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Bank of Canada warns of inflation 'feedback loop'

Price increases could become self-fulfilling prophecy, further fuelling inflation

Ian Vandaelle || October 3, 2023

Bank of Canada official Nicolas Vincent warned there could still be significant hurdles when it comes to getting inflation back to target. PHOTO BY JAMES PARK/POSTMEDIA

Bank of Canada official Nicolas Vincent has warned there could still be significant hurdles when it comes to getting inflation back to the central bank’s target of two per cent.

The Montreal speech on Oct. 3 was the first by Vincent in his role as external non-executive deputy governor. He is also an economics professor at HEC Montréal.

Here are the key takeaways:

Bank of Canada still grappling with pandemic disruption

Beyond the human toll, the COVID-19 pandemic upended the economic orthodoxy in ways the central bank did not necessarily account for. With little to do and nowhere to go, Canadians accumulated savings at a rapid clip — hitting a savings rate high of 26.5 per cent in the second quarter of 2020 — which is still being drawn down. This, in combination with a surprisingly resilient labour market, has led to pent-up demand — and the cash to back it up — creating supply-demand imbalances, said Vincent.

"A robust labour market and savings accumulated during the pandemic have supported strong consumption," he said. "This has created what economists call a state of excess demand — a situation where demand runs ahead of supply— thereby driving up prices and wages."

Out of the Bank of Canada's control

Then there are the factors the Bank of Canada can't control, such as energy prices, which are determined by global markets. Gasoline prices, for example were up 0.8 per cent year-over-year in August, according to data from Statistics Canada (after falling 12.9 per cent year-over-year in July), making it one of the main contributors to headline inflation's rise to four per cent. That higher cost of gas raises the cost of many other goods and services. Your local restaurant, for example, has to get its vegetables somewhere, and the increased costs it faces are passed along to consumers, contributing to higher inflation.

Pandemic price changes

Not just consumers changed their behaviour through the pandemic: companies did as well, said Vincent, increasing prices with a greater frequency than economists have observed in the past.

"Price increases were larger than normal during this period, driven by the higher costs that firms were facing and helped along by strong demand. Firms also raised prices more frequently than usual," he said. "We believe that this behaviour by firms — both here and abroad — is intimately linked to the stronger-than-expected inflation we've seen."

That essentially led to a game of chicken, where firms gauge whether their competitors are able to secure enough supply to meet demand, and then raise their prices to protect their profit margins if they suspect competitors will be unable to secure an adequate flow of goods. Ultimately, this behaviour raises prices for consumers.

Self-perpetuating

The biggest risk, said Vincent, is there's a chance these price increases — and consumer concerns over future price increases — become a self-fulfilling prophecy, further fuelling inflation in the near-term as shoppers look to avoid higher prices down the line, creating a "feedback loop."

"Perhaps the biggest risk of all is the idea that recent pricing behaviour could become self-perpetuating. If you continue to expect your suppliers and competitors to make frequent price changes, you might be more prone to do the same yourself, creating a feedback loop," he said.

"Under certain conditions, this could make prices even more sensitive to shocks. In other words, if recent pricing behaviour settles into a new normal, it could complicate our return to low, stable and predictable inflation."