**Policy Brief on the Canadian Economy and Inflation**

Canada experienced hikes in inflation and experienced a rise in the Consumer Price Index of 6.8% at the end of 2022, according to Statistics Canada, which sets itself on the higher end based on historical annual gains (Canada, 2022). The increase in inflation was attributed to the rise in energy prices due to the Russia-Ukrainian conflict and the uneasiness surrounding the supply of gasoline as well as increases in consumer demand as COVID-19 restrictions lifted (Canada, 2022). As a result, Canadians are facing price increases in on many frontiers of living expenses from groceries, housing, and fuel to clothing.

Going into 2023, The Bank of Canada has aimed to target its two percent inflation rate. To combat increasing inflation, they have engaged in contractionary monetary policy by increases in the real interest rate. More recently, the Bank of Canada has planned to hold the interest rate at 4.5 percent as inflation begins to settle. The policy the Central Bank has engaged in has been effective in “slow[ing] the economy by forcing people and businesses to pull back on spending”, which is also in part because of Russia’s invasion on Ukraine (The Canadian Press 2023). These actions by the Bank of Canada of controlling inflation through the interest rate now spark debates surrounding an induced recession as well as the severity, given the exogenous factors which influence the Canadian economy.

As a result of the increase of interest rates by the Bank of Canada, costs have risen across many sectors which in turn decrease “consumer confidence and spending” (“Will Canada Slip into a Recession within the next 12 Months?” 2023). From this decrease in consumer confidence, spending may fall and feed into this negative feedback loop to induce a recession. However, According to The Conference Board of Canada, forecasters optimistically predict that this potential recession would be mild due to the number of household savings accumulated through the pandemic (“Will Canada Slip into a Recession within the next 12 Months?” 2023). Additionally, the resilience demonstrated in the Canadian labor force and high immigration rates serve to lessen the potential recessionary blow (Thanthong-Knight & Hertzberg, 2023). However, some economists take on a more pessimistic view and argue that issues such as sticky inflation and heightened tensions between Russia and Ukraine may result in detrimental effects on the economy given the current state of inflation being well above target. It is also recognized that the Canadian economy tends to be reflective of economic conditions in countries such as the United States, so critics argue that domestic policy alone will not be enough to save Canada from external inflation-inducing factors (“Will Canada Slip into a Recession within the next 12 Months?” 2023). Therefore, economists’ outlooks on the extent of Bank of Canada’s developments vary depending on the exogenous factors and expectations they include in their forecasts.

Based on the recent pause of interest rates from the Bank of Canada, many economists view the policy as a valid decision as inflation is gradually decreasing. Considering the recent chaos in the banking sector in the US, some economists attribute the instability to the increasing interest rates that both the FED and Bank of Canada have engaged in. Due to the influence of the US economy on Canada’s economy, there is some amount of a ripple effect that Canadians would face if banking issues persisted (Bloomberg 2023). Therefore, the recent action taken by the Bank of Canada is viewed in a positive light which may slow down the current banking instability as well as a loss in consumer confidence.

Increasing interest rates is a common monetary policy practice which can be recalled during The Volcker Disinflation when the Central Bank in the US exercised increasing the real interest rate to fight inflation at the expense of a recession. The Bank of Canada has similarly engaged in this recently as reflected in the increase of interest rates to about 4.5% from about 4.25% coming out of 2022 (“Interest Rates” 2021). This strategy aims to induce a recession through the decrease of output and consumption which will lead to a fall in inflation. Based on this method, the resulting recession should only be temporary until inflation has declined to the desired level of around 3% (The Canadian Press 2023). Once the target inflation rate has been reached, the Bank of Canada would lower the real interest rate to pull the economy out of the recession.

The announcement of maintaining interest rates by the Bank of Canada taps into increasing consumer confidence and supports the optimistic opinion that a mild recession may occur but will not create a detrimental hit to the economy. Since inflation is heavily reliant on the interest rate set by the Bank of Canada, which has been announced to remain constant for the time being, as well as peoples’ expectations, which may be tamed by the confidence for stability by officials, a spiraling economy seems more like a distant possibility. However, keeping exogenous shocks such as international conflicts out of the picture is insensitive considering their influence on the Canadian economy. For example, oil prices have sharply risen following the Russia-Ukraine war which has contributed to the observed inflation, but this is completely out of the hands of Canadian policymakers. Therefore, it seems more realistic to hold a more pessimistic approach when considering the severity of a recession Canada may potentially fall into since there are more factors at play apart from domestic policy that have the power to exacerbate the situation.

Based on the recent spike in inflation and contractionary monetary policy exercised by the Bank of Canada, it is likely that the economy is heading towards a recession. Based on the Bank of Canada’s recognition of pausing interest rate increases due to current short-term difficulties individuals face, the probable recession may not be very severe. It appears that the Central Bank is being careful with the extent they push the economy and maintain room to breathe for banks and borrowers. Since it is generally recognized that increasing interest rates is a tool to combat inflation at the expense of a recession, authorities seem aware of this outcome. Additionally, in the case of a recession, the amount of household savings accumulated over the pandemic serves as a safety net for individuals and may not result in a detrimental hit.

Due to the savings individual households have accumulated, the economy is equipped with the optimal conditions for the government to continue their push in contractionary monetary policy. The current pause in interest rates increases seems reasonable in response to recent banking instability and securing confidence in the Central Bank and their recognition of public concerns. However, once this period has rolled over the Central Bank should engage in more aggressive policy where the hit can be shorter and effective where its intentions of mitigating inflation are clear, and the issue of diminishing household savings can be lessened.

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‌ “Will Canada Slip into a Recession within the next 12 Months?” 2023. The Conference Board of Canada. March 24, 2023. [https://www.conferenceboard.ca/insights/will-canada-slip-](https://www.conferenceboard.ca/insights/will-canada-slip-into-a-recession-within-the-next-12-months/) into-a-recession-within-the-next-12-months/.

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