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COMMENTARY

INFLATION OF 2022: WHY CANADA'S CENTRAL BANK IS IN A FIX

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Important Note: Monetary system is a part of the macrocosm. Trying to separate it arbitrarily might lead to disastrous consequences for the economy in the long run. The price system is not parallel or tangential to the macroeconomy that can function independently or irrespective of whatever is happening in the rest of the economy. A seemingly smooth monetary transmission that is indifferent to financial or macro consequences may create an illusion of partial stability, but for the time being. Especially when partial stability itself is weakening the macro stability in the process. Partial stability within a macro or structural instability can't sustain for long.

The public health crisis caused by the Covid-19 pandemic is yet not over, and Canada is confronting one after another economic crisis. During the early stages of the pandemic, it was low effective demand, joblessness, and related recessionary fears. Consequently, the needful expansionary monetary and fiscal measures were the initial policy response. And now there is another economic crisis, raging inflation of 2022. These crises are not unique to Canada, as most economies are going through similar conditions globally. However, Canada's helplessness to respond to the inflation crisis and why it is helpless are somewhat unique.

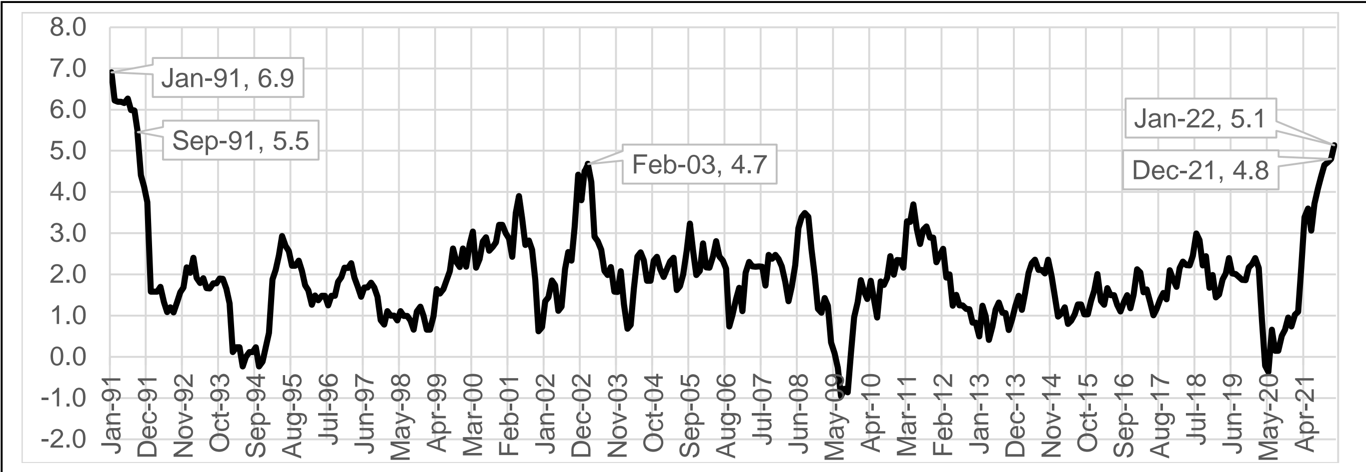
Unfortunately, these are bad policy choices of Canada's central bank in the past that it finds itself in a fix now in its response to the latest inflation crisis. Since the 1990s, the bank has been lowering its policy rate under its inflation-targeting monetary framework. And now it finds itself stuck in a low-rate trap that it can't increase the rate even if current inflationary pressure demands so. Because, if it increases the policy rate to manage the inflation crisis, it may create other crisis(es) in the process – asset crisis, debt crisis, systemic crisis[2] due to accumulated financial vulnerabilities. What to choose, whether inflation crisis or other(s)? It appears to be in a dilemma.

The success of any economic policy is when it leads to the betterment of an economy in normal times and sails it through crises with minimum miseries in tough times. Monetarism has swayed the economic management in Canada and its peer countries

since the oil-crisis-led stagflation of the 1970s. However, monetary policy was evolving all those years until it finally settled at inflation targeting in the 1990s. The inflation targeting strategy has become one of the favorite monetary frameworks worldwide now. But the global pandemic has tested and raised a question mark on its credibility. Its magic worked until there were no interruptions in the supply of international (predominantly Asian) goods. Once supply chains are disturbed, these economies suddenly find their retail stores' isles empty and record-break raging inflation. That is how the secret of these economies' low inflation has been exposed – imported low inflation just like imported goods! Clearly, this was an almost unlimited supply of foreign goods that has largely kept the price inflation within the targets all these years and not the magic of inflation targeting.

Canada's annual Consumer Price Index (CPI) has risen historically highs to 5.1% in January 2022 from 4.8% in December 2021 (Graph 1). The last time the inflation rate happened to be higher than this level, at 5.5%, was 30 years ago, in September 1991. It was around the same time inflation targeting was introduced as a monetary policy strategy on 26 February 1991. Thanks to the inflation targeting strategy, Canada is now in a worse position than it started. Then, at least the economy had some flexibility, particularly with respect to the interest rate, to manage the crises. But now, it has placed the economy into a low-interest trap and risks of multiple crises that have left almost no room for the policymakers to manage the economy in the time of actual crises, e.g., current raging inflation. Now interest rate is near zero (0.25%), yet the central bank can't increase it to fight the soaring inflation. Because if it uses interest rate to release some inflationary pressure or maintain its inflation target by cooling down the effective demand, other crises, which are waiting to happen, might blow the economy.

Graph 1: Canada's Consumer Price Index Inflation, Jan 1991 - Jan 2022
(Year-over-year percentage change, monthly data, not seasonally adjusted)



Source: Calculations are based on the following table (accessed on 17 February 2022): Statistics Canada. Table 18-10-0004-01 Consumer Price Index, monthly, not seasonally adjusted.

The Covid pandemic has undoubtedly caused the current surge in prices by creating an imbalance in the supply and demand conditions. Excess demand, deficient supply,

demand-shift, and uncompetitive market forces (corporate power) have contributed to the inflation of 2022. On the demand side: on the one hand, there is abundant financial support given by the Canadian government, and on the other expansionary monetary policy measures by the central bank such as interest rate reduced to near zero (0.25%), quantitative easing, and liquidity operations. There are interruptions in the domestic and international mobility of people/goods/services on the supply side. Other two important factors have been: a demand-shift, because of lockdowns, from services to goods, thus creating demand pressure on goods' prices (which are already deficient in supply) on the demand side; and opportunistic pricing by the businesses[3] on the supply side.

The worst part of the current inflation crisis is the central bank's inaction, that too, when it found no slack left in the economy.[4] Because its own bad policy choices in the past have left no leeway for the bank, it has to watch soaring prices helplessly. Moreover, these past policies have contributed to the messy structural conditions in the Canadian economy that it can't maneuver its policy rate freely to manage the economy in the current crisis.

In Canada, the central bank has made economic policy choices, for example, prolonged low-interest rates (led by actual/expected low inflation and necessitated by economic stagnation) under the inflation targeting strategy, deregulation/liberalization of the financial sector, self-regulation of the financial/asset industry. One of the worst choices has been targeting only one goal of inflation with the monetary policy rather than multiple macroeconomic goals that might have placed the economy otherwise in a better position.[5] The compulsion of keeping the price level within (given low) targets, at any cost, has made both macro stability and structure of the economy fragile in the process. The price level has been disconnected from the realities of the economic conditions prevailing in the macroeconomy. The financial vulnerabilities have been accumulated to a level where these can crash the entire system anytime; just a trigger is needed. The bank has chained itself in a low-interest trap and systemic failure risk. Unfortunately, it left no leeway for itself to maneuver and manage the economy in a crisis, like the inflation of 2022.

These policy choices of the past have resulted in, partially or wholly, all these years: struggling real economy, dependency on foreign goods/services, accumulated vulnerabilities with the financialization of the economy, overheated asset economy, loads of debt, exhausted conventional/non-conventional monetary policy instruments, shrunk fiscal policy legroom, and increased income inequalities alongside evaporated middle class (resulting in lowered effective demand) because of disappearing manufacturing sector. If we forget the mess created in the normal times, for the time being, it could have lessened the miseries of Canadians in the current hard time by releasing some inflationary pressure. But Covid has exposed loud and clear that it has tied its own hands with its past bad policy options.

How past policy choices have contributed to the economic conditions that Bank of Canada is left with no more options now than to watch soaring inflation helplessly.

Real economy stagnation: It is self-evident from the trend in Table 1 how Canada's real economy is stagnating. GDP growth rate and investment rate are on a secular decline. On the other hand unemployment rate, current account deficit, and per capita debt (high debt to fill the stagnant income and sustain the consumption-based economy) are on the rise. Canada has paid a heavy price in terms of stagnation in its real economy for the price stability with its inflation-targeting monetary strategy.

Table 1: GDP, Investment, Unemployment, Current Account Balance, and Per Capita Debt Before and After Inflation Targeting, Period Averages

	Pre-inflation targeting 1961-1990	Post-inflation targeting 1991-2020
Gross Domestic Product Growth Rate at Market Prices (at 2012 constant prices) (%)	4.1*	2.1
Gross Investment** Growth Rate (%)	10.4*	4.3
Unemployment Rate (%)	7.1*	7.9
Current Account Balance ($ X 1,000,000)	-6,747	-19,860
Per Capita Debt	53,155***	125,904

Notes: *1962-1970

** This is 'Non-financial capital acquisition' that includes 1. gross fixed capital formation, 2. inventories, and 3. net acquisition of existing assets.

***During 1990. Debt data was not available before that.

Sources: Statistics Canada Tables, accessed on 10 February 2022, are listed as below:

GDP Growth Rate – Table 36-10-0369-01: Gross domestic product, expenditure-based, at 2012 constant prices, annual (x 1,000,000).

Gross Investment Growth Rate – Table 36-10-0111-01: Current and capital accounts - National, Canada, quarterly.

Unemployment Rate – For data up to 2015 ('Data table for Chart 4' in the following archived content): Usalcas, Jeannine and Mark Kinack. History of the Canadian Labour Force Survey, 1945 to 2016. Statistics Canada. January 2017. https://www150.statcan.gc.ca/n1/pub/75-005-m/75-005-m2016001-eng.htm
And for unemployment data from 2016 to 2020: Table 14-10-0327-01 Labour force characteristics by sex and detailed age group, annual.

Current Account Balance – For data up to 1980: Archived Table 36-10-0043-01 Balance of international payments, current account, annual (x 1,000,000)
And for data from 1981 to 2020: Table 36-10-0014-01 Balance of international payments, current account and capital account, annual (x 1,000,000).

Per Capita Debt – For data on Total Debt Outstanding: Table 38-10-0234-01 Credit market summary table at book value, national balance sheet accounts (x 1,000,000)
And for data on Population: Table 17-10-0009-01 Population estimates, quarterly.

Structural anomalies/disorders: Price stability has been brought about primarily through cheap imports. That way, low inflation can be said to be imported too. Instead of a hard way, i.e., competing with foreign goods in a globalized economy by making its own industries competitive, Canada opted for an easy way, i.e., import. Not to forget, in retrospect, one of the apparent reasons for permitting imports to take over was the rush to bring low inflation. Increased dependency on cheap imports has consequences like deindustrialization, growing manufacturing trade deficit, gig economy, and lack of diversification. Debt (expenditure>income) has become almost a necessity to finance consumption against stagnating domestic income. The secular low interest rate has let

loose the easy money to fuel the asset economy rather than the real economy. Fiscal legroom has also shrunk owing to several factors: the disappeared middle class, 99% vs. 1% type of income inequality, saturated revenues under regressive indirect taxes, proportionately low taxes on big corporates (in fact, low taxes are one of the incentives to lure these as nations/cities compete because these corporates are simply too big to lose), safe tax heavens for elite people/corporates, tax biases in favor of capital/asset holders, and low incentives for the government (all levels) to be tax prudent in light of less costly borrowings (low-interest rate). The central bank may not be fully responsible for all these aforementioned fiscal conditions. Still, it can't deny partial accountability to the extent its monetary policy has caused structural distortions in the economy to facilitate those conditions to transpire. Therefore, the way the Bank of Canada has brought about price stability in the economy, i.e., at the cost of structural and financial stability, is not a great idea at all. Now economy seems to have three main drivers – oil, immigration (add international students too), and real estate. Keeping a low rate has become a necessity along with all these structural anomalies in the macroeconomy, even if rising inflation demands the contrary.

Table 2: Top 5 Industries' Share in Total Industrial Output, 1997, 2019 (Before Covid), and 2020 (During Covid)

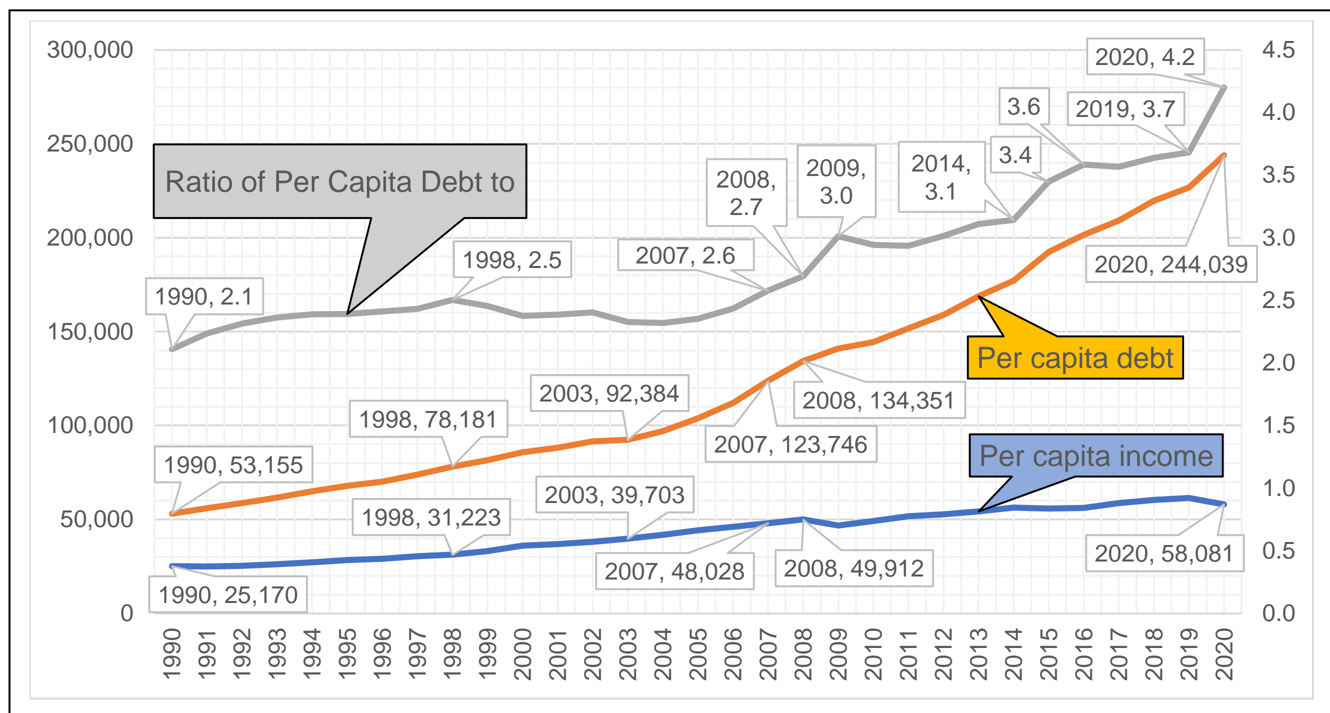
	Total output of select industries ($)*			Share of select industries in all industrial output (%)		
Industries	1997	2019 (Before Covid)	2020 (During Covid)	1997	2019 (Before Covid)	2020 (During Covid)
All industries	1,172,439	1,986,183	1,884,083	100	100	100
Real estate and rental and leasing	128,893	253,457	257,129	11	13	14
Manufacturing	170,644	198,175	178,981	15	10	9
Finance and insurance	66,488	137,115	143,404	6	7	8
Mining, quarrying, and oil and gas extraction	103,724	154,259	142,560	9	8	8
Construction	74,212	143,672	140,588	6	7	7
Financial industries' total (real estate, finance, and construction)	269,593	534,244	541,121	23	27	29
Public sector**	377,469	363,055	240,422	32	18	13
All industries excluding public sector	794,970	1,623,128	1,643,661	68	82	87

Notes: * These are Seasonally adjusted at annual rates and in Chained (2012) dollars.
** Public sector combines the North American Industry Classification System (NAICS) codes 61, 62, 91; these codes represent Educational services [61], Health care and social assistance [62], and Public administration [91].
Source: Statistics Canada. Table 36-10-0434-06 Gross domestic product (GDP) at basic prices, by industry, annual average, industry detail (x 1,000,000)

Financialization of economy: If the public sector (13% in 2020) is excluded, one-third of the rest of the economy is made of just three industries – real estate, finance, and construction (Table 2).[6] These three industries, primarily representing the financial sector and related activities, are among the top 5 industries; the other two are manufacturing

and oil/gas/mining. The share of these three has increased from 23% of all industrial output (including the public sector) in 1997 to 27% in 2019 (before the Covid) and 29% in 2020, even during the Covid pandemic. Probably secular low interest rate under the inflation targeting and far-better/ever-increasing returns in the speculative asset economy have caused collateral damage to the real economy by crowding-out economic activity from it. By the way, manufacturing has declined from 15% of all industrial output in 1997 to 9% in 2020 (Table 2). Neither the real-economy stagnation nor the financial sector progression has affected the price inflation until the recent price hike. Thanks to the inflation calculation method, which includes low-priced foreign products but excludes ever-inflating domestic assets. The Covid-led supply chain disruptions, esp. global, have exposed how much the economy is addicted to cheap imports. But ongoing home-made asset inflation and inflating debts are, unfortunately, tying the hands of the Bank of Canada to manage the current consumer price inflation. What will happen to the financialized macroeconomy of Canada if the interest rate is increased and the asset economy gets a hard landing? Genie (asset economy) seems to be out of the bottle now and out of control of the master (Bank of Canada) too!

Graph 2: Canada's Per Capita Debt and GDP during 1990-2020



Note: Debt represents total debt outstanding held by households (consumer credit, non-mortgage loans, and mortgages), non-profit institutions serving households, non-financial private corporations, non-financial government enterprises, federal general government, other levels of general government, non-residents, and domestic financial institutions.

Sources: Following three Statistics Canada tables (accessed on 10 February 2022) were used in the calculations: 1. for data on Total Debt Outstanding – Table 38-10-0234-01 Credit market summary table at book value, national balance sheet accounts (x 1,000,000); 2. for data on GDP at Market Prices – Table 36-10-0104-01 Gross domestic product, expenditure-based, Canada, quarterly (x 1,000,000); and 3. for data on Population – Table 17-10-0009-01 Population estimates, quarterly.

Debt economy: Imagine an individual who doesn't have enough income but wants to keep up with the Joneses. How can he finance his shopping list? Simply by borrowing, if there is no other source. The same has been with Canada. Its consumption-based economy has to run even when income growth is stagnant. Borrowing is made handy with an easy monetary policy and deregulated/liberalized financial sector. Low inflation expectations could also maintain certainty on the future low interest rate. So, the debt party has gone on that per capita debt rose more than four times than the per capita income in 2020, increasing from about two times in 1990, as seen by the per capita debt to per capita GDP ratio in Graph 2. In the current scenario, if the Bank of Canada increases the interest rate and debtors can't pay, the entire financial system boom might bust. Bringing price stability might bear a price tag of systemic contagion and, therefore, system failure. Is the bank ready to take that risk by taming the present inflation?

Concluding Remarks: Who is in charge the economy? Who is managing it? Mountains of debt, burning assets (esp. real estate), financial vulnerabilities, deindustrialization, real economy stagnation, and so on – this has not happened all of a sudden in Canada. These have been in the making for years. When imports can fulfill the economy's demand at lower prices (keeping low prices is mandatory under the given monetary policy strategy), why incentivize producers to invest, produce, compete, and take all risks? Moreover, when stocks and real estate can provide better (and increasing) returns with minimum risks (and that too at the lowest interest rates), why would investors want to invest in the real economy? Furthermore, when debt can bring in the required macro effective demand at low cost, why bother if income is stagnating? Magic wand of low interest rate, under the inflation targeting monetary strategy, can do it all alone!

The Canadian economy finally has three pillars now primarily to depend on – real estate, oil, and immigration. If oil has steam, the Canadian economy's engine is doing fine. Even if oil is not helping, still no problem; the real estate remains on standby to steam the engine, and immigration is a ready-made fuel to steam the real estate and other parts of the economy. Unfortunately, this dependency has lost the nation's social, political, and economic freedoms by creating social/political polarization and economic concentration (e.g., regional, industrial, and wealth-related). In the present context, this dependency has lost the freedom of economic policymakers to maneuver the economy, not only in normal times but also in the times of actual crises, for example, the inflation of 2022. Since the policymakers, given this dependency, are now constrained by economic concentration, lack of economic diversification, and heightened economic vulnerabilities. Who is responsible? Why ask this question? After all, Canada's financialized economy is self-regulating itself the way the financial, stock market, and real estate markets are doing themselves. Why interfere when laissez-faire is working!

[1] The present commentary is in conformity with and furtherance of the findings in the following two research studies by the author:
"Inflation Targeting in Canada Re-evaluated". Economic Policy Dialogue (EPD), February 2020. http://www.epdonline.org/wp-content/Inflation-Targeting-in-Canada-Re-evaluated.pdf
"Monetary Policy in Canada: Time for Change". Economic Policy Dialogue (EPD), May 2019. http://www.epdonline.org/wp-content/Monetary-Policy-in-Canada-Time-for-Change.pdf

[2] "A systemic crisis emerges when problems in one or more banks are serious enough to have a significant adverse impact on the real economy. This impact is most often felt through the payment system, reductions in credit flows, or the destruction of asset values." p.1. Quintyn, Marc G and David S. Hoelscher. "Managing Systemic Banking Crises". Occasional Paper 224. IMF, 2003. Accessed on 6 February 2022. https://www.elibrary.imf.org/view/books/084/04527-9781589062245-en/04527-9781589062245-en-book.xml

[3] Ioanes, Ellen. "Corporate Pricing is Boosting Inflation – But We're Still Buying". Vox, 20 February 2022. Accessed on 21 February 2022. https://www.vox.com/2022/2/20/22943257/inflation-corporations-price-hikes-consumer-price-index
Bryant, Chris. "Inflation Is Great If You Have Pricing Power. Just Ask Mercedes." Opinion. Bloomberg, 21 February 2022. Accessed on 21 February 2022. https://www.bloomberg.com/opinion/articles/2022-02-21/inflation-shows-warren-buffett-was-right-about-pricing-power-just-ask-mercedes
Reich, Robert. "Why the White House Stopped Telling the Truth about Inflation and Corporate Power". Opinion. The Guardian, 20 February 2022. Accessed on 21 February 2022. https://www.theguardian.com/commentisfree/2022/feb/19/white-house-biden-inflation-corporate-power

[4] "The job market is tight, businesses face historically high capacity constraints, and measures of core inflation are above 2%. The Bank's estimate of the economy-wide output gap is consistent with these indicators. Taken together, these factors support the Bank's assessment that, overall, slack is absorbed in Canada." (Box 3. Economic slack in the fourth quarter of 2021. p.14.). Bank of Canada. "Monetary Policy Report January 2022". January 2022. Accessed on 26 February 2022. https://www.bankofcanada.ca/wp-content/uploads/2022/01/mpr-2022-01-26.pdf

[5] For a difference, in its Dec 2021 five-yearly monetary policy review and renewal of its mandate, the Bank of Canada seems to have agreed to consider employment, too, though reluctantly. The following paragraph indicates the reluctance (underlines are by the author of the commentary to emphasize the reluctance of the Bank):

> The Government of Canada and the Bank of Canada believe that the best contribution of monetary policy to the well-being of Canadians is to continue to focus on price stability. The Government and the Bank also agree that monetary policy should continue to support maximum sustainable employment, recognizing that maximum sustainable employment is not directly measurable and is determined largely by non-monetary factors that can change through time. Further, the Government and the Bank agree that because well-anchored inflation expectations are critical to achieving both price stability and maximum sustainable employment, the primary objective of monetary policy is to maintain low, stable inflation over time.

Bank of Canada. "Joint Statement of the Government of Canada and the Bank of Canada on the Renewal of the Monetary Policy Framework". Released on 13 December 2021. Bank of Canada Website. Accessed on 26 February 2022. https://www.bankofcanada.ca/2021/12/joint-statement-of-the-government-of-canada-and-the-bank-of-canada-on-the-renewal-of-the-monetary-policy-framework/
Also, this is quite clear that it should not be confused with a dual mandate. As quoted elsewhere on the Bank of Canada website ("Our renewed monetary policy framework". Accessed on 26 February 2022. https://www.bankofcanada.ca/core-functions/monetary-policy/monetary-policy-framework-renewal/):

> This time, we ran a "horse race" of key alternatives to inflation targeting. We used a combination of economic models, lab experiments and public consultations to weigh the pros and cons of:
>
> - average inflation targeting
> - a dual mandate that targets both inflation and employment
> - targeting nominal gross domestic product—both its level and growth
> - price-level targeting
>
> In the end, no alternative was better than flexible inflation targeting.

[6] 33% = (29/87)*100 during 2020.