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With inflation on the rise, the Bank of Canada has two choices

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Canada's year-over-year inflation rate hit 8.1% in June, a high not seen since the 1980s. But it's not inflation itself that poses a risk to the economy—it's the interest rate hikes introduced by central banks in response.

As the Bank of Canada moves to raise interest rates, it is important to understand (a) what is causing inflation right now, (b) what happens when interest rates increase, and (c) what else governments can do to fight inflation.

What is causing inflation?

01 From the first quarter of 2020 to the second quarter of 2022, the average annual rate of inflation was 4.4%, compared to only 1.7% from 2010 to 2020. Since the pandemic, the annual excess inflation rate has been 2.6%.

02 The worldwide increase in inflation in 2021 was primarily caused by disruptions and bottlenecks in the production and distribution of goods. Global trade slowed considerably during lockdowns, and the effects are still being felt: container shipping prices have increased sevenfold since the pandemic began, and delivery times have doubled.[1] Delays in the production of computer chips have impacted a number of sectors, including the automotive, electronics and appliance industries.

03 As shown in Table 1, nearly 51% of inflation can be attributed to increased transportation costs. The average annual increase of 28% in the price of gasoline alone is responsible for 42% of direct excess inflation.

Key points

- Direct energy costs account for more than 52% of the excess annual inflation that Canada has seen since the pandemic began. 05
- Corporate profits have risen much faster than wages and have contributed to the current inflation rate. 08
- The Government must act to protect household income, better regulate economic activity and accelerate the ecological transition. 20
- The Bank of Canada's interest rate hikes do not address the root causes of inflation, and workers will be the ones paying the price. 29

1 BANK OF CANADA, *Monetary Policy Report*, April 2022, p. 7.

Table 1

Contributions of Consumer Price Index (CPI) components to overall inflation, Canada (Q1 2020 to Q2 2022)

COMPONENT	SHARE OF TOTAL BASKET	AVERAGE ANNUAL INFLATION	CONTRIBUTION TO EXCESS INFLATION*	SHARE OF EXCESS INFLATION
Energy	6.27	24.9%	1.44%	52.3
Gasoline (transportation)	*4.28*	*27.7%*	*1.15%*	*42*
Food	15.94	4.6%	0.38%	13.8
Shelter (excluding energy)	26.23	4.5%	0.64%	23.5
Owned accommodation	*19.46*	*4.8%*	*0.57%*	*20.8*
Transportation (excluding gasoline)	11.84	4.1%	0.25%	6.6
Transportation (including gasoline)	*16.12*	*10.7%*	*1.40%*	*51.1*
Household furnishings and equipment	5.20	6.9%	0.35%	12.7
Other	29.48	1.5%	-0.24%	-9
Total	100	4.4%	2,56%	100%

* Difference between the average annual rate of inflation for the period and for 2010–2020.

SOURCE: Statistics Canada, Table 18-10-0004-01. Authors' calculations.

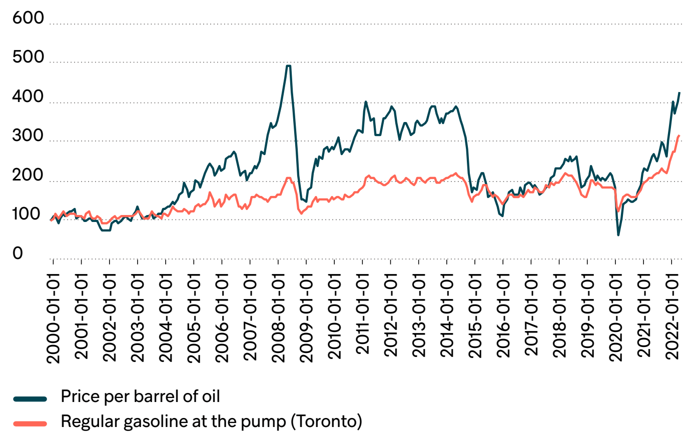
04 The second biggest contributor to excess inflation is shelter, particularly owned accommodation expenses, which alone account for 22% of excess inflation. Factors affecting housing affordability include speculation, the replacement of rental housing with tourist accommodations, and delays in social housing development.[2] Rising interest rates will also put additional strain on mortgage holders.

05 Home energy costs are responsible for 10% of current excess inflation. Taken all together, direct energy costs account for more than 52% of the excess annual inflation that Canada has seen since the pandemic began. This makes sense considering that oil and natural gas have experienced accelerating inflation: crude oil sat at a pre-pandemic price of around US$60 per barrel, but was selling for US$115 in June 2022, representing a staggering 92% increase.

06 High crude oil prices are partially to blame for the prices at the pump, which skyrocketed from $1.15 to a record high of $2.01 per litre of regular gas in June 2022. The other part of the puzzle is refining margins, which shot up 330% to 46 cents per litre in May 2022.[3]

Graph 1

Changes in price of oil per barrel (Brent) and price of gasoline in Toronto, 2000–2022



SOURCES: Statistics Canada, Table 18-10-0001-01; Federal Reserve Economic Data, *Crude Oil Prices: West Texas Intermediate (WTI)*. Authors' calculations.

07 The price of food, which has increased by an average of 4.6% since the pandemic, accounts for nearly 14% of excess inflation. The war in Ukraine has created challenges for the many countries that are dependent on imports of wheat, sunflower oil and fertilizer from Ukraine, further driving up agricultural prices already on the rise due to climate change. Take the droughts seen in Canada, the western US and Brazil last summer, for example, which led to smaller harvests in these major exporting countries.

Corporations posting record profits

08 One cause of inflation that does not appear in the Consumer Price Index data is corporate profits. While workers' wages have stagnated, corporations appear to have largely taken the high levels of inflation as an opportunity to raise their prices, raking in record profits and driving inflation higher.

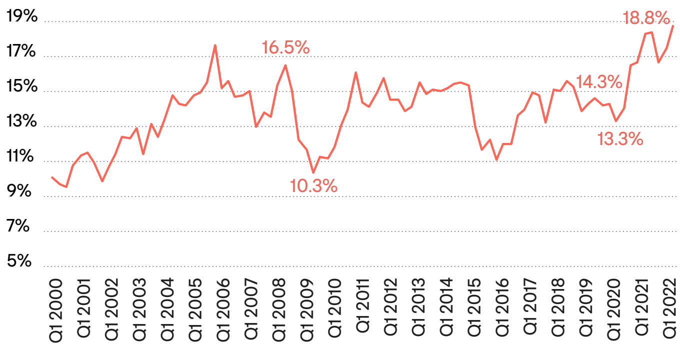
09 Graph 2 shows the growth in Canadian corporations' profits since 2000. In the first quarter of 2022, corporate after-tax profits hit an all-time high of 18.8% of GDP.

2 CANADA MORTGAGE AND HOUSING CORPORATION, *Canada's Housing Supply Shortages: Estimating what is needed to solve Canada's housing affordability crisis by 2030*, June 2022.

3 RADIO-CANADA, "Marge de raffinage et plafond pour l'essence," Zone Économie, May 17, 2022.

Graph 2

Corporate profits after tax as a percentage of GDP (1-year moving average)



SOURCE: Statistics Canada, Table 36-10-0103-01. Authors' calculations.

10 Corporate profits have increased by 1.8 percentage points in the last four quarters compared to the average for the five years prior to the pandemic. This means that corporations have made over $91 billion in additional net profits over the past year.

11 The commodity sector leads the pack with additional net profits of around $60 billion. The manufacturing sector saw a net profit increase of $9 billion, largely driven by wood and paper product manufacturing (+$6.2 billion). The retail sector has also enjoyed a boost in profitability, generating $14.2 billion in additional profits from October 2021 to March 2022. Food and beverage stores have more than doubled their profit margins, posting over $3.6 billion in additional profits, while the financial sector recently saw excess profits of $21 billion.

What is the best way to fight inflation?

Should we raise interest rates?

12 Some assert that the best way to beat back the flames of inflation is for the Bank of Canada to raise its policy interest rate. In fact, this course of action is already underway: from January to July 2022, the Bank hiked its key rate from 0.25% to 2.5%.

13 The idea behind hiking interest rates is to reduce demand for goods and services. When interest rates go up, economic activity slows on both fronts: businesses are less inclined to make investments, and consumers are more careful about how they spend their money.

14 The 1980s and 1990s were a lesson in the risks of this strategy, which can result in economic stagnation or a recession, producing bankruptcies and high unemployment.

15 Not only do higher interest rates hurt workers, they fail to address issues related to the global supply chain, the war in Ukraine and climate change.[4]

16 As well, by increasing unemployment, the central bank's policy threatens to deprive workers of the strong bargaining power (boosted by labour shortages) they can leverage to ensure their wages match or exceed inflation.

Should we cap pay raises?

17 First of all, the data show that recent wage increases are not a cause of inflation. In fact, increasing wages to keep pace with inflation is the most effective way to tackle problems caused by generally rising prices. Most households will not substantially feel the impacts of inflation if their pay stays on par with or ahead of the Market Basket Measure.

18 Indexing wages is therefore critical during a time of inflation. Wages can be indexed through bargaining (individual or collective), regulation (minimum wage legislation and government orders) and ripple effect from the public sector. The income of social assistance recipients and retirees must also be adjusted and compensated by the government to cover the spike in commodity prices, an increase that often exceeds the overall inflation rate.[5]

19 Some worry that increasing wages will trigger a spiral in which inflation drives up wages, in turning leading to higher inflation in the long term.[6] However, cost-of-living adjustments to wages have no long-lasting amplifying effect on inflation.[7] This makes sense, as wages are only one factor in production costs, alongside raw materials and components, capital financing, profit margins and productivity.

How can we address inflation without hurting workers and the most vulnerable people?

20 Inflation must be taken as yet another sign that we need to accelerate the energy transition, fight the unproductive concentration of wealth and lower certain regressive prices.

REDUCING BOTH ENERGY COSTS AND GREENHOUSE GAS EMISSIONS

21 Rising prices always make changes to our consumption patterns more attractive. Soaring gas prices should be used to incentivize people to choose public transit, carpooling and active modes of transport more often, slow down when driving, and reconsider the use of motorized recreational vehicles.

22 Governments have a central role to play in changing consumer behaviours. They should work to quickly expand public transit networks across the country and consider making public transit free. These initiatives would help alleviate the impact of rising energy costs while also reducing greenhouse gas emissions.

4 While raising interest rates may put downward pressure on housing prices, mortgage rates will be driven up, meaning anyone who owns a home will be forced to make higher payments.

5 Pierre-Antoine HARVEY and Minh NGUYEN, *L'inégalité face à l'inflation*, socio-economic report, Institut de recherche et d'informations socioéconomiques, June 17, 2020.

6 Frederic BOISSAY et al., "Are major advanced economies on the verge of a wage-price spiral?" *BIS Bulletin*, May 4, 2022.

7 Francis VAILLES, "Une mauvaise bonne nouvelle," *La Presse*, June 11, 2022.

23 The surge in red meat prices since the start of the pandemic (7% per year on average) is another incentive to rethink what we eat. Red meat is the most water- and energy-intensive source of protein to produce and the biggest contributor to agricultural pollution. Alternatives to red meat are widely available and should be promoted.

24 The government of Sweden has made home appliance repairs tax-deductible in a bid to fight waste and overconsumption. Canada could introduce similar measures.

PUTTING DOWNWARD PRESSURE ON CORPORATE PROFIT MARGINS

25 Measures should be taken to limit corporations' ability to raise their prices without fear of competition, such as increasing industry oversight and fighting price-fixing.

26 Governments can also support investments and nurture start-ups to help create a diverse base of producers and distributors, and may want to consider nationalizing industries that are practically natural monopolies or essential services (internet services, oil refining, child care, food services in public institutions, etc.).

27 The Canadian government could also take a page out of the UK's book and impose a tax on oil companies making excess profits, as the UK did earlier this spring.[8] In addition to discouraging some of the "greedflation" rearing its head in the oil industry, the tax revenue could be reinvested to offset Canadian consumers' lost purchasing power.

IMPOSING PRICE CONTROLS

28 Another option for governments is to consider imposing price controls, as they have done in past crises. This would help curb inflation and decrease profit margins. Governments could offset overall inflation by lowering the rates and prices under their control (e.g., hydroelectricity rates, payroll contributions, child care fees), or even eliminating some of them (e.g., public transit fares).

With inflation on the rise, monetary authorities have two choices

29 The Bank of Canada's monetary policy is not neutral: it creates winners and losers. By choosing to hike interest rates that will cause the economy to slow down (and unemployment to rise), the Bank of Canada is asking workers and non-financial small businesses to absorb the costs of its anti-inflation measures. Meanwhile, creditors benefit directly from higher interest rates, as the future value of their assets is protected.

30 A strategy that is tolerant of moderately high inflation offset by an equivalent increase in income, on the other hand, will have little impact on workers, retirees and social assistance recipients. With this strategy, it is the wealthy and creditors who would be adversely affected by higher inflation, as the relative value of their assets and loans and the actual return they make would be lower.

31 In other words, by causing interest to raise, the Bank of Canada is transferring wealth to the wealthiest in our society. It might even cause a recession that will hit most Canadians hard.

32 It is those Canadians who need protection in the form of wage and social benefit indexing. Contrary to what some assert, these measures will not trigger an inflationary spiral. There are also a number of prices that governments could either freeze or eliminate altogether.

33 Governments cannot wait any longer to address the root causes of the inflationary trend taking hold: supply chain disruption, higher food and fossil fuel prices, rising housing costs, and excess profits made by some corporations. It is time to take action by accelerating the energy transition, reassessing how the real estate market is regulated, and reining in excess corporate profits.

8 Andrew JEONG, "U.K. imposes windfall tax on oil and gas company profits as inflation bites," *The Washington Post*, May 27, 2022.