# Tiff Macklem: Putting the resolute in resolutions - looking ahead to lower inflation

Remarks by Mr Tiff Macklem, Governor of the Bank of Canada, at the Business Council of British Columbia, Vancouver, British Columbia, 12 December 2022.

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## Introduction

Good afternoon. It's a great pleasure to be here. I want to thank the Business Council of British Columbia for inviting me to speak today. I am particularly looking forward to sitting down after my remarks and discussing the issues facing the province, the challenges confronting the Canadian economy and the questions being put to the Bank of Canada.

This is my final speech of 2022-and what a year it has been. A year-end speech often looks back at what's happened and ahead to what's next. This one fits that mould. What's different is that nothing about our recent economic experience fits the mould of the last 30 years. The pandemic brought on-again, off-again shutdowns to the global economy, dramatic shifts in the goods and services consumers wanted to buy, and a myriad of hurdles for producers to supply them. All of this, combined with Russia's horrific aggression in Ukraine, has brought sharply higher inflation and rapidly rising interest rates.

Last week, we raised our overnight policy rate by 50 basis points to 4.25%, our seventh consecutive rate increase since we began raising interest rates in March to fight inflation. Deputy Governor Sharon Kozicki explained our decision in a speech last Thursday. Today, I'd like to provide a broader perspective. I want to reflect on what we've learned in 2022, discuss what could lie ahead and explain what we're focused on at the Bank of Canada. It's a bit early for New Year's resolutions, but I already know what ours is: Restore price stability.

We are resolute in our commitment to return inflation to the 2% target. Higher interest rates are working to rebalance the economy. Domestic demand is slowing, and we expect growth in gross domestic product will be close to zero through to the middle of next year as the economy adjusts to higher interest rates. This will relieve domestic price pressures, and inflation will come down. The adjustment will not be easy, but restoring price stability is the most important thing we can do to improve the economic and financial well-being of Canadians.

## Looking back

A year ago, the economy was getting closer to capacity, but we were still coping with new waves of the COVID-19 virus. Unemployment was a percentage point higher than it is now. Supply chain disruptions combined with strong global demand for goods had driven total consumer price index inflation up to 4.7%, but services price inflation remained relatively low, and inflation was not broad-based. At that time, we expected supply issues to gradually resolve and inflation to come down to close to our 2% target by the end of 2022.

At about 7% today, inflation is a long way from what we had expected. What happened? Three things surprised us. First, supply problems-both global and domestic-proved to be more persistent and pervasive than we had anticipated. This put upward pressure on many prices. Second, Russia invaded Ukraine, sending prices for energy and agricultural goods sharply higher. And third, once we got through the Omicron wave early in the new year, the economy fully reopened, and consumers wanted to catch up quickly on what they had missed for two years. But businesses could not keep up with demand, and this put significant upward pressure on services prices.

With the information we had a year ago, it was impossible to foresee all these developments. But it's too convenient to write off the high inflation of 2022 as just bad luck. We need to reflect on what we learned.

I see three lessons.

First, restoring supply is harder than restoring demand. Hyper-efficient global supply chains are a marvel of system design, transportation and logistics. And when they are working, we take them for granted. But the pandemic reminded us that a chain is only as strong as its weakest link. With the waves of the virus hitting different parts of the world at different times, supply and demand could not recover in tandem. Moreover, the large shift in demand during the pandemic toward goods and away from services put even more pressure on clogged supply chains. Businesses couldn't meet customer demand, and prices of goods rose sharply. With hindsight, the monetary and fiscal policy tools that were used to stabilize the economy worked effectively to support demand during the pandemic, but we underestimated the supply challenges.

Second, averages can obscure inflationary pressures. We need a more granular understanding of the balance between demand and supply when the forces driving demand diverge dramatically across sectors. Public health measures restricted the demand for services. At the same time, other parts of the economy were experiencing excess demand as consumers bought goods to replace the services they couldn't get. But the inflationary impact of excess demand for goods was larger than the disinflationary forces in close-contact services. As a result, our inflation models that focus on the average or aggregate imbalance between demand and supply in the economy had a hard time predicting the rise in inflation.

Third, supply disruptions are more inflationary when the economy is overheated. For the last 30 years, supply shocks-typically energy-have tended to have a temporary effect on inflation. A run-up in oil prices, for example, would boost inflation for a year or so, but oil prices would typically plateau or reverse, and inflation would come back down all by itself. Since it takes more than a year for the full effect of monetary policy to work through the economy, central banks have tended to look through the direct impact of supply disruptions on inflation. That means we don't respond by raising interest rates.

This year, the inflation response was different. As I've already mentioned, we were faced with a series of negative supply shocks just as the economy was reopening. And the effects of these supply shocks on prices and inflation was faster and more pronounced than usual. Businesses, flush with customers, weren't worried about raising their prices. So they passed on the higher input costs more quickly to final goods prices. And customers, eager to finally buy what they wanted, paid the higher prices. As a result, the impact on inflation of the energy and agricultural price shocks was faster, larger and more widespread than our models suggested.

In sum, since we started inflation targeting in the early 1990s, we have not been hit by large negative supply shocks at the same time as our economy was overheating. The lesson from 2022 is that even if long-term inflation expectations are well anchored, when the economy is in excess demand, businesses raise their prices more quickly and by more when their costs increase.

All three lessons are linked, and we have taken them to heart. You don't get 8% inflation because one thing went wrong. Our experience in 2022 is that surprises can combine and interact with each other, resulting in outsized effects on inflation.

I'd be pleased to talk more about these lessons and how we are adapting in our discussion, but now I want to look ahead to 2023.

## Looking ahead

Our top priority is getting inflation back to the 2% target. By raising interest rates, we are trying to dampen demand so supply can catch up. That will bring the overheated economy back into balance, and inflation will come down. Interest rate increases have begun to work, but they will take time to feed through the economy.

We have increased interest rates rapidly both because inflation rose quickly and because the economy was overheating. Once we started to see the momentum in domestic demand, we moved forcefully. Since March, we have raised our policy rate by four percentage points. Increasing rates rapidly to rebalance demand and supply and to keep long-run inflation expectations anchored to our target is our best chance of restoring price stability without a severe economic contraction.

At last week's decision to raise the policy rate by 50 basis points we indicated that, looking ahead, we will be considering whether there is a need to increase the policy rate further. This means that decisions to raise the rate or to pause and assess the impact of past rate increases will depend on incoming data and our judgments about the outlook for inflation.

We are trying to balance the risks of over- and under-tightening monetary policy. If we raise rates too much, we could drive the economy into an unnecessarily painful recession and undershoot the inflation target. If we don't raise them enough, inflation will remain elevated, and households and business will come to expect persistently high inflation. With inflation running well above target, this is the greater risk. If high inflation sticks, much higher interest rates will be required to restore price stability, and the economy will have to slow even more sharply.

We are watching very closely to see how the economy is responding to higher interest rates. We are looking at an expanded range of labour market indicators to assess the balance in the job market and the impacts on workers. We're watching to see how supply chains are resolving and how businesses are passing on changes in costs to consumers. We're also keeping an eye on measures of core inflation to gauge underlying inflationary pressures. And finally, we're closely watching inflation expectations because keeping them well anchored is critical to restoring price stability.

## Looking beyond tomorrow

Over the two decades up to 2020, a number of disinflationary forces helped keep inflation low. A relatively stable global political landscape combined with a broad consensus in favour of free markets and international trade encouraged investment and supported productivity. Technological advancements also lifted global productivity, shrank distances and lowered costs. The entry into the global trade system of vast new labour markets in China and Eastern Europe pushed down the prices of many traded goods. Global supply chains grew rapidly, minimizing costs by linking the global economy through heightened specialization and trade. These supply developments all fostered a period of solid growth, low inflation and low interest rates.

But these forces are now shifting. The failure to adequately share the benefits of growth has fuelled populism that is causing countries to turn inward. Support for globalization is stalling or even reversing, and productivity growth is trending down. And as the growth in the working-age population slows and businesses find it harder to hire workers, there could be persistent upward pressure on wages. If higher wage costs are not matched by improvements in productivity, the costs of production will increase.

Almost three years of the pandemic and the invasion of Ukraine by Russia have also highlighted some of the vulnerabilities of interconnected trade. The pandemic made clear that relying too much on highly specialized supply chains can have downsides. And Russia's weaponization of its natural gas supply has underscored the risks of assuming all countries share the same interests in peace and prosperity. Rising geopolitical tensions, more broadly, have underscored the fragility of some business relationships.

In the future, it seems likely that supply chains will be shorter, more diversified and more resilient. Trade will likely narrow to more trusted partners. These changes will increase resilience but at the cost of efficiency. And through this adjustment, production costs could rise, increasing price pressures.

Over the long term, it seems likely that we won't have the same disinflationary forces that we've had for the past 30 years. These potential developments could make it harder to bring inflation back to the 2% target and keep it there. But how much harder is very difficult to say.

These are fundamental uncertainties we'll need to confront in the years ahead. But by constantly focusing on achieving the 2% inflation target, our monetary policy framework is well designed to address uncertainty and adapt to new developments. If the inflationary forces going forward are stronger than we expect, we will start to see inflation coming in above our forecasts. And we will adjust our policy settings to achieve the 2% target. If, on the other hand, disinflationary forces return and inflation starts to come in below our forecasts, again we will adjust to hit the target. Assessing the impacts of shifting forces will be difficult in the moment, but we can be confident that our framework is designed for all seasons.

## Conclusion

Let me conclude. I've spent most of my time talking about hard lessons and difficult decisions. But I want to end on a note of optimism.

While global forces are shifting, the future will be a lot better than the last three years. Aging demographics, rising geopolitical tensions and climate change all mean global economies could face more supply shocks than in the past. But even if volatility does not return to the pre-pandemic level, we can expect it will be much lower than what we have all endured these past three years.

I also want to stress that the future is not destiny-what we do now will influence how we are positioned when the future arrives. The more we invest in increasing supply through trade, automation, innovation, training and immigration, the faster the Canadian economy can grow without creating inflationary pressures. Canada thrives in a world of open trade and investment flows, and its market access is among the best in the world. We need to protect this and deepen our trading relationships. Businesses need to look to the future and leverage automation to free up workers for higher-value roles and provide training to prepare them for these opportunities. Governments need to foster innovation and ensure Canada remains a country of choice for new immigrants.

The Bank of Canada's job is to ensure price stability. Low, stable and predictable inflation is fundamental to a well-functioning and growing economy that delivers prosperity for its citizens.

People ask me why we need to be so aggressive about raising interest rates to combat inflation. They also ask me why we need to get inflation all the way back to 2%.

It's simple even though it can be difficult. The longer inflation remains high, and the higher it is, the harder it is for Canadians to plan their spending and savings. Inflation erodes the value of money. It distorts and confuses the information and incentives that consumers, businesses, entrepreneurs, savers and investors rely on to make their economic decisions. It feeds frustration, social tensions and a sense of unfairness.

We want to restore price stability in the best way possible for Canadian workers and businesses. We know the adjustment is difficult. But it will be worth it. Our monetary policy is working, and once we all get through this adjustment, our economy can grow healthily with low inflation. That's what lies ahead if we follow through.

Our resolution is simple, and our resolve is absolute. We will restore price stability for all Canadians.

Thank you.

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