Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Inflation Watchers

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Re: **Three Reasons to Think Inflation Could Return Sooner than Later**

The Bank of Canada's latest quarterly Monetary Policy Report (MPR) sketched the long and likely winding road the economy needs to travel before it gets back to its pre-pandemic self. And, with it, the long road that inflation will have to take to return to its target rate of two percent.

At the same time, the bank announced it would hold the target overnight rate of interest at its effective lower bound of 25 basis points (i.e., 0.25 percent), "until economic slack is absorbed so that the two-percent inflation target is sustainably achieved," which the bank estimates will not happen until sometime in 2023.

This amounts to "forward guidance" about the path of the overnight rate target – an effort to reduce policy uncertainty that in theory will help keep longer-term interest rates low, boost spending and put upward pressure on inflation. In September, so-called headline inflation was running at an annual rate of 0.5 percent, well below the two-percent target.

And even the adjusted CPI inflation index, introduced over the summer to account for pandemic consumption changes, has only been marginally above headline inflation, including its most recent reading (from August) of 0.4 percent – versus 0.1 percent for headline inflation. That is more inflation than the standard measure implies but 0.4 percent per year is a long way from target.

There are many reasons to think an inflation rebound is far away: restrictions that will keep demand subdued, weak business investment driven by uncertainty around the virus and lost jobs at the bottom of the income distribution – where people typically spend a higher percentage of their income.

Cautious economists are always looking at the other side of the coin, however.

So we ask: are there any reasons to think inflation could move towards two percent faster than the Bank's prediction? The short answer is yes, and some of the reasons can be found in the Bank's own statistics and publications.

First, the Bank's three different measures of core inflation, which are abstracted from the more volatile components of CPI, are already running at close to two percent. In fact, the so-called "CPI-median" measure, currently at 1.9 percent, has not dipped below 1.8 percent since the beginning of the pandemic. All three measures suggest the weakness of headline inflation may be temporary. Its fall has been driven by big drops in a few items, most notably energy.

Second, the MPR included a substantially lower estimate of the economy's potential output since the Bank's last estimates in April 2019. By the end of 2022, the Bank thinks potential output will be three percent lower than it had expected in its April 2019 MPR – mostly because of weak business investment, but also from lower labour market participation and disruptions to immigration. That implies, other things equal: smaller potential supply, a smaller output gap (the difference between actual and potential output) and therefore greater upward pressure on inflation.

Third, the Bank's balance sheet has grown at an unprecedented pace since the beginning of the pandemic. The rate of growth has flattened of late, as continued increases in government bond purchases have been offset by the end of measures it took early on that succeeded in stabilizing financial markets.

Still, all of the Bank's recent bond-buying has translated into a 27.6-percent growth in the money supply – technically, in "M1+," which is mostly cash in circulation and chequing accounts – in the 12 months to September. That's the biggest increase since 1985. Current slack in the economy means this jump in the money supply does not threaten an immediate increase in inflation, but money growth as fast as that has to raise longer-term concerns. Pure monetarism went out of style in economics a few decades ago, but that much more money chasing fewer goods and services, as potential output declines, is cause for inflation worry. In the end, something has to give.

The Bank's promise to keep the overnight interest rate at 25 basis points, its effective lower bound, is only conditional. That gives it an opening – should economic slack shrink and inflationary pressures rise – to raise interest rates before 2023. That would be bad news for governments that have taken on massive new debts, but a good-news sign for the rest of us that the recovery was stronger than anticipated – which in the long run may be how we deal with those debts.

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