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Why the final stretch of the inflation fight is perilous

TIM SHUFELT || FEBRUARY 7, 2024

Not only does the Bank of Canada need to conquer inflation, it needs Canadians to believe it will do so.SEAN KILPATRICK/THE CANADIAN PRESS

In the fight against inflation, the front line has shifted to the home front.

What began as one giant worldwide problem has morphed into a slew of localized predicaments taking shape country by country. For the moment, quelling rampant inflation is no longer the order of the day.

The most pressing need is that annual inflation seems stuck at 3 per cent to 4 per cent and refuses to make the final descent down to the 2-per-cent target. This pattern is holding across major developed economies.

The forces now driving inflation are domestic, persistent and not easily fixed. This is what keeps central banks on a war footing even as financial markets clamour for rate cuts. To ease off of tough policy now would be to invite a 1970s-style second wave. Declaring victory too soon back then helped pave the way for an inflationary resurgence – a fact that looms large in the central banking playbook to this day.

This is the last mile of the disinflationary slog. Eliminating the last bits of excess price growth from the system may require more pain than consumers, businesses and investors are prepared for.

Shelter costs are rising at close to 6 per cent a year, in part because of an undersupply of housing converging with a rapidly expanding population. Wages are growing at 4 per cent to 5 per cent, as Canadian workers try to claw back some of the purchasing power lost to inflation. And the public still expects inflation to remain stubbornly high – a belief that can be self-fulfilling when businesses set prices or workers push for higher wages.

"A couple of generations have just had their first taste of real inflation," said Doug Porter, chief economist at Bank of Montreal. "I think there is a lot of skepticism over whether the Bank of Canada can actually get inflation back down to 2 per cent."

That all puts the central bank in a tough spot. Not only does it need to conquer inflation, it needs Canadians to believe it will do so. Here is a closer look at the obstacles standing in the Bank of Canada's way.

The wage problem

To the astonishment of economists everywhere, the worst outbreak of inflation in a half-century faded away quickly and without breaking the economy.

In the past year and a half, Canada, the U.S. and Europe have seen growth in consumer prices decline from peaks of 8 per cent to 11 per cent down to around 3 per cent. We can now credit this near-miraculous disinflation to the unwinding of the supply chain crisis.

The mess of shortages, backlogs, and delays that bogged down global commerce starting in 2021 sorted itself out as the pandemic faded. Supply and demand came back into alignment and the flow of goods around the world normalized.

The taming of runaway inflation quickly followed. In December, the White House Council of Economic Advisers estimated that 80 per cent of the reduction in inflation seen in 2023 was owing to the unwinding of the global supply disruption.

The shock to global goods prices may be over, but it bestowed a new set of problems on national economies everywhere.

While falling inflation comes as a relief, it's not as though the rise in prices is reversing. Canadians are now forced to reckon with an enormous jump in prices that has become entrenched in the economy. The average price of a new car in Canada was more than

$67,000 in December, according to AutoTrader. That's up from about $40,000 prepandemic – an increase of 67 per cent in just four years.

For the average Canadian household, losing that kind of purchasing power amounts to a big pay cut. So they push for pay raises and unionized workers head to the bargaining table. Last year, there was a spike in labour disruptions, including strikes by port workers in British Columbia and federal government employees, among others.

"That's exactly how it plays out. This big global thing turns into a domestic thing," said James Orlando, director of economics at Toronto-Dominion Bank.

Bargaining for cost-of-living wage adjustments is a gradual process that usually occurs once a collective agreement expires. In Canada, where nearly one-third of the labour force is unionized, upward pressure on wages in response to excess inflation could take years to unfold.

Rising wages are clearly making the Bank of Canada uneasy. "Productivity growth is effectively stalled and wages are still rising robustly," the bank said in a report published last week. The risk is that businesses might pass higher labour costs onto consumers, adding further to inflation.

But there is one way the Bank of Canada can help cool off wage growth: by regaining the trust of Canadians.

The credibility problem

The Bank of Canada spent much of 2021 telling Canadians not to be alarmed about a spike in consumer prices. The world's other major central banks agreed. The burst of inflation, officials repeatedly insisted, was a blip brought on by the economic distortions of the pandemic and would prove to be "transitory" – a word that will live in central banking infamy.

By March, 2022, when the Bank of Canada raised its policy interest rate for the first time since the onset of the pandemic, Canada's consumer price index was growing at an annual rate of nearly 7 per cent – the highest in more than 30 years.

The bank has been trying to restore its credibility with the Canadian public ever since.

Once an inflationary mindset takes hold, it can be difficult to dislodge. People tend to perceive the problem as worse than it actually is. And they seem to resign themselves to an inflationary future.

Despite the recent progress made in controlling price growth, consumers are anticipating that inflation will be 5 per cent in a year's time, according to a recent Bank of Canada survey.

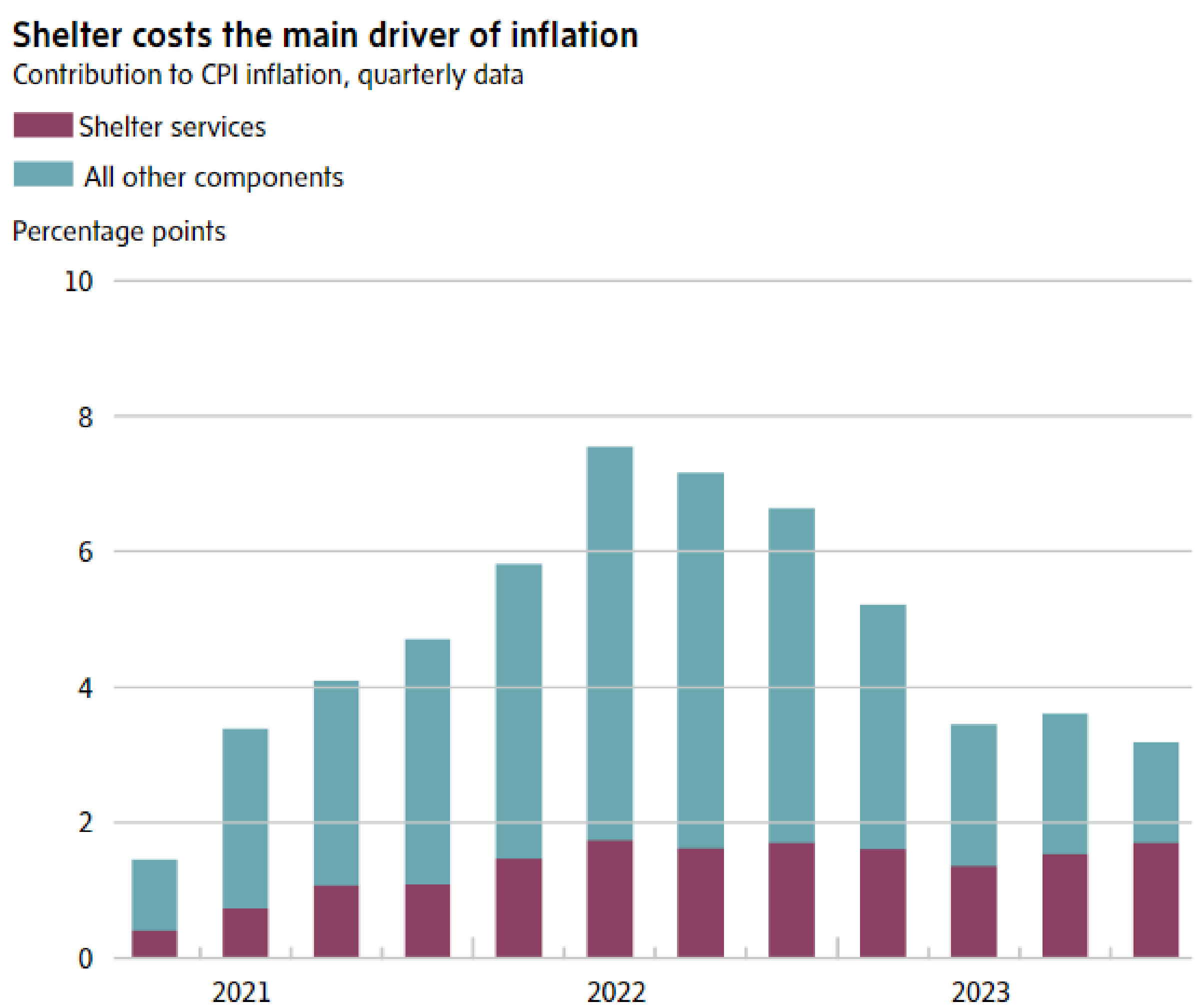
Those kinds of beliefs have a way of manifesting themselves into reality. If you're expecting that type of hit to your finances, you're inclined to fight for higher wages.

Similarly, business owners that are braced for persistent inflation are less likely to make new hires, and more likely to raise prices to protect profit margins. The Bank of Canada's latest survey of businesses shows that 93 per cent of companies expect inflation to remain above 2 per cent over the next two years.

"Breaking this psychology is what raises the possibility that the Bank of Canada will opt to leave interest rates high for longer," said a recent TD report co-written by Mr. Orlando.

But that's not the only hurdle keeping the bank from cutting policy rates.

The shelter problem



THE GLOBE AND MAIL, SOURCE: BANK OF CANADA

There is really only one component of the Canadian economy keeping excess inflation alive, but it’s a doozy.

Shelter costs account for nearly 30 per cent of the basket of goods that make up the Canadian consumer price index. And that one line item is still far too hot. Shelter costs rose by 6 per cent year-over-year in December. Within that, rents increased by 7.7 per cent.

With shelter excluded, inflation drops to within the Bank of Canada’s target range.

The sharp rise in rents is the product of a supply shortage and booming demand spurred by high rates of immigration.

These are forces largely beyond the Bank of Canada’s control. The bank admitted as much in its last monetary policy report: “Persistent structural supply challenges and strong underlying demand from population growth will likely continue to put pressure on house and rental prices.”

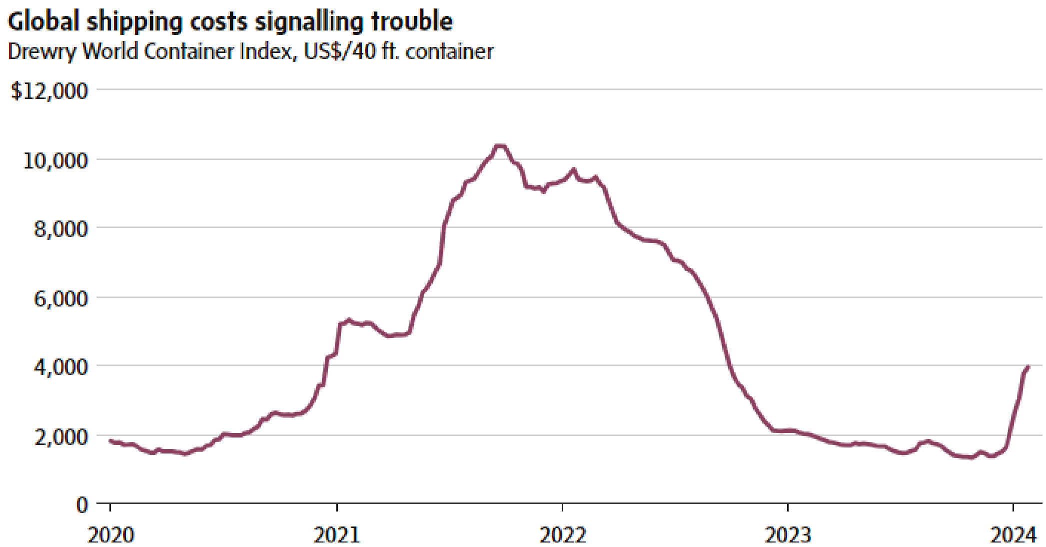
Let’s say shelter inflation continues humming along at a 6-per-cent pace. Getting overall inflation down to a 2-per-cent target would require near-zero price growth in the rest of the CPI basket, Mr. Orlando said.

Could the Bank of Canada wipe out non-shelter inflation, even if it wanted to? Even during the low inflation period in the decade after the global financial crisis, inflation excluding shelter averaged 1.75 per cent. “The Bank of Canada has a shelter problem and there are no easy answers,” Mr. Orlando said.

Does the bank stand its ground on interest rates and risk putting too much pressure on the Canadian economy? Or could it cut rates with headline inflation still above target without further damaging its credibility?

It may be helpful to consider a historical precedent that still lurks in the hearts of central bankers.

The second wave



THE GLOBE AND MAIL SOURCE: BLOOMBERG

Even though inflation has largely become a domestic problem, pressures on a global scale are building again.

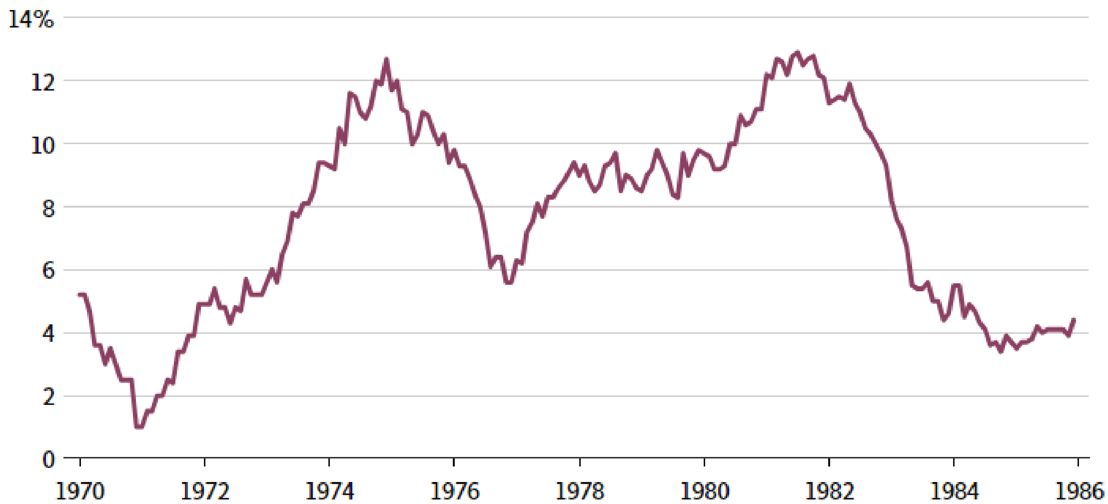
Shipping costs have recently spiked higher as a result of attacks on cargo ships in the Red Sea by Houthi rebels in Yemen. Since November, the Drewry World Container Index, which tracks freight costs across several major routes, has nearly tripled.

At a time of heightened geopolitical tensions, further snarling of the transportation network is certainly possible. As is a spike in oil prices. These are the catalysts that could set off a second wave of global inflation.

In the late 1970s, a second oil price shock helped reignite a global inflation problem. “It was like a match on dry tinder,” Mr. Porter said. High inflation expectations had never really gone away after the first wave of inflation peaked in the early 1970s. And the economy was doing relatively well.

The dreaded second wave of inflation

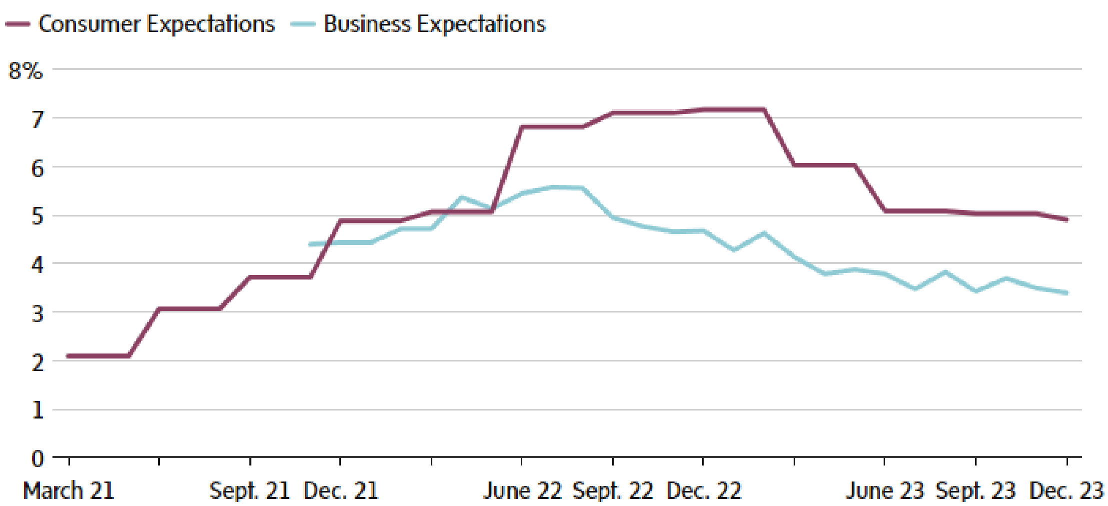
CPI per cent change, year over year



THE GLOBE AND MAIL, SOURCE: STATISTICS CANADA

Inflation expectations are still too high

Expected CPI inflation rate one year from now



THE GLOBE AND MAIL, SOURCE: BANK OF CANADA

The second wave proved to be just as bad as the first, with Canadian inflation peaking at 12.9 per cent in 1981.

The main lesson to come from that era was to not turn one's back on inflation too soon and ease off of the key policy levers. That error helped prolong the crisis for years. It ended only with policy rates that reached as high as 21 per cent in Canada, and a brutal recession during which unemployment hit 12 per cent in 1983.

"I wouldn't lightly dismiss comparisons to the 1970s and 1980s," Mr. Porter said. "It's certainly still in the back of the minds of many central bankers."