OPINION

The Bank of Canada did its job: Rising interest rates and inflation look to be ending

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The central bank's raising of interest rates is probably at an end, but the debate over its merits and effects will dominate the year.

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The Bank of Canada raised its policy rate to 4.5 per cent Wednesday. That's the highest level for Canada's foundational interest rate since 2007, and the climb from 0.25 per cent one year ago is the fastest rise in a generation.

These higher rates – along with the high inflation that prompted them – create significant burdens for many. It's no surprise that conflicts between politicians, consumer groups, labour organizations and corporations are increasing as the economic pie is shrinking.

Luckily, there is good news on the horizon: both rising interest rates and high inflation may soon be at an end, all without a recession.

I say this for several reasons.

First, the full effect of interest rate increases will not be known for some time.

Higher rates tend to lower spending on homes, vehicles, renovations, large durable goods such as appliances and so on. Lower demand tends to lower prices (or dampen price increases) and therefore ease inflation. Normally, though, the full effect takes between a year and a half and two years to appear.

Recognizing this, the central bank noted explicitly that if its current outlook for the economy holds, then the "Governing Council expects to hold the policy rate at its current level while it assesses the impact of the cumulative interest rate increases."

Second, recently published research by my University of Calgary colleague Sonja Chen and I demonstrates that Canada's inflation was driven so high in the first place mainly by supply-side factors such as higher global food and fuel prices.

There is little the bank can do about those, but most of those pressures have dissipated significantly. Oil is one-third lower now than its highs last summer. Global food prices are down more than 13 per cent. Fertilizer prices are down almost one-fifth. The Bank of Canada's own commodity price index is down more than 30 per cent from its previous highs. And the World Bank's latest outlook projects further drops in those prices throughout 2023.

Soon, commodities will be a drag on inflation – a welcome relief to consumers.

Third, and perhaps most importantly, inflation pressures in Canada have already fallen sharply. In fact, since July, inflation has averaged only 2.9 per cent (seasonally adjusted, on an annualized basis). In a very real sense, most of Canada's inflation pressures may be behind us.

It's true that core inflation, which strips out volatile components such as food and energy, is higher. But even two of the central bank's core main inflation measures have averaged close to 4 per cent – still too high, but far lower than the headline rate of 6.3 per cent in December.

Even more striking is the fact that of that 6.3-per-cent inflation rate, more than 5.5 percentage points are due to price increases that occurred between January and May last year.

So until those months drop out of the calculation, Canada's inflation rate will remain high even if true underlying price pressures have evaporated. But when they do, the headline rate will fall quickly – perhaps approaching normal levels by this summer.

None of this means there aren't risks, of course.

One concern is that higher rates will cause a recession. While a possibility, it is neither the Bank of Canada's goal nor an inevitability. The bank currently expects Canada's economy to grow by 1 per cent in 2023 – slower than normal, but not a recession.

Monetary policy has caused recessions in the past. When U.S. rates were rapidly raised from 9 per cent in July, 1980, to 19 per cent by the end of the year, for example, a deep recession started a year later.

But today – like most of the past three years – is unusual.

Job vacancies are incredibly high. There is currently about one unfilled job for each unemployed worker. That's quadruple the normal amount. Businesses can therefore respond to lower consumer demand by cutting vacancies rather than jobs.

A global recession is a possibility, however. Many economies are in worse shape than Canada's. But there is good news even there. "The risk of a severe global downturn remains but appears to have lessened," the central bank observed Wednesday.

Canada's economy has weathered incredible disruptions over the past few years. And monetary policy is, in part, to thank.

It's true the Bank of Canada missed its inflation target, but so too have central banks all over the world. Whatever hindsight allows us to see clearly today, we must not forget the fog of war we all faced during the pandemic.

Today, the central bank is clearly committed to bringing inflation back to 2 per cent. And it appears it might – just might – be able to achieve that soon without driving Canada's economy into recession. A soft landing for the economy may very well be on the horizon.

Good news indeed.