Ken Boessenkool and Mike Moffatt: It's time for the banana talk, Mr. Macklem

The Bank of Canada needs to clearly communicate to Canadians what's happening with inflation.

Nov 17 21 7

By: Ken Boessenkool and Mike Moffatt

Canada's headline inflation rate (the Consumer Price Index) is bursting through the upper end of the Bank of Canada's target range of between one and three per cent, hitting 4.7 per cent in last month's release. Tiff Macklem, governor of the Bank of Canada, is urging calm, calling this inflation "transitory but not short-lived."

Opposition politicians are doing what opposition politicians do — lighting their hair on fire suggesting the slightest hint of inflation portends an economic apocalypse. Much more staid bank economists are starting to hedge their bets.

The elderly among us are getting night chills remembering (or misremembering) days of runaway inflation, rising debts, persistent unemployment … and all the hard work it has taken governments of all stripes to start making promises that they could actually keep.

So, what, exactly is going on?

In an advanced economy like Canada, most inflation comes from demand-side forces, that is the demand for goods and services exceeding the economy's current ability to produce those goods. Or as it is often summarized, "too many dollars chasing too few goods." This is known as demand-pull inflation and can occur for a variety of reasons from a spike in demand for a country's exports to consumers and businesses being confident, perhaps overconfident, about the future of the economy, which causes them to increase their spending.

You can think about demand-pull inflation like this. Imagine a two-person, two banana, two-dollar economy. Each person pays one dollar for each banana. Now imagine you drop two more dollars into the economy. Each person now pays two dollars for each banana. But nothing else has changed and this would be 100 per cent inflation. This is demand-pull inflation, and the solution is simple: eliminate two of the dollars.

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Monetary policy plays a crucial role in both creating and regulating demand. If the economy is overheating, and demand is too high, the Bank of Canada can step in and raise interest rates. More specifically, they can raise the target for the overnight rate, which has two big impacts.

First, it causes all other interest rates in the economy to rise. Mortgages, car loans, small business loans all become more expensive. Consumers cut back on their purchases, demand settles down, and inflationary pressures subside.

Second, higher interest rates in Canada cause international investors to want to buy Canadian dollar debt. You need Canadian dollars to buy Canadian debt, so this drives up demand for the loonie, pushing up our exchange rate with our trading partners like the United States. This makes our exports less competitive, driving down international demand for everything from Canadian wheat to cars to oil.

During the pandemic, the Bank of Canada, like central banks around the world, has driven interest rates down by buying up large quantities of government bonds, known as quantitative easing. Many of these bonds were newly issued by governments to pay for COVID-related expenditures, and by purchasing those bonds, interest rates were kept at, or near, all-time lows. This kept demand high and prevented the loonie from skyrocketing (relative to the Greenback) during the pandemic. Does this mean there are too many dollars chasing too few goods?

If so, the typical prescription would be for the Bank of Canada to let interest rates rise, let the loonie soar, and cool off the economy. This is how you stamp out demand-pull inflation. Or as one central banker famously put it, "take away the punch bowl just as the party is heating up."

Unfortunately, like everything in the pandemic era, things are not so simple. There are four reasons why there is more going on than a simple "low-interest rates causing demand-pull inflation" story.

In the first place, inflation unsurprisingly went negative in April and May of 2020 as the pandemic shut down the global economy. It stayed below the Bank of Canada's lower bound of one per cent for the rest of the year. Thus some of what we are seeing now are base effects; because inflation was unusually low one year ago, we can expect today's measure to be higher just because, well, math.

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But inflation has been rising faster month over month, so while math is part of the answer, it isn't enough. A second possibility is pent-up demand driving

temporary price spikes. Think about haircuts. Normally, purchases of haircuts are spread across the year. But salons and barbershops were closed or restricted, off and on for the last 18 months. So when they return to “normal” there will be many more people than usual — and many more dollars than usual — pursuing haircuts. This is pent-up demand. This increase in demand may cause a temporary spike in the cost of haircuts, but once pent-up demand is satisfied — or folks decide to settle for longer hair — demand will be smoothed and prices will come down. There is pent-up demand across a wide swath of consumer goods and services with any resulting inflation more likely temporary than permanent.

Third, much of the inflation we’re seeing is on the supply, rather than demand, side of the economy, a phenomenon known as cost-push inflation. Rising global energy prices are one such example, which not only drives up the cost of filling up our car, but it has knock-on effects for prices of many other goods, and a few services.

But, fourth, and most importantly, the economy is experiencing inflation, not just through rising prices of inputs, but their lack of availability. The lack of microchips, for example, has shut down all sorts of domestic manufacturing — auto parts, autos, other consumer goods — so we will see inflation going up because we have the same amount of dollars chasing too few goods. Global supply chain disruptions are not going to be solved by any decisions the Bank of Canada makes. Or as Manulife Investment Management Global Chief Economist Frances Donald has so eloquently pointed out, no amount of interest rate increases in Canada will open up ports in China. Nor will it repair rail lines or roads into the Port of Vancouver after the flooding of this week.

Let’s return to our two-person, two banana, two-dollar economy, where each person pays one dollar for each banana. Now imagine you take away one banana temporarily (say it is stuck on a boat in the Port of Vancouver). Now with only one banana, each person pays one dollar for half a banana or two dollars for one banana. Destroying one of the dollars does not solve the core

problem, that we have a banana stuck on a boat, and our inflation is only transitory, as it disappears once the banana arrives.

In short, our standard monetary policy playbook was not designed for these times. Treating pent-up or supply-side inflation as demand-pull inflation will result in applying exactly the wrong solution — monetary tightening, rising interest rates. Rising interest rates in the face of supply-side inflation could exacerbate the short-term economic harm of these supply-side challenges just as we start to recover. This economic harm will be, to quote the Bank of Canada governor, transitory, but not short-lived. If some of these supply-side shocks impact our domestic economy (production of automobiles or automobile parts), then the last thing we would want is the Bank of Canada to harm the economy further by raising rates.

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This puts the Bank of Canada in a tough spot, as they are required by mandate to keep inflation near two per cent, a mandate that makes no distinction between demand-pull and cost-push inflation. If the Bank of Canada sticks too closely to that mandate, they risk unnecessarily damaging the economy. However, if they allow inflation to persist, they create an opportunity for opposition politicians to question the independence of the organization.

Keeping inflation above two per cent could also harm the credibility of the Bank of Canada — its reputation is pegged to its ability to control inflation. If Canadians see the current inflationary spike as portending a long, continued rise in inflation, that in and of itself could drive further inflation. In short, there is a serious price to be paid if Canadians become convinced that old-school, demand-side inflation is what we are seeing if that, in fact, is not what we are experiencing.

And so we call on the Bank of Canada governor to look to that often under-utilized tool of monetary policy — public communications — to explain in plain language why Canadians are seeing prices rise, and what he intends to do about it.

In short, the Bank of Banana-Land needs to explain how much inflation is due to too many dollars and how much inflation is due to too few bananas.

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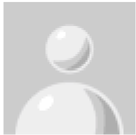

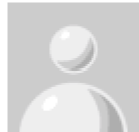

Amal
Nov 17

I have never heard inflation explained quite this plainly before. Thank you.
7Reply

Roy Brander (at brander.ca)
Nov 17

The talk the newspapers would be giving if they weren't mostly neoliberal is the simple analysis in The Guardian to counteract the "Inflation is the Terrible Top Problem for Joe Biden" subject of most Times and Post inflation articles right now.

It used three numbers for Jack Average (American, our numbers are lower). Inflation is 6.2% since last October, but Jack's wages are up 5.8%. Jack is also an average $66,400 in debt on the mortgage and car.

So where Jack used to have $100 in his pocket and $100 in grocery bills, he now faces paying $106.20 with his $105.80 in wages, and must pull 40 cents from his luxuries budget to pay for necessities. But his full necessities are $30,000 per year, vs $10,000 in 'luxuries' (or at least, non-necessities), so he has to do that 300 times, sucking $120 from his bar/restaurant/nice-clothers/Xmas/vacation fund into his food/clothing/shelter budget. (Worse, those luxuries are up $620 from their $10,000 start, so he's lost 7.4% of his luxuries.)

Sucks to be Jack, by $740 of fun lost to inflation.

BUT! Jack's $66,410 in debt has effectively shrunk 5.8% in size relative to his ability to pay, so his *wealth* has increased by $3851. (Shrinking debt == increased wealth).

Until Jack has to renegotiate his mortgage at new, higher rates, he's clearly winning from inflation. And the rich end of the economy, that makes money by loaning their great wealth to Jack, have effectively lost 6.2% of the wealth they go a-loaning with.

Reckoning at least the first few years of modest inflation as a wealth-transfer from the rich to the indebted class, as I did with Jack getting $3851, is also a useful model to view it with.

And that, says the lefty Guardian, is why every paper that's neoliberal may be recognized as such by how alarmed they are by the very first news of inflation. In 2008, it was posed as "Wall St. vs Main Street", and oh, my god, how Wall Street won that one.

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