

To: Monetary Policy Watchers

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Re: **Pathways to Price Stability**

Given the high degree of uncertainty in today's global economy and biases regarding desired policy outcomes, views going into last Wednesday's Bank of Canada rate announcement varied dramatically.

Disagreements abounded: Are further increases needed, yes or no? Rates will be coming down soon, versus no they won't.

While total CPI inflation is trending down, measures of underlying inflation, as calculated by the Bank of Canada's core rates of inflation, remain stubbornly high at or above 5 percent.

By any measure, we still have some ways to go to get back to the Bank's 2 percent inflation target.

A focus on levels of economic activity (i.e., the output gap), versus growth rates in the economy, and a look back to the 1970s and 1980s point to risks suggesting higher rates, and for longer, than some might expect.

From an overnight policy rate at the effective lower bound (0.25 percent), the Bank of Canada has raised the policy rate in steps of 25, 50, 50, 100, 75, 50, 50 and 25 basis points over an 11-month period. An unprecedented rate of increase to today's 4.5 percent.

Nonetheless, in considering what level of interest rates are needed to stabilize the economy along a path of both full employment and inflation on target, it is important to distinguish between *rates of growth* in the economy and *levels of activity* at which the economy is operating.

A distinction not often made.

The quarterly Bank Monetary Policy Report released alongside the Wednesday rate hike, estimated the economy to be in even greater excess demand – that is, the level of demand is above what the economy can supply on a sustained basis – than in its October report.

The immediate policy challenge is to ensure the economy is on a solid path to bring aggregate demand and supply back into balance to avoid persistent upward pressure on inflation.

There are a number of potential pathways. In line with the Bank's latest projection, demand growth could stall for the necessary number of quarters to re-establish balance – our so-called soft landing.

Or, growth could be negative for several quarters, re-establishing balance somewhat sooner than in the first scenario. It is unlikely that the supply side of the economy could be counted on to accelerate over a short period to provide all the adjustments of re-balancing.

What we all wish to avoid, including policymakers, would be a deeper and more prolonged downturn in the economy than necessary. One of the best ways to avoid that is not to let demand get too much out of balance in the first place. But given excess demand in the economy today, a downturn may be unavoidable to bring the level of demand in balance with supply.

The second challenge for the Bank, jointly with the first, is to calibrate the level of interest rates to ensure the path of the economy is consistent with both re-establishing and sustaining its 2 percent inflation target.

In the inflationary period of the 1970s and 1980s, the cycles of high and variable inflation (11 percent in 1974, 7.5 percent in 1976, 12.5 percent in 1981, 4 percent in 1985, and 5.5 percent in 1991) were accompanied by cycles of sharply rising and falling interest rates (11.5 percent in 1974, 7.0 percent in 1975, 22 percent in 1981, and 13.75 percent in 1990.) Over those two decades, consumer price inflation averaged 7 percent, resulting in the purchasing power of every dollar earned by Canadians falling to below 25 cents compared to 1970. Put differently, a $100 basket of goods and services in 1970 would cost $400 in 1990.

Since 1991, up until last year, inflation in Canada has remained very close to the Bank's 2 percent target. As a result, Canadian purchasing power has been largely maintained.

In comparing the boom/bust cycles of the '70s and '80s to the years since, the single most important difference was the deep-seated inflation psychology throughout the earlier two decades was turned around in the '90s. For certain, this involved a difficult period of adjustment, but once that adjustment was made the benefits of preserving the purchasing power of our dollar began to accrue.

What might all this imply for our current situation, especially in terms of our interest rate cycle?

Two things, it seems:

A quarter or two of negative growth in the economy would not necessarily translate into an immediate decline in interest rates if we remain in a state of excess demand, as levels of activity are just as important as growth.

And the pace of any decline must ensure that an inflationary psychology hasn't taken hold and that expectations are remaining anchored to the Bank's 2 percent target.

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