TECCANADA
The Executive Committee

WHAT INFLATION IN CANADA MEANS FOR BUSINESS LEADERS

with MARK ZELMER

It's no secret that the term inflation has acquired a whole new level of attention this past year. Inflation in Canada and across the globe is skyrocketing and the effects of this on the lives and livelihood of you, Canadian leaders, is impossible to ignore.

TEC Canada's mission is to equip you with the tools and information to help you make better decisions, adapt to change, and become better business leaders.

It's in this light that we had the pleasure of receiving a White Paper from Mark Zelmer to offer you a professional and in-depth perspective on what the economic landscape means for you and your business. Working with the Bank of Canada, the OSFI, and the IMF over the past 35 years, Zelmer boasts a wide range of policy experience to enlighten us on all things inflation.

Without further ado, please enjoy Mark Zelmer's personal views on where this latest bout of Canadian inflation came from, how the Bank of Canada plans to bring the inflation rates back down, the economic consequences, and what you can do as a business to prepare for and survive the turmoil.

Please note: these opinions should not be attributed to the organizations that Mark is currently, or has previously been, associated with. This report was put together September 15, 2022.

Take it away, Mark!

Mark Zelmer
Senior Fellow at the
C. D. Howe Institute

Inflation - an Intro

For more than 30 years, Canadians have been able to conduct their economic and financial affairs without much thought to inflation. Until this year.

Chart 1

Source: Screen Shots of Charts from Bank of Canada Website

Data as of July 2022

Source: Bank of Canada - Inflation: Definitions, Graphs & Data

Chart 1 shows Canada's inflation performance since 1991—the year the Government of Canada and the Bank of Canada introduced inflation targets. As you can see, the framework had been working well before the pandemic and enabled Canadians to benefit from a tailwind of falling interest rates over most of the period.

The biggest challenge for central banks since the Global Financial Crisis 15 years ago had been to keep inflation from falling below target.

The occasional price increases above target were fleeting and had little impact on the public's expectations for future inflation. They remained well anchored throughout at around the 2% mark.

All that changed this year. Inflation in Canada and abroad has reappeared with a vengeance with the Consumer Price Index surging by more than 8% for two of the twelve months ending in June.

Chart 2

Consumer Price Index as of July 2022	12-Month Percentage Change
United Kingdom	10.1
Euro Area	8.9
Italy	*7.9*
Germany	*7.5*
France	*6.1*
United States	8.5
Canada	7.6

Source: Economist Magazine

While Chart 2 shows that the Canadian rate is below those of the United States, the European Union as a whole and the United Kingdom, it is of little comfort to the many Canadians coping with the loss in purchasing power of their incomes. The ongoing shortages in goods and services paired with the difficulty businesses face in hiring staff could be signs that prices in those markets need to rise further to balance supply and demand.

Thus, there may be more inflation pressures in the pipeline than the Consumer Price Index suggests.

What is Causing Inflation in Canada?

I think the Bank for International Settlements has some insight to offer around what exactly the cause of inflation in Canada, given it serves as a global hub for central bankers and the inflation story is a global phenomenon.

It cited the confluence of three factors in its June 2022 Annual Report:

1 *The surprisingly strong rebound in global economic activity, turbocharged by pent-up consumer demand for goods and services and the economic stimulus supplied by many governments during the pandemic.*

2 *The strong pivot in consumer demand from services to goods.*

3 *The central bank community was surprised by the difficulties that emerged from adjusting supply as evidenced by the bottlenecks in global supply chains that held back production and distribution around the world.*

Furthermore, this was aggravated by a few more elements:

1 *Many businesses hoarding inventories as a precaution, moving from a “just-in-time” to a “just-in-case” inventory management philosophy.*

2 *Global supply chain disruptions brought on by China's Zero-Covid policy, which led to periodic shutdowns in many parts of that important economy.*

3 *The onset of the Ukraine War and its effects on the prices of oil, food, and other tradable goods as economic measures were deployed for geopolitical purposes.*

So, Who is Responsible?

While one can certainly excuse central bankers for not foreseeing the Ukraine War and its economic consequences, they were rather slow to respond to the other factors at play.

It would not have taken much imagination to anticipate that the public would go out and spend money after having been restrained by public health measures during the worst phase of the pandemic, and that this behaviour would be plagued by supply constraints given the pent-up demand and the challenges of restarting normal business operations.

Monetary policy works with a lag. The decisions made today take time to work their way through the economy before affecting inflation. In their July 2022 Monetary Policy Report, the Bank of Canada claimed the lag to be around 18 months to two years, which is why it now expects it will take until the end of 2024 to bring inflation back down to the 2% target.

Considering that lag, and with interest rates close to zero back then, perhaps the Bank could have begun gradually increasing these rates in the middle of 2021 to return them to more normal levels before the economy started to overheat.

Why Didn't Banks Raise Interest Prices Sooner to Contain the Inflation Genie?

A simple question, perhaps, but one that has two key parts to the answer:

Part 1 *Because interest rate decisions consider economic supply shocks.*

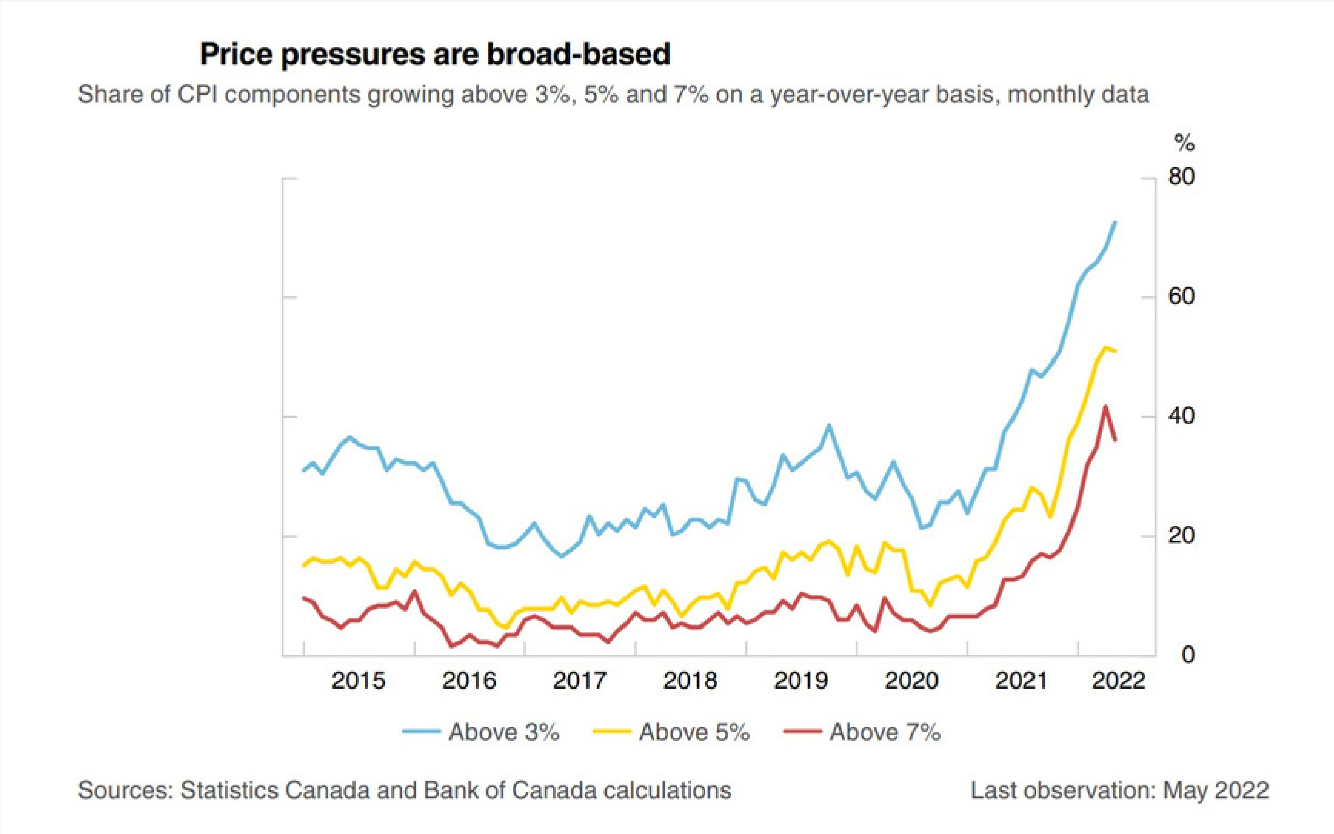
Since the introduction of inflation targets in 1991, the Bank of Canada's practice has been to look through transitory factors affecting inflation and instead focus on the underlying inflation trend. That way, Canadians and the economy are spared from interest rates jumping around in response to short-lived events. This worked well for the first 30 years of the inflation targeting framework because most of the gyrations in the Consumer Price Index were transitory in nature and easy to identify and explain. As a result, those gyrations did not undermine public confidence that inflation would remain around 2%.

I suspect that this experience led central bankers to believe they could look through the supply shocks that have arisen as the economy in Canada and abroad returned to life after the pandemic, and wait to see if the pandemic was truly over before raising interest rates.

> ***Central bankers have conceded that they did not anticipate and were not prepared for the continual waves of supply disruptions that emerged over the last couple of years.***

Those waves have served to undermine the public's faith that inflation will stay low and have now forced the hand of central bankers.

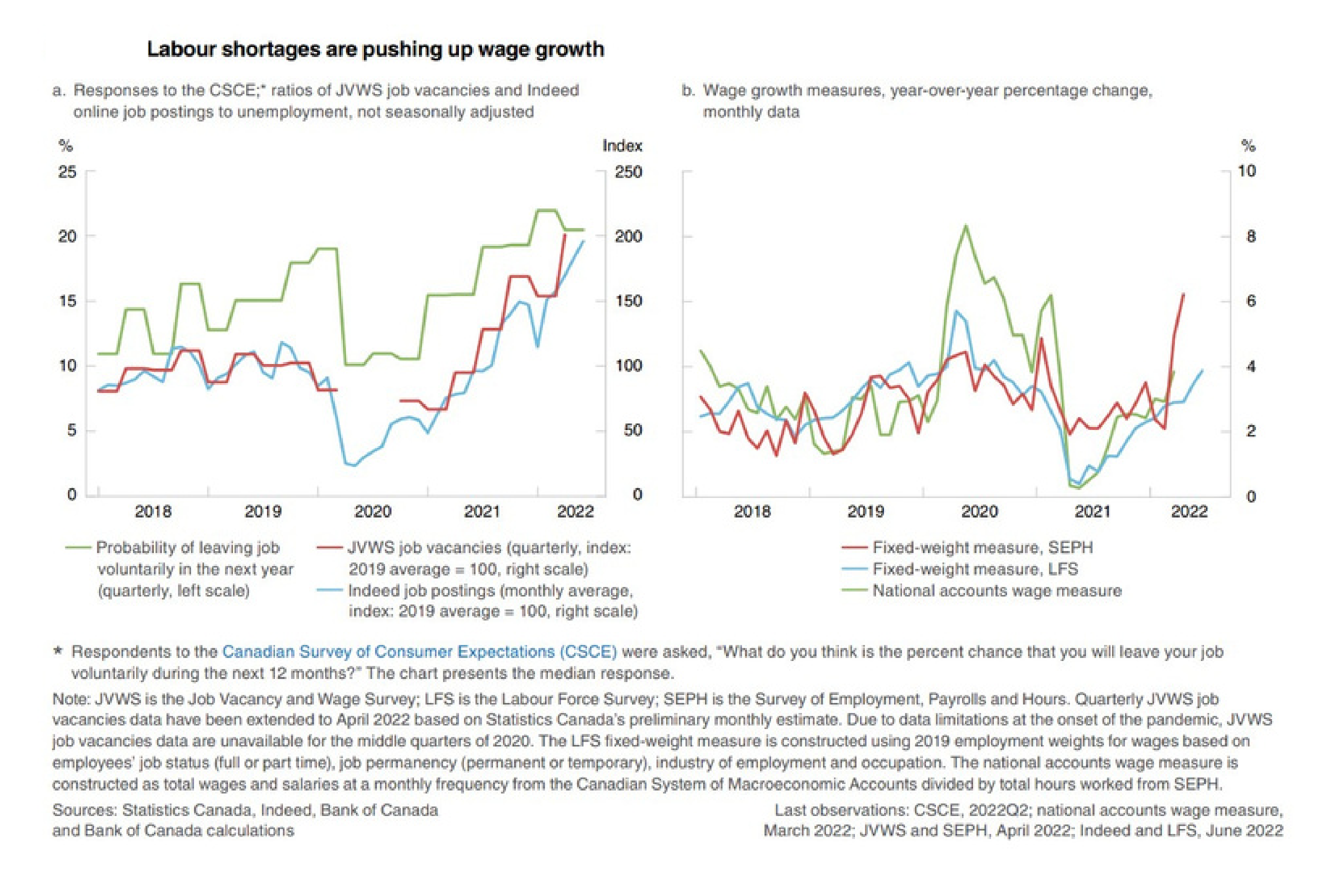
Chart 3



Source: Bank of Canada Monetary Policy Report, July 2022

Chart 3 shows the proportion of the Consumer Price Index components that are now growing by more than 3%—the upper end of the inflation target range.

Chart 4



Source: Bank of Canada Monetary Policy Report, July 2022

According to chart 4, tighter labour markets are leading to a pickup in wage growth. Together, they suggest that inflation has broadened out and is now affecting price behaviour and wages.

As a result, the Bank of Canada, the Federal Reserve in the United States, and central banks in other countries are moving fast to shut down that chain reaction before it becomes too embedded. Otherwise, as the 1970s and 1980s has shown, it could become a lot harder to bring the public's inflation expectations back down to 2%.

Back then, 20% interest rates and a severe recession were needed to break the inflation psychology that had emerged over the preceding decade. By clamping down now, today's central bankers are hoping to quickly curb inflation pressures before they're set in stone and require us to have to drive down that road again. But that is not the whole story.

Part 2

Because of questionable experimentation by the Bank of Canada and the Federal Reserve (in my opinion).

In June of 2022, Bank of Canada Deputy Governor, Paul Beaudry, publicly acknowledged that when inflation started to rise in 2021, the Bank opted against raising interest rates, not only because inflationary shocks from abroad don't tend to last very long, but also because it wanted to ensure those who lost their jobs during the pandemic could get back to work.

> ***Or, to put it another way, the Bank decided to keep interest rates at record lows and probe to see how far the economy could expand and how many jobs could be created before inflation pressures emerged in earnest.***

The Bank of Canada was not alone in this regard. A similar course of action was signaled by the Federal Reserve back in August of 2020 when it announced that, following a major review of its monetary policy framework, it would pay more attention to shortfalls of employment from its maximum level in its interest rate deliberations going forward.

While it is laudable to want to help as many people as possible find work given the pandemic's disruptions to many lives, I do not believe it was a prudent course of action under the circumstances. In my opinion, that strategy did not pay enough attention to the risk that expected inflation might move higher in response to the unprecedented supply shocks that were bombarding the economy, nor to the time that would be required for interest rate hikes to bring those expectations back to 2%. Plus, I would have also thought twice about conducting such an experiment in an environment where money was extremely cheap and speculation was rampant, most notably in housing markets and some new emerging markets like those for crypto assets.

How Severe of a Recession are We In For?

It's hard to say, but I fear there is a risk that the looming recession could be nastier than many people think.

Let me explain.

What really matters right now is how the economy will behave going forward. I believe the Bank of Canada and many other economic forecasters might be too optimistic in their outlooks.

Economists are not very good at forecasting or admitting to the possibility of severe recessions ahead of time. In his 1954 book, The Great Crash of 1929, John Kenneth Galbraith recounts how many business and political leaders repeatedly assured the population that business conditions were fundamentally sound even as the economy spiraled all the way down to the depths of the Great Depression in 1932.

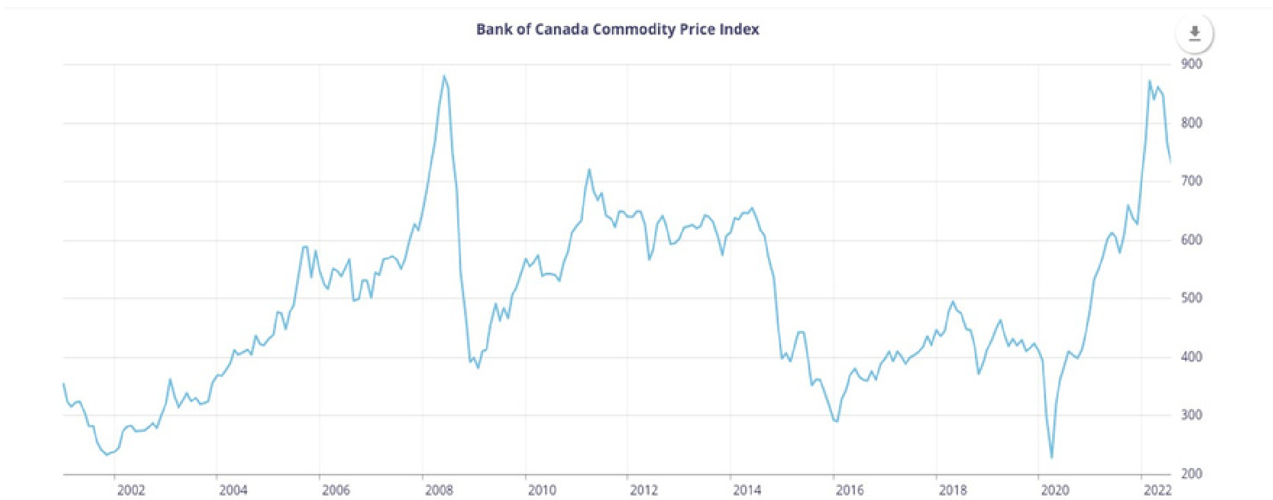
Our modern version of this incantation is to start by forecasting a soft landing, then a mild recession, and so on. The argument in favour of a soft landing assumes that a moderation of economic growth will reduce job vacancies in a tight labour market without having a big impact on overall employment. That, of course, assumes that the vacancies are primarily located in the industries that would be most affected by rising interest rates and that the firms in question would curtail vacancies rather than cut costs by eliminating actual wage-paying jobs.

Personally, I find that line of argument rather sketchy. And I'm not alone.

Former US Treasury Secretary, Larry Summers, and his colleagues at the Petersen Institute for International Economics in the United States, Olivier Blanchard and Alex Domash, gave a withering critique of that argument in a paper published by the Petersen Institute in July.

The Bank of Canada does make the fair point that prices for many commodities we export are elevated given the current geopolitical situation, so Canada is likely to be less affected by the global slowing than many other countries.

Chart 5



Source: Screenshot of chart from Bank of Canada website

Data as of August 2022

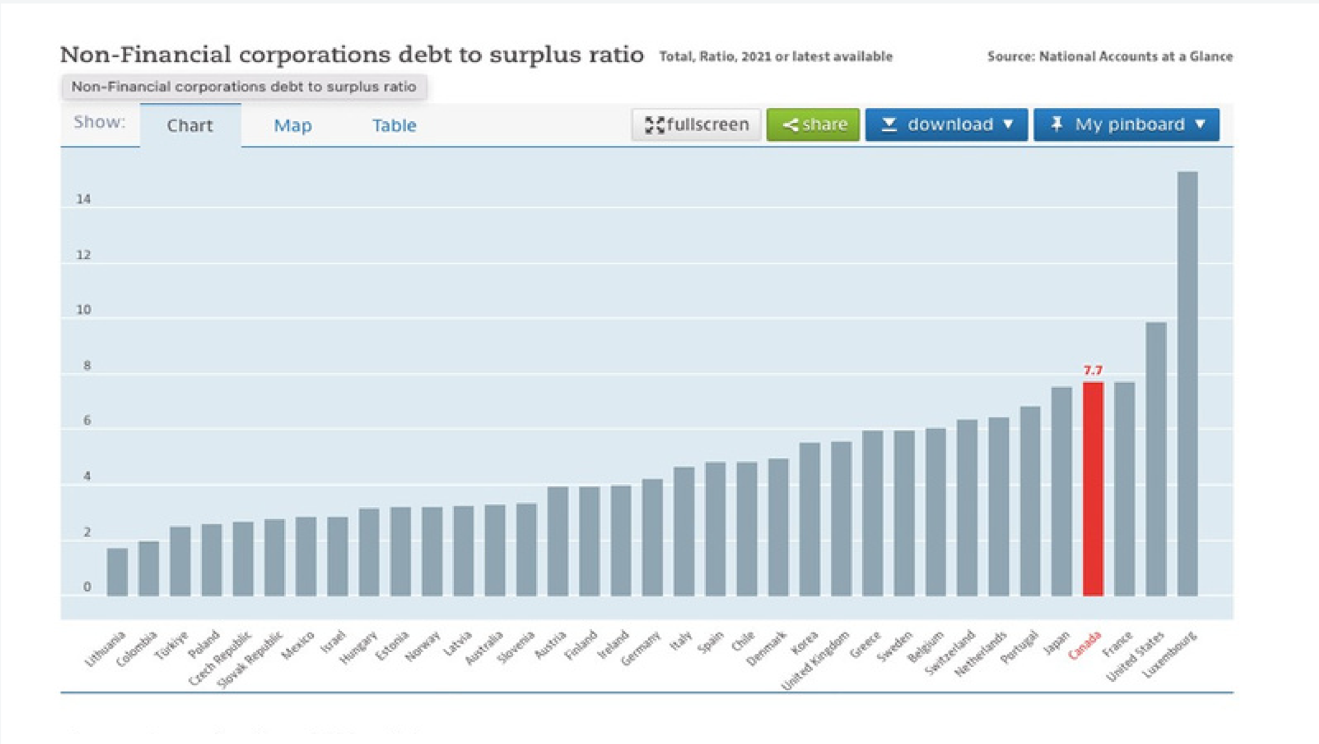
Source: Bank of Canada Commodity Price Index

However, that benefit might be fleeting as the Bank's own Commodity Price Index shown in Chart 5 suggests that prices for many commodities we export have begun to ease as global economic growth slows down.

Chart 6

[Source: OECD Household debt](#)

Chart 7



Source: [OECD Non-Financial corporations' debt to surplus ratio](#)

Charts 6 and 7 show that Canada's private sector is more heavily indebted than most countries. Not just the household sector; business indebtedness is also high. Therefore, interest rate increases may have a bigger impact on Canadians than they would on folks in other countries.

In addition, while oil prices are still high, we may not receive as much benefit from them as we have seen in the past because private sector investment that normally comes to Canada when oil prices are high is now impeded by environmental and social constraints that were not in place in past cycles.

When the Bank of Canada had to rein-in inflation in the 1980s and early 1990s, the Canadian dollar appreciated, helping moderate domestic economic activity. In effect, the exchange rate did some of the heavy lifting, containing the needed rise in interest rates. We do not have that in our favour this time around because the US dollar is currently very strong relative to other currencies including the Canadian dollar. As a result, interest rates may need to do most of the job on their own.

> ***Ultimately, I believe this means higher interest rates will be required in Canada to bring inflation under control and I fear that we could be in for a nasty recession before the inflation genie is returned to its bottle.***

It may look like stagflation for a while because the economy will likely need to contract before we see inflation back down to 2%.

At this point, you are likely wondering how high interest rates will need to go and how severe of a recession we are in for…

I would be lying if I said I knew. I don't. Nor, frankly, does anyone else. However, there are a couple of things to look out for:

1 *On the interest rate front...*

Fixed-income markets are currently pricing in further interest rate hikes, which should begin to unwind later in 2023 as the recession takes hold and inflationary pressures abate. However, I would not rule out short-term interest rates crossing 5% before this cycle is over if central bankers are prepared to bring inflation back down to 2%, even if it means triggering a recession.

To me, there is simply too much inflation in the pipeline to get it under control with interest rates just above the 2-3% neutral range calculated by the Bank of Canada and the Federal Reserve. This is especially true here in Canada given the tepid response of the exchange rate to the interest rate hikes that have already been announced. Given how much interest rates have risen this year, 5% might sound high. However, that would still leave interest rates below the current rate of core inflation.

Having said that, Bob Prince of Bridgewater Associates makes a good point that there is also the risk that central banks may ease up on the brakes too soon as the economy weakens. If that happens, we could be in for a 1970s style stop-and-go economy.

Fortunately, recent statements from the Bank of Canada plus Chairman Powell's remarks last month at the Federal Reserve's Jackson Hole Economic Symposium suggest that today's central bankers are well attuned to this risk. Hence, I suspect they will likely err on the side of keeping interest rates higher for longer to be sure that the inflation genie has been well and truly corked in its bottle before they take their feet off the monetary brakes, even if it means a recession.

Bottom line: don't be surprised if short-term interest rates need to rise further than markets and many commentators are suggesting these days.

2 *The severity of the recession will likely be determined by a confluence of several factors:*

- How many jobs (not vacancies) are lost as the economy contracts
- How damaging higher interest rates are to the financial condition of many households and businesses, and how they will adjust spending in response
- How well the financial system copes with the contraction in economic activity

Experience suggests most recessions that emerge in response to monetary tightening tend to be fairly short-lived, so long as the economic weakness does not undermine the stability of the financial system.

Looking beyond the recession, I share the views of the Bank for International Settlements General Manager, Augustus Carstens, who argued at the same Jackson Hole Symposium last month that inflation pressures could be more prominent in the future than the past 30 years. The best days in the expansion of global trade that came with the opening of China and many other emerging market economies are likely behind us.

Going forward, I believe that greater attention to security and resiliency of supply lines and more emphasis on what has been called "friend-shoring" will mean that the disinflationary pressures of the past 30 years will not be as prevalent in the future. Plus, now that interest rates have found bottom and are returning to more normal levels, households and firms will no longer benefit from the tailwind of declining interest rates present over the past 40 years.

WHAT DOES THIS MEAN FOR YOU AS YOU LEAD YOUR ORGANIZATION?

If I am correct that we could be in for a potentially nasty recession, then planning for survival is the first order of the day. Those of you working with small tech companies know what I mean as you have already witnessed a big swing from a world of abundant capital to one that is now more akin to a parched desert. While there are no easy answers, it does mean that you should:

1 *Get your finances in order and look for ways to be cash positive*

Don't count on investors to fund your future cash burn rate. Reduce debt loads and leverage and build liquidity buffers at your firms. If that means getting new capital, now is the time to do so. Do not assume your friendly bankers will be as nice in tougher times as they were when times were sunny—bankers tend to become much more severe and focused on debt collections when times are tough. A stronger financial position will make it easier for you to cope with the stresses that come with a recession and survive to profit from the eventual economic recovery. Meanwhile, it will put you in a better position to snap up opportunities that may emerge in the interim.

2 *Look for ways to further automate and digitize your business process*

Attracting and retaining staff is likely going to be an ongoing challenge in the years to come as the population ages and older people leave the workforce. This challenge is compounded by changing work attitudes post-pandemic as evidenced by those promoting "Quiet Quitting". Bear in mind that it is not simply a question of how best to automate and digitize at the lowest cost—cyber risks are on the rise and growing geopolitical tensions are likely to trigger more state-sponsored cyber incidents as economic warfare intensifies. This will increase the benefits of having automated and digital systems that are robust, resilient, and cost-effective.

The economic environment in which we have lived for the past 30 years is changing. Central banks in Canada and the United States among others are now working hard to put the inflation genie back in its bottle even. While they will eventually succeed, we cannot count on an inflation and interest rate environment in the future as favorable as we have had it in the past. Businesses that recognize this and adapt are more likely to survive and prosper than those pining for the past.

Thank you, Mark Zelmer, for your insights on the inflationary period we are facing and how Canadian business leaders can come out on top. For more insights from experts to help you become a better business leader, subscribe to the TEC Canada newsletter here.