ECONOMIC VIEWPOINT

Low, Stable and Predictable Inflation Is Still a Winning Strategy in the Long Run

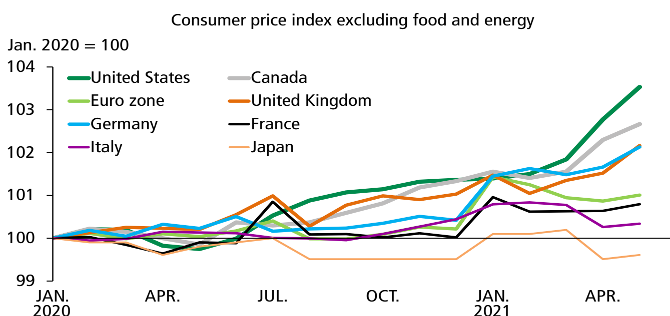
By Hendrix Vachon, Senior Economist

In economics, as in life, sometimes hard choices have to be made. Central banks must once again choose between promoting strong job creation and curbing inflation. If the pandemic continues to slow, the economic situation will improve further and the unemployment rate will drop. At the same time, new inflationary pressures are expected to emerge, but the problem is that in some countries inflation is already exceeding established targets. This is forcing several central banks to adjust their interventions, or at least to think about it. The labour market recovery may be slowed down, but economics has shown that letting inflation run is not a better option.

Inflation Is Back

At the outset, we have to keep in mind that the surge in inflation is still very recent and is largely the result of certain base effects, such as the sharp difference in gasoline prices today versus a year ago. We can also expect some easing in the prices of several commodities that have spiked in recent quarters. The surge in inflation does not seem to be uniform across major economies either. If we look at the G7 countries, the fastest price growth is in the United States and Canada (graph 1). In Europe and Japan, inflation generally remains below or near official targets. Germany and the United Kingdom must be watched more closely.

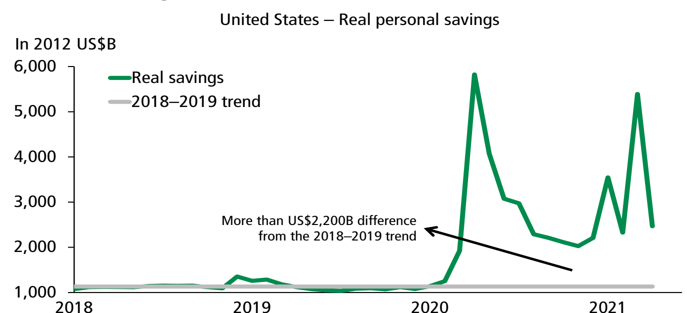
GRAPH 1
Among the G7 countries, price growth is fastest in the United States and Canada



Sources: Datastream and Desjardins, Economic Studies

Inflation is likely to recede in the next few months. However, within a few quarters, with the expected improvement in the economic situation, new inflationary pressures should emerge and they may be more persistent. The large excess savings stockpiled during the pandemic introduces an additional inflationary risk if this surplus were to be released fast into the economy (graph 2).

GRAPH 2
Savings stockpiled during the pandemic lead to an increased risk of overheating



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

When real GDP exceeds its long-term trend, also called potential GDP, inflationary pressures are usually more visible. Potential GDP is an estimate of what the economy can produce

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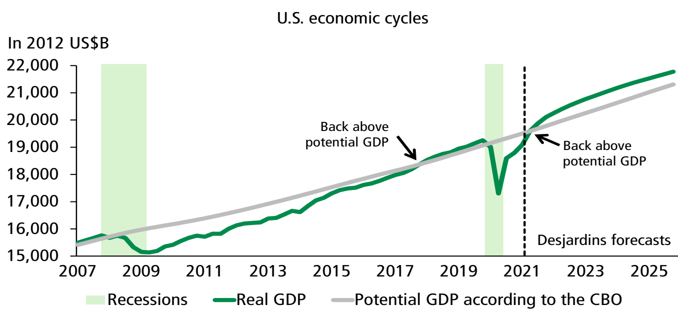
with normal, non-excessive use of available production capacity. In the previous economic cycle, it took eight years after the 2009 trough for real GDP to rise above potential GDP in the United States. This time around, the transition should take place about a year after the low point in real GDP (graph 3). In Canada, it will likely take a few more quarters, partly because of the third wave of the pandemic, which required new restrictive measures.

GRAPH 3
Potential GDP will soon be exceeded in the United States

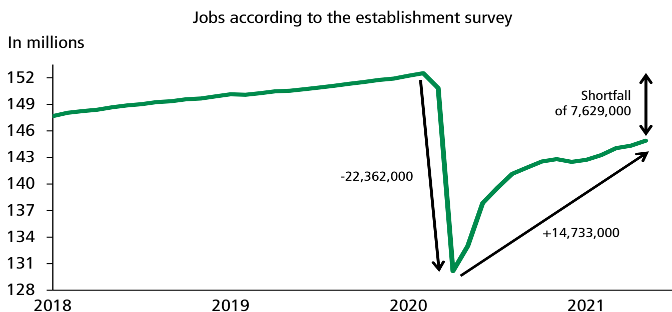


CBO: Congressional Budget Office
Sources: Bureau of Economic Analysis, CBO and Desjardins, Economic Studies

The U.S. Job Market Is Recovering More Slowly

While real GDP is recovering very quickly in the United States, the same cannot be said for the job market. In May, more than 7,600,000 jobs were still needed to get back to pre-pandemic levels (graph 4). Put differently, the U.S. employment level in May was 95% of its pre-pandemic peak, a shortfall of 5%. By comparison, the shortfall in Canada was 3% in May (graph 5).

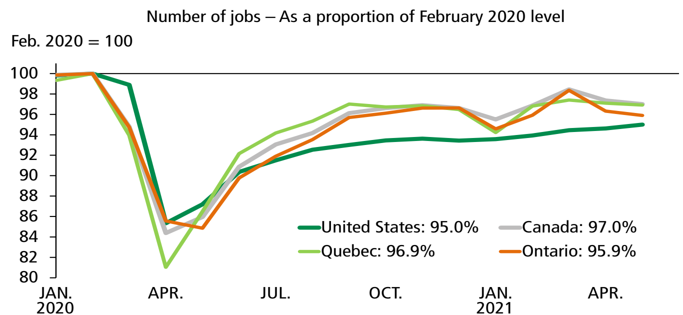
GRAPH 4
The U.S. job market's shortfall remains considerable



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

And there's the big dilemma. Should central banks maintain their very accommodative policies to encourage a quicker recovery in employment, or does the risk of too much inflation require policies that are less accommodative, or should we at least get ready for them? The choice appears to be more difficult in the United States where inflation is currently higher while the shortfall in employment remains considerable.

GRAPH 5
Employment recovery is further ahead in Canada



Sources: Datastream and Desjardins, Economic Studies

The Federal Reserve and Bank of Canada Change Their Tone

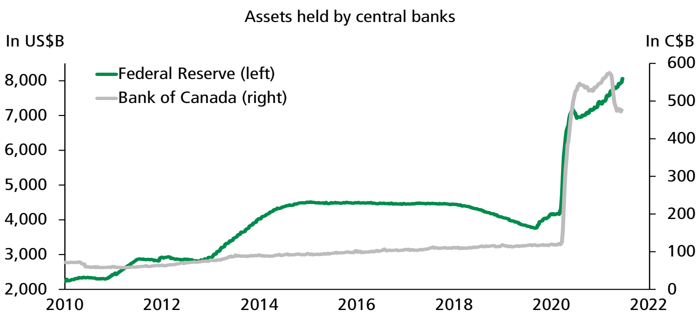
For several months, the Federal Reserve (Fed) has maintained a very cautious stance, suggesting that it would prioritize employment first. In fact, it does not have a very restrictive inflation target. Instead, it has a dual objective: to maximize employment while maintaining an inflation rate of 2%, on average, over a period of a few years. This gives the Fed more flexibility in terms of inflation, but recent data still motivated a change of course. At its June 16 monetary policy meeting, the Fed did not formally signal that it would change its monetary policy in the near term, but the more optimistic forecasts from Fed leaders suggest that it will happen soon. At the press conference, Fed Chair Jerome Powell also reported that discussions regarding a reduction in asset purchases have taken place. These discussions will continue in future meetings.

The Bank of Canada (BoC) has been less hesitant to adjust its monetary policy to changes in the economic outlook, inflation and the liquidity needs of the financial system. The pace of asset purchases has already been reduced twice. Purchases are now at C$3B per week, down from C$5B at their peak. The BoC has also ended other programs aimed at providing temporary liquidity to Canada's financial system, thereby reducing the size of the BoC's balance sheet (graph 6 on page 3).

Several Advantages to Keeping Inflation Low, Stable and Predictable

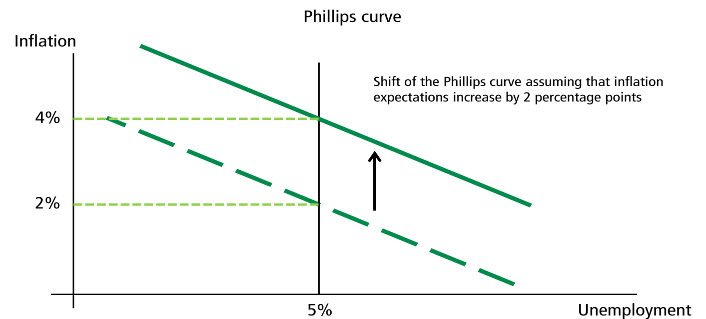
Should we call the Fed and the BoC killjoys? Not at all. The truth is that while job creation is a laudable goal, keeping inflation low, stable and predictable is the preferred option in the medium and long term. Economics proves this brings several advantages.

GRAPH 6
The Bank of Canada has already reduced the size of its balance sheet



Sources: Datastream, Statistics Canada and Desjardins, Economic Studies

GRAPH 7
Inflation expectations interfere with the relationship between inflation and unemployment



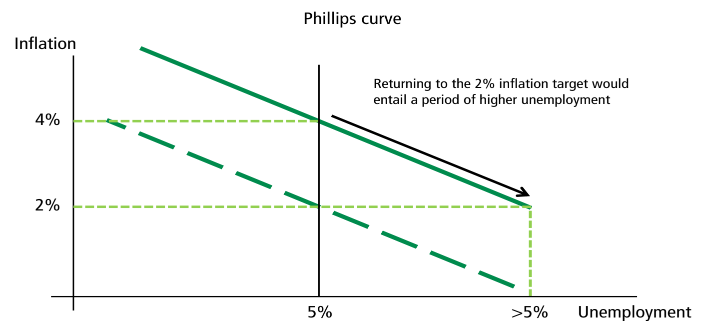
Source: Desjardins, Economic Studies

First, it protects the purchasing power of people whose income does not increase at the same pace as prices. This is often the case for people living off their savings, such as retirees. Low, stable and predictable inflation also makes it easier to see how the prices of different goods and services are changing and helps people make better consumption and investment decisions. Low inflation helps provide fertile ground for investment by reducing the uncertainty associated with significant price fluctuations. The generally lower interest rates observed in an inflation targeting regime also promote investment. This is because there are no high inflation risk premiums reflected in interest rates. Ultimately, economic growth should be higher in the medium and long term when inflation is under control.

Analyzed from another angle, a low, stable and predictable inflation rate has the advantage of being self-reinforcing if it also keeps inflationary expectations low. When businesses and individuals are confident that the inflation target will be met in the medium and long term, they are less inclined to react to short-term price fluctuations. This prevents a series of price and wage adjustments that would fuel an inflationary spiral.

Low and well-anchored inflation expectations also require less adjustments to interest rates to achieve target inflation. This advantage can be illustrated with the Phillips curve, which models the relationship between inflation and the labour market. It is an inverse relationship where inflation falls as the unemployment rate rises. Inflation expectations can disrupt this relationship, however. The more expectations increase, the more the Phillips curve moves upwards. For the same unemployment rate, inflation will then be higher (graph 7). Subsequently, if a central bank wanted to return to the inflation target, it would have to tighten its monetary policy to the point where it would have to tolerate higher unemployment than in the initial situation (graph 8). Eventually, inflation expectations could fall again, allowing the central bank to gradually adjust its monetary policy, and unemployment would drop.

GRAPH 8
If inflation expectations are higher, returning to the inflation target would be more costly in terms of unemployment



Source: Desjardins, Economic Studies

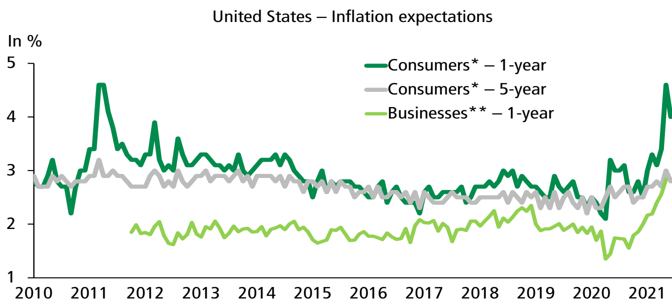
The recessions in the early 1980s and 1990s were in part the price to pay for reducing the inflation rate. Low and stable inflation was not really anchored in the population's expectations and called for higher interest rates and a more abrupt slowdown in the economy to correct the situation.

Threat of De-anchoring Expectations

Thus, beyond short-term movements in inflation, central banks must above all ensure that expectations remain well anchored. Their credibility and ability to intervene with the least possible impact on the economy are at stake. In this regard, various indicators were beginning to point to a risk of inflation expectations de-anchoring, especially in the United States.

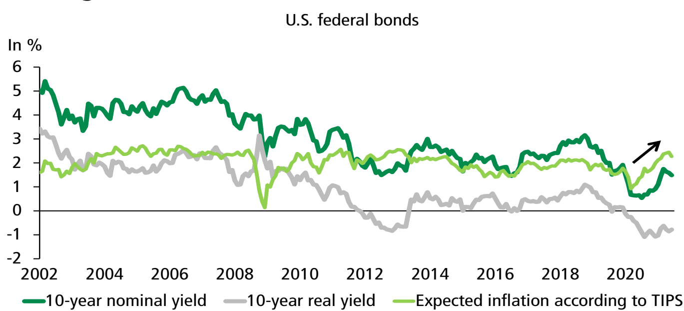
For example, the University of Michigan publishes a monthly survey on consumer inflation expectations. Expectations have increased considerably, for both next year and over a longer horizon (graph 9). The Atlanta Fed publishes a similar indicator for businesses, which also expect inflation to accelerate sharply. Inflation expectations can also be tracked using bond market data. The difference between nominal bond yields and real bond

GRAPH 9
Consumers and businesses raise their inflation expectations



* University of Michigan consumer confidence index; ** Federal Reserve Bank of Atlanta.
Sources: University of Michigan, Federal Reserve Bank of Atlanta and Desjardins, Economic Studies

GRAPH 10
Market inflation expectations had increased prior to the June meeting of the Federal Reserve



TIPS: Treasury Inflation Protected Securities
Sources: Datastream and Desjardins, Economic Studies

yields gives an estimate of the inflation expected by the market. Again, the numbers were rising until recently (graph 10).

Employment Can Be Stimulated in Many Ways

By helping the economy, controlling inflation ultimately helps employment. The objectives are therefore not so opposed to each other. Moreover, if central banks maintain good credibility, this will require fewer adjustments to interest rates that could hurt the economy and the job market. All of this is rather reassuring, because there is also theoretical evidence that shows the importance of not letting unemployment remain too high for too long. Indeed, Keynesian economists defend the hysteresis hypothesis[1] that high unemployment has long-term consequences for the labour market and the economy in general.

The fate of employment, however, does not rest solely in the hands of central banks. Several government policies are aimed at supporting employment and economic growth. These include employment insurance, training and job search programs that tackle unemployment head-on or seek to minimize its unwanted effects. In addition, the government naturally acts as an automatic stabilizer of economic cycles. When the economy is doing badly, tax revenues decline, but the government spends as much, and often more, to support people and businesses affected by the crisis, or through economic stimulus plans.

Governments can also undertake structural reforms to achieve higher levels of employment. These reforms may target the general population or more specific groups. Measures to support childcare, allowing more women to enter the labour market, are a good example.

Toward Fully Justified Monetary Tightening

For a few months now, we have been predicting that monetary tightening would soon begin in the United States and Canada. The first step will be to gradually wind down asset purchases. This process is already underway in Canada. Then, after a short pause, the Fed and the BoC could begin to raise their key rates, likely toward the end of 2022.

If inflationary pressures are stronger than expected, this scenario could be moved up by a few months. The opposite could also be true in the event of a new shock, such as a new vaccine-resistant variant of the coronavirus. It is also important to keep in mind that the effect of interest rate hikes takes time to be felt in the economy and on inflation. It's preferable for central banks to be one step ahead rather than one step behind. That said, the signals recently sent by central banks, particularly the Fed, should push up several bond yields, already introducing some form of monetary tightening.

The pace of key rate increases will also be an important factor. The earlier the rate hikes begin, the more gradual they can be. Our scenario currently calls for a pace of about 25 basis points per quarter. This would bring us to a Canadian overnight rate of 2.00% in 2024. On the U.S. side, tightening could be slightly stronger, with the upper range of the federal funds rate reaching 2.50%. These levels would be similar to what was observed in 2019.

[1] According to the hysteresis hypothesis, recessions may leave permanent scars on the economy due to the impacts on people who are forced into unemployment. They may lose some of their skills, their know-how or their ability to find another job, even after a recession. Likewise, a long period of unemployment may change a person's attitude toward work, such that they may want to work less. As a result, recessions permanently inhibit the job search process, which contributes to keeping the unemployment rate high for a longer period of time.