FEBRUARY 2023

The State of The Canadian Economy & Inflation

Report of the Standing Senate Committee on Banking, Commerce and the Economy

The Honourable Pamela Wallin, Chair
The Honourable Colin Deacon, Deputy Chair

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THE COMMITTEE MEMBERSHIP

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Chair

The Honourable
Colin DEACON
Deputy Chair

The Honourable Senators

Diane Bellemare

Clément Gignac

Tony Loffreda

Elizabeth Marshall

Paul J. Massicotte

Donald Neil Plett

Pierrette Ringuette

Larry W. Smith

Yuen Pau Woo

Hassan Yussuff

Ex-officio members of the committee:

The Honourable Senator Gold and/or Gagné

The Honourable Senator Plett and/or Martin

Other Senators who have participated in the study:

The Honourable Senator Duncan

The Honourable Senator Marwah

The Honourable Senator Moncion

Parliamentary Information and Research Services, Library of Parliament:

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Senate Communications Directorate:

Ben Silverman, Communications Officer

ORDER OF REFERENCE

Extract from the *Journals of the Senate* of Thursday, December 16, 2021:

With leave of the Senate,

The Honourable Senator Wallin moved, seconded by the Honourable Senator Quinn:

That the Standing Senate Committee on Banking, Trade and Commerce be authorized to study matters relating to banking, trade and commerce generally, as described in rule 12-7(8); and

That the committee submit its final report no later than June 30, 2023, and that the committee retain all powers necessary to publicize its findings until 180 days after the tabling of the final report

The question being put on the motion, it was adopted.

Gérald Lafrenière

Interim Clerk of the Senate

EXECUTIVE SUMMARY AND COMMITTEE OBSERVATIONS

From September 22 to December 1, 2022, the Standing Senate Committee on Banking, Commerce and the Economy (the committee) conducted a comprehensive study on the state of the Canadian economy and inflation.

The committee heard from the Governor and Senior Deputy Governor of the Bank of Canada, former governors of the Bank of Canada and the Bank of England, the Parliamentary Budget Officer, professors of economics, bank economists, as well as representatives from the Competition Bureau Canada, the Institute of Fiscal Studies and Democracy, the Canada West Foundation, the Centre for Future Work and the Centre for the Study of Living Standards.

Witnesses expressed wide-ranging views on the various factors contributing to Canada's high inflation. The committee highlights that there were at least nine points of consensus among most of the witnesses:

- The tightening of monetary policy is justified.
- The situation now also reflects excess demand as inflation is now largely driven by domestic factors and not just forces such as supply chain constraints.
- Spending should be constrained and more targeted.
- Rising interest rates are beginning to affect economic growth and growth is expected to slow. However, there is no consensus on the severity of the slowdown and its duration.
- Rising interest rates could exacerbate the housing issues in Canada.
- There is no evidence of a wage spiral in Canada.
- Greater participation in the labour market would help reduce labour shortages.
- The depreciation of the Canadian dollar against the U.S. dollar could increase inflation through import prices.
- Increased competition is an important way to fight inflation in the long-term.

Other issues received more debate, such as the relationship between money supply, inflation and the economy.

While the general observation of witnesse has been that central banks that engaged in quantitative easing and national governments that rolled out extensive financial

support and recovery packages throughout COVID-19 were doing the right thing, there has been a growing sense that these policies may have been too aggressive or too generous. In the slow return to normalcy, central banks around the world are gripped with troubling inflation rates and are now employing measures to get inflation back under control – first by rapidly raising interest rates and now with smaller increases while they wait and see if it is working.

The causes of inflation affecting Canada are many – both domestic and foreign - and there are conflicting views as to whether the government and its institutions either overestimated or underestimated the compounding effects of various market forces, global events, and policies and tools they rolled out. The slow withdrawal of COVID-19 supports was widely seen as an early contributor to inflation. What is evident is the need for enhanced Parliamentary oversight over the deployment of fiscal and monetary tools, particularly in times of crisis and uncertainty.

Stemming from this, the committee also observes that:

- the Bank of Canada should be more transparent and periodically make public its assessment of the effect of its interventions on inflation and on the evolution of key economic indicators;
- government's total spending should be constrained and its investment should be more targeted; and
- business investment is an important driver of productivity and living standards.

It is yet to be seen if our inflationary crisis could have been avoided if we knew then what we know now about the public health emergency and the contingent effects of stimulus and support spending. The massive increase in money supply and central banks' assertion that inflation was transitory fueled more debate. This is a clear signal for the committees in both chambers whose mandate it is to monitor and study the fiscal and monetary environment that they must continue to be more diligent in their work. Furthermore, contemporary and future budgets must address the prolonged problems of underinvestment in Canada and our competitiveness abroad.

INTRODUCTION

> *Even if Canada were to enter into a recession, with the state of the labour market right now, I don't think it would be a recession à la 1982, where we saw massive layoffs and unemployment spiking. I think a recession, if it were to happen, it would be relatively painless, so to speak, compared to other recessions.*
>
> Yves Giroux, Parliamentary Budget Officer.[1]
>
> *The potential to get it wrong is pretty significant. There is real risk, a significant probability of something that is worse than short and shallow in terms of recession, that's worse than even the downside scenario that Minister Freeland put in her Fall Economic Statement.*
>
> Kevin Page, President and CEO of the Institute of Fiscal Studies and Democracy.[2]

In discussing the Bank of Canada's efforts to bring inflation back to target, several witnesses spoke about the risk of a recession.

Tiff Macklem, the Governor of the Bank of Canada, noted that it is increasingly evident that the higher interest rates are beginning to weigh on economic growth, especially interest rate-sensitive parts of the economy like housing and spending on big-ticket items (e.g. cars and appliances). According to Mr. Macklem, the effects of higher interest rates will take time to spread through the economy.

Mark Carney, Vice Chair of Brookfield Asset Management Inc. and Head of Transition Investing and former governor of the Bank of Canada and Bank of England, told the committee that a recession is likely, both globally and in Canada, although there are some uncertainties about the exact timing. China, Europe and the United Kingdom are effectively in recession, the United States will likely be in a recession at some

[1] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 27 September 2022 (Yves Giroux, Parliamentary Budget Officer).

[2] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 1 December 2022 (Kevin Page, President and CEO of the Institute of Fiscal Studies and Democracy).

point next year, and Canada will likely experience a few quarters of negative economic growth. Talking about the sharp reaction of financial markets to the U.K. government's mini-budget, Mr. Carney also explained that in the current environment of coordinated monetary policy tightening there will be rising tensions between various macroeconomic objectives: monetary policy and fiscal policy, financial stability and price stability, price stability and currency integrity in Europe, price stability and growth in emerging markets, internal and external balances in Japan.

Kevin Page, President and CEO of the Institute of Fiscal Studies and Democracy, told the committee that the stage is set for the third global economic shock in less than 15 years – the 2008 global financial crisis, the 2020 global pandemic and possibly the 2023 global recession to fight high inflation. According to Mr. Page, this upcoming recession is a self-inflicted recession in many ways because the Bank of Canada and other central banks are increasing interest rates to deliberately take demand pressure out of their economy in order to reduce inflation. In this environment, the potential to make a monetary policy mistake is very significant because interest rate increases take time to affect the economy and the short-term outlook is very uncertain.

After commending the Minister of Finance for presenting a downside scenario in the Fall Economic Statement 2022, Mr. Page argued that the government should, however, have included its policy response to the downside scenario. According to Mr. Page, the government should prepare for the upcoming recession, help vulnerable people, protect economic capacity, restore macroeconomic stability, and launch a post-pandemic policy agenda to promote competitiveness, sustainability, inclusion and resilience.

John Greenwood , Chief Economist, International Monetary Monitor Ltd., warned that in the United States there is a risk of a more severe recession and higher unemployment than necessary to reduce the U.S. inflation rate because the Federal Reserve stepped too hard on the accelerator during the pandemic with 18% average broad money growth, and is now steping too hard on the brake with sharp interest rate increases and quantitative tightening, which have reduced broad money growth to almost zero in the United States. Mr. Greenwood also noted that the Bank of

England plans to reduce the size of its balance sheet by £80 billion in the next 12 months, which means that broad money growth could also decline significantly in the U.K. if banks do not lend more money to counteract this decline in broad money growth.

Steve Ambler, Associate Professor, Université du Québec à Montréal, argued that the Bank of Canada has to be careful not to overtighten its monetary policy because month-over-month inflation data – which gives a better idea of where inflation is headed than annualized monthly inflation data – suggests that inflation is moving down rapidly towards 3%. Mr. Ambler also recommended that the Bank of Canada stop its interest rate increases to assess their full effects on the economy because he believes that increasing interest rates above 4.25 % would increase the risk of recession.

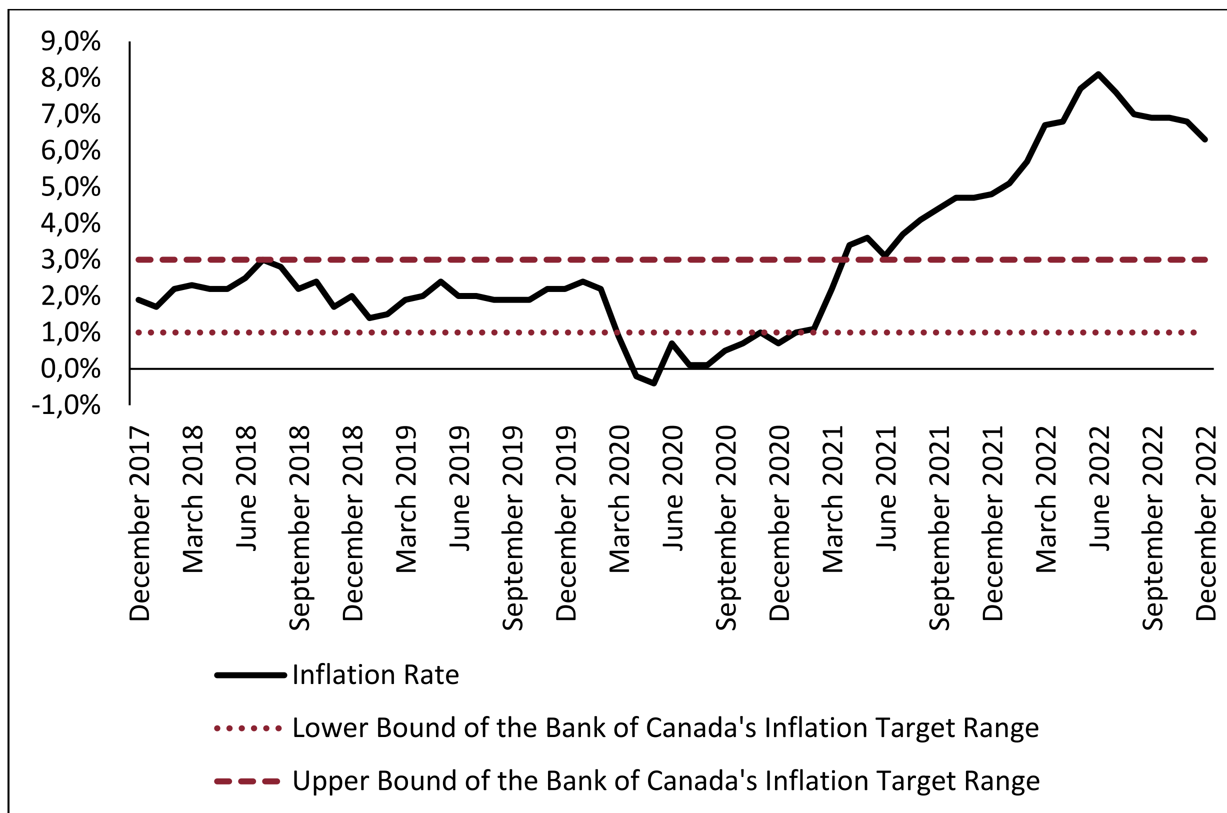
OVERVIEW OF THE STATE OF THE CANADIAN ECONOMY AND INFLATION

High and Persistent Inflation

Inflation in Canada and the G20

As shown in Figure 1, Canada's inflation rate evolved within the Bank of Canada's inflation target range of 1% to 3% during the December 2017 to March 2020 period, but decreased below 1% between April 2020 and February 2021 because of the COVID-19 pandemic. The inflation rate then briefly returned to 2.2% in March 2021 before rising above 3% in April 2021 up to a peak of 8.1% in June 2022. As of December 2022, the inflation rate had decreased to 6.3%.

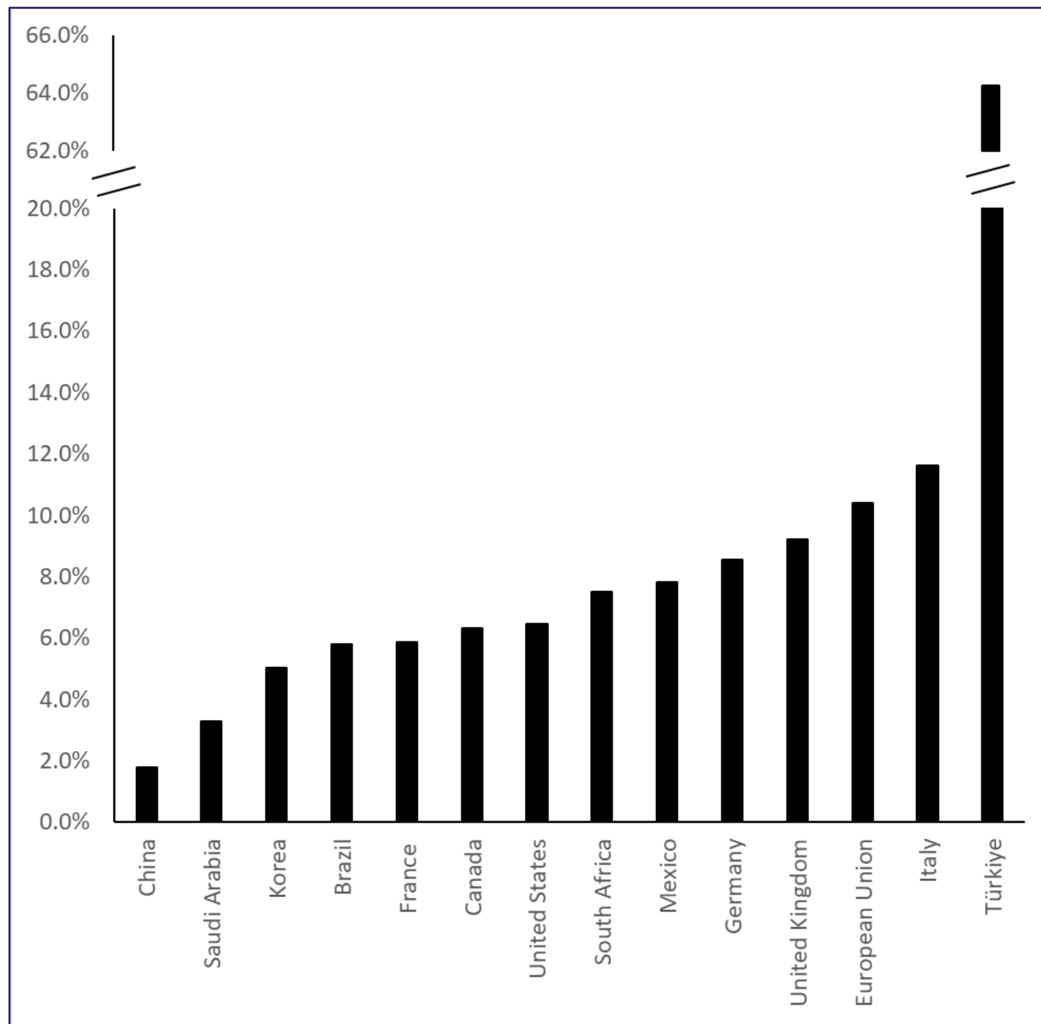
Figure 1 – Inflation Rate, Canada, December 2017 to December 2022 (%)



Source: Figure prepared by the Library of Parliament using data from Statistics Canada, The Daily, *Consumer Price Index, December* 2022, Chart 1.

Figure 2 shows that Canada had the 6th lowest inflation rate in December 2022 among the 14 Group of Twenty (G20) countries for which the OECD published data. For their part, the United States and the United Kingdom ranked 7th and 11th, respectively.

Figure 2 – Inflation Rate, G20, December 2022 (%)



Note: The Organisation for Economic Co-Operation and Development did not publish data for Argentina, Australia, India, Indonesia, Japan and Russia.

Source: Figure Prepared by the Library of Parliament using data from the Organisation for Economic Co-Operation and Development, *Inflation (CPI)*, accessed on 20 January 2022.

Homegrown Inflation

> *When you look across the CPI basket, 80 or 90% of individual components are running at 3% or higher right now as well. The breadth tells you that this is not, and never has been, a transitory shock to the economy that came from outside. This was excess demand in the economy.*
>
> Robert Kavcic, Senior Economist and Director, Bank of Montreal.[3]

Domestic Fiscal Stimulus

Jack Mintz, President's Fellow, University of Calgary's School of Public Policy, explained that inflation was caused by a combination of supply shocks (e.g., health restrictions, supply chain bottlenecks, energy and labour shortages) and government deficits, accommodated by a sharp increase in the money supply. According to Mr. Mintz, it is easy to attribute the rise in domestic inflation to external factors only, but these external factors do not explain inflation differences across countries. For example, China, Japan, Switzerland and Saudi Arabia have inflation rates below 4% although they have faced the same external factors as other countries with much higher inflation rates. This means that other factors, including government fiscal deficits and accommodative monetary policy, also played a significant role in affecting the level of inflation in Canada.

> Mr. Mintz and Mr. Carney said that the government could provide very targeted and temporary support to vulnerable Canadians, but they stressed that it is counterproductive for fiscal and monetary policies to work at cross purposes. Simply put, "if one foot is on the brake with monetary policy, it's foolish for the other to stomp on the gas."[4]

[3] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 25 October 2022 (Robert Kavcic, Senior Economist and Director, Bank of Montreal).

[4] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 20 October 2022 (Mark Carney, Vice-Chair of Brookfield Asset Management Inc. and Head of Transition Investing).

Mr. Page told the committee that the deficit of about 1.5% of the gross domestic product (GDP) for 2022–2023 is not a major inflation concern because he believes that the economy is operating below trend and seems to be headed for a slowdown. That said, Mr. Page stressed that the government should not be launching major structural programs or new long-term programs financed by deficits. It is important for the government's fiscal policy to continue towards smaller deficits as the economy closes its output gap (i.e., the gap between potential output and current output). Mr. Page also said that the measures announced in the *Fall Economic Statement 2022* for vulnerable people (e.g., doubling of the Goods and Services Tax credit, helping students with interest debt and supporting the energy transition) are modest and not inflationary. Mr. Page argued that we have to support the energy transition towards lower CO_2 emissions whether we have inflation or not.

With respect to federal human resources spending, Mr. Page told the committee that it is difficult to reconcile the rapid and broad-based growth in human resources spending across federal departments that started in 2015 and accelerated since the pandemic, with the government's spending plan for the next five years. According to Mr. Page, the government should publish a long-term human resources plan embedded in its long-term spending plan and broken down by department and type of employee (i.e., full-time and part-time) because the basic data currently published by the Treasury Board of Canada Secretariat and the Clerk of the Privy Council is not embedded into the government's long-term spending plan. Parliament and Canadians need this plan to hold the government to account and assess whether the federal government has the public service that it needs to facilitate Canada's energy transition, promote competitiveness, and help municipalities, provinces, territories and Indigenous people to deal with these questions of resilience.

Mr. Ambler highlighted that federal spending increased by 73% in 2020–2021 and will remain 27% higher in 2022–2023 than in 2019–2020. Mr. Ambler also stressed that there has also been a permanent increase in the ratio of federal spending to GDP growth, which is now well above the empirical range of 15% to 25% of GDP where the contribution of government spending to GDP growth peaks and becomes negative.

Mr. Carney said that the government's considerable fiscal support package was necessary during the depths of the pandemic. However, in hindsight, it went on a little longer than was strictly necessary, which added to inflationary pressures.

Trevor Tombe, Professor of Economics, University of Calgary, noted that the income supports provided by governments during the pandemic increased demand for goods and services, and may therefore potentially have been a source of inflationary pressure.

Jim Stanford, Economist and Director, Centre for Future Work, argued that there is no connection between the size of a country's deficit and its rate of inflation. For example, Japan had a bigger deficit than Canada, but a lower inflation rate, while Germany had a smaller deficit than Canada, but a higher inflation rate. He also remarked that the overall impact of fiscal policy is not inflationary because the government's deficit has been shrinking rapidly due to the phasing out of COVID-19 supports.

Furthermore, Mr. Stanford suggested that fiscal policy could play a more important role in the fight against inflation, along with labour market and social policies.

Domestic Monetary Stimulus

> *The central bankers don't want to talk about the money supply, and they want to claim that everything under the sun causes inflation but the money supply. The reason for that is because they are the ones responsible for the growth in the money supply. If it gets out of control, and you have inflation, they don't want to be blamed for it.*
>
> Steve Hanke, Professor of Applied Economics, Johns Hopkins University.[5]
>
> *The increase in the money supply was not primarily because of the Bank of Canada's asset purchases. The increase in the money supply was because private bank lending ended up being more resilient than expected, in part because of this huge and ultimately unsustainable boom in mortgage lending.*
>
> Jim Stanford, Economist and Director, Centre for Future Work.[6]

Mr. Macklem predicted that the inflation rate will fall from 7% in the final quarter of 2022 to around 3% by the end of 2023 before returning to the Bank of Canada's 2% target by the end of 2024.

Asked about the extent to which the Bank of Canada monitors the growth rate of the money supply, Mr. Macklem responded that the Bank of Canada examines many statistics, including the growth rate of the money supply. If the Bank of Canada sees that Canadians have more money, it will expect them to want to spend more money on goods and services. Mr. Macklem then explained that he used to monitor the money supply every week when he began his career as an economist, and that during that time his colleagues and him learned that the relationship between money supply, inflation and the economy is not consistent over time. Furthermore, central banks' 1970s attempts to target the rate of growth in the money supply were a failure.

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[5] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 20 October 2022 (Steve Hanke, Professor of Applied Economics, Johns Hopkins University).

[6] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 29 September 2022 (Jim Stanford, Economist and Director, Centre for Future Work).

Mr. Greenwood told the committee that the Governor of the Bank of Canada's testimony about the relationship between the money supply and inflation was disingenuous because the average rate of growth of the broad money measure M3 in Canada during the decade of 1972 to 1981 was 17.4%. This represents almost three times the ideal rate of 6% needed to keep inflation under control. According to Mr. Greenwood, this lack of monetary control explains why inflation averaged 9.6% per year during the 1973 to 1982 period.

Mr. Macklem acknowledged that the Bank of Canada should have started to raise interest rates in 2021 if it knew everything that it knows today. Mr. Macklem also recognized that the central banks of many emerging countries like Brazil and Mexico had been more proactive than the Bank of Canada and other major central banks in raising their interest rates at the first signs of global inflationary pressures because they did not have the same credibility based on a long history of low and stable inflation. However, Mr. Macklem stressed that the Bank of Canada was among the first major central banks to unwind its quantitative easing program in April 2021 and one of the major central banks that increased its interest rates the most rapidly. According to Mr. Macklem, the fact that Canada's inflation rate is among the lower half of the distribution of countries is related to how rapidly the Bank of Canada unwound quantitative easing and increased interest rates compared to other major central banks.

Asked whether the Bank of Canada's quantitative easing program was created to finance the government's COVID-19 deficits and whether there has been a clear distinction between monetary policy and fiscal policy since the introduction of this program, Mr. Macklem responded that the distinction between monetary policy and fiscal policy has always been very clear in his mind and that quantitative easing "is just another way of lowering interest rates." According to Mr. Macklem "there's

nothing kind of special about [quantitative easing] in this whole thing. It's part of the package."[7]

In response to questions about the Bank of Canada's operating losses, Mr. Macklem explained that the Bank of Canada will experience operating losses this year and over the next three years because of interest rate mismatches between its liabilities and assets. Carolyn Rogers, Senior Deputy Governor of the Bank of Canada, also explained that the indemnity agreements[8] between the Bank of Canada and the federal government cover market-to-market losses related to the Bank of Canada's quantitative easing program, but not interest rate mismatches. For the third quarter of 2022, the Bank of Canada experienced a comprehensive loss of $522 million.[9] In addition, in 2020-2021, "the government recorded net losses totalling $19 billion in respect of the Bank's purchases of Government of Canada bonds. This net loss is recorded as part of Other revenues – enterprise Crown corporations and other government business enterprises on the Consolidated Statement of Operations and Accumulated Deficit." [10] This loss was covered by the indemnity agreements that Ms. Rogers mentioned in her testimony.

Mr. Greenwood pointed out that the Governor of the Bank of Canada's testimony suggesting that quantitative easing is just another way of lowering interest rates, failed to mention that the Bank of Canada's government bond purchases directly increased M3, which accelerated from 7.8% in January 2020 to 16.3% by June 2020 and remained at an elevated 12% level until February 2021. According to Mr.

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[7] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 1 November 2022 (Tiff Macklem, Governor, Bank of Canada).

[8] According to the Bank of Canada, "During the second quarter of 2020, indemnity agreements with the Government of Canada were put in place so that we could support the provincial, corporate and Government of Canada bond markets. If the Bank decides to sell assets, any losses resulting from these sales within the Government Bond Purchase Program, Provincial Bond Purchase Program, Provincial Money Market Purchase Program, Commercial Paper Purchase Program and Corporate Bond Purchase Program are indemnified by the federal government. Gains on disposal are remitted to the government." See Bank of Canada, *About the Bank of Canada's balance sheet*, 10 September 2021.

[9] Bank of Canada, *Quarterly Financial Report – Third Quarter of 2022*.

[10] Receiver General for Canada, "Section 1—Financial statements discussion and analysis," *Public Accounts of Canada 2021: Volume I*, p. 18.

Greenwood, this increase in M3 is directly responsible for Canada's inflation problem – not the supply chain bottlenecks or the energy and food price increases to which many people attribute the rise in inflation. Mr. Greenwood then recommended that a 6% M3 growth rate target within a range of 3% to 9% be added to the Bank of Canada's legislative mandate.

Jean-François Perrault, Senior Vice-President and Chief Economist, Scotiabank, told the committee that he does not for a second believe that the Bank of Canada has been politically influenced, but he acknowledged that some people believe so. According to Mr. Perrault, the Governor of the Bank of Canada has been independent, and his mistakes were not political in nature. For his part, Pierre Fortin, Emeritus Professor of Economics, University of Quebec at Montreal, declared that the Governor of the Bank of Canada was right to avoid the risk of killing jobs with what would have been a costly increase in interest rates with no benefit had inflation quickly disappeared like it did in 1971, 1991 and 2003 without any need for central bank intervention.

With respect to the link between the government's deficits, the Bank of Canada's quantitative easing and inflation, Mr. Greenwood explained to the committee that there are only three ways to finance a government deficit: raising taxes, borrowing money from the private sector or printing money. When a government finances its deficit by either raising taxes or borrowing money from the private sector, the government has more money to spend on goods and services, while the private sector has less. However, when the government finances its deficit by printing money – i.e., the central bank finances the government deficit through a more rapid increase in the rate of growth of the money supply – both the government and the private sector have more money to spend on goods and services, which increases inflation. Steve Hanke, Professor of Applied Economics, Johns Hopkins University, provided a similar explanation when he said that there would not have been inflation had the government sold its bonds to the public rather than the Bank of Canada, which would likely have requested significantly higher interest rates. When a central bank finances government deficits through a more rapid expansion of the rate of growth of the money supply, the deficits are monetized.

Asked why foreign central banks' quantitative easing programs did not generate inflation in 2008, Mr. Hanke and Mr. Greenwood explained that unlike 2008 when bank lending was constrained because banks needed to recapitalize their balance sheets and faced more stringent banking regulations, during the 2020 pandemic, bank lending was strong and the additional central banks' money creation through quantitative easing and long-standing low interest rates led to the excessive production of money that created the current inflation problem.

Mr. Hanke deplored that everyone is looking for the causes of inflation in the wrong places (e.g., the COVID-19 pandemic, supply chain bottlenecks, the Russian invasion of Ukraine). According to Mr. Hanke, inflation is, always and everywhere, only caused by one factor: an excessive growth in the money supply. For example, he explained that he recently finished a study on 157 countries from 1990 to 2021 that found an almost perfect one-to-one relationship between the rate of growth of the money supply and the rate of growth of inflation. Moreover, Mr. Hanke informed the committee that according to his calculations the Bank of Canada contributed to 46% of the broad money supply since 2020 compared to only 3% during the 2010 to 2020 period. Like Mr. Greenwood, Mr. Hanke suggested that the Bank of Canada should only allow the money supply to grow at a rate of around 6% or 7% per year in order to consistently meet its inflation target of 2%.

Mr. Hanke also pointed out that inflation is a very regressive tax that mostly affects low-income people whose income is fully subject to inflation because they spend their entire income on goods and services. On the other hand, high-income people generally benefit from inflation because they own stocks, real estate properties and commodities that tend to increase in value many months before inflation starts to increase. According to Mr. Hanke, the lags between money supply growth rate increases and asset price increases range from one to nine months compared to 12 to 24 months for inflation increases.

Mr. Ambler argued that the money supply is a poor predictor of inflation when inflation is close to target and stable, but a much better predictor when inflation is high and highly variable as is currently the case. According to Mr. Ambler, annualized

3-month growth of broad money measures M1++ and M2++[11] both predict that inflation will drop soon. Mr. Ambler also explained the relationship between the government's deficits, the Bank of Canada's quantitative easing program and the rapid expansion of the money supply as follows:

- Government transfers were financed by deficits;
- The Bank of Canada purchased newly issued government bonds;
- Government's deposits at the Bank of Canada increased and the Bank of Canada's holdings of government bonds increased;
- The government used its new deposits at the Bank of Canada to provide transfers to households and firms;
- Government's deposits at the Bank of Canada decreased, settlement balances (called central bank reserves in other countries) increased[12], and deposits in the banking system increased.

Asked whether money supply growth is a factor of inflation, Robert Kavcic, Senior Economist and Director, Bank of Montreal, responded that the textbook explanation for inflation – too much money chasing too few goods and services – has merit and likely contributed to inflation given that all major central banks simultaneously introduced quantitative easing programs to support liquidity in the financial system. However, Mr. Kavcic suggested that money supply growth may not be the most prominent of the different factors affecting inflation.

Shelter Cost Increases

Mr. Tombe mentioned that shelter cost increases were the second-largest contributor to rising inflation after energy price increases. According to Mr. Tombe,

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[11] For definitions of the monetary aggregates M1++ and M2++ see Bank of Canada, *Monetary aggregates*.

[12] Settlement balances are interest-bearing deposits held at the Bank of Canada that belong to participants of Canada's payment system.

there would likely not have been such a rapid increase in home prices during the pandemic had municipal and provincial policies facilitated an increased supply of housing to meet the significant increase in demand.

Mr. Carney said that we could see evidence that most of the inflation was now homegrown by looking at the excess demand in the housing sector. Mr. Stanford identified what he called the housing bubble, as a key source of recent inflation. Mr. Stanford also noted that although home prices have started to decline recently, housing inflation could continue to increase because Canada's Consumer Price Index takes account of housing through the cost of servicing a mortgage rather than the price of the home. Similarly, rents which tend to increase when interest rates increase, could also increase housing inflation.

Mr. Kavcic explained that as the housing market weakened because of the higher interest rates, the rental housing market strengthened because landlords were easily able to increase rents to passthrough their higher property carrying costs to tenants given the persistent undersupply of quality rental stock in Canada and the record immigration increase into Canada in 2022. These immigrants included many students and non-permanent residents who are typically renters.

Pent-up Consumer Demand for Services

Mr. Macklem commented that with the economy now fully reopened, service prices are rising rapidly because households want to enjoy many of the close-contact services that they have missed during the lockdowns, but businesses cannot keep up with this strong and sudden rise in demand for services.

Mr. Carney underscored that although global factors contributed to the beginning of the rise in inflation, most of the inflation is now homegrown. For example, we can see this by looking at the service sector, particularly the pent-up demand for services that all Canadians have experienced. According to Mr. Carney, the Bank of Canada is right to tighten its monetary policy to reduce inflation by removing this excess demand in the Canadian economy.

Higher Profits in Less Competitive Sectors

Mr. Stanford told the committee there has been an increase in profits in several sectors of the economy – grocery store chains, telecommunications, banking, energy – and that there is evidence that company profits in Canada have widened during the current inflationary period to their highest share of GDP to date. In his view, this suggests that companies are exerting their market power to take advantage of supply chain disruptions and strong consumer spending.

Ms. Rogers said that profit margins in the private sector have held steady, which indicates that companies are passing on their increased costs to their customers. She pointed out that this happens and is sustained in an environment where there is excess demand and less competitive forces.

To address excess profit taking, Mr. Stanford advocated for a tax on excess profits, which could be applied on profits above a certain threshold rate of return, and that those tax revenues be used to support lower-income Canadians. According to Mr. Stanford, this measure has been used in several European countries and the United Kingdom for businesses in the energy sector.

Global Factors Exacerbating Inflation in Canada

Global Supply Chain Bottlenecks

Mr. Macklem said that Canadians who could not consume any of the services they wanted because of the COVID-19 pandemic and lockdowns substituted these services for goods. They could not go to the gym, so they bought home exercise equipment. They were spending more time at home, so they bought a new television or a new computer. Mr. Macklem then explained that the global supply chains that had been impaired by the COVID-19 pandemic could not meet the strong global demand for goods, which initially increased the prices of goods and inflation in Canada and other countries.

Mr. Kavcic noted that when people were locked down during the early stages of 2020 they renovated their houses, bought goods like exercise bikes and televisions, which led to a dramatic increase in the global demand for goods. For example, there was a $300 billion increase in U.S. consumer spending on goods compared to the pre-pandemic baseline. According to Mr. Kavcic, there is no supply chain in the world that would have been able to satiate such a dramatic and sudden increase in demand. Simply put, throughout the pandemic, many years' worth of demand was compressed into a very short period of time, all that demand came onto the market at a time when there was no additional supply, and the relief valve for this major imbalance between global demand for goods and supply was inflation.

Yves Giroux, Parliamentary Budget Officer, told the committee that closing many segments of the economy and then gradually reopening and lifting restrictions on the movement of individuals, as well as some goods, created severe disruptions in the economy. At the same time, there were disruptions in the supply of these goods, notably with the closing down of some factories in China due to lockdowns. According to Mr. Giroux, supply chain bottlenecks are a combination of supply disruptions and strong demand that was supported by government support measures.

Mr. Tombe acknowledged that it is difficult to perfectly separate supply and demand-related causes of inflation because they are interrelated. For example, the individuals who received government transfers during the pandemic probably purchased more physical goods given the shift away from services and, to a lesser extent, services than they would have otherwise. This may have stretched the capacity of ports and supply chains around the world.

Mr. Stanford argued that disruptions in supply chains, difficulties in international transportation, and the reallocation of consumer spending from services to goods contributed to the acceleration in inflation.

Energy and Food Price Increases

> Mr. Tombe indicated that energy was the largest contributor to inflation and that 60% of non-energy inflation was due to items that historically are sensitive to oil prices, such as groceries, flights, and restaurant meals.

Mr. Stanford also felt that the largest single source of inflation in Canada was the increase in the price of petroleum products. He further explained that changes in global oil prices do not necessarily reflect changes in global oil supply, but that expectations in the oil market can drive spikes in energy prices. He underscored that gasoline refined from oil produced in Canada and distributed in Canada is affected by global oil prices. Mr. Macklem said that the Bank of Canada does not typically raise interest rates as global oil prices rise, given that global oil prices fluctuate; however, the energy supply issues, coupled with the Russian invasion of Ukraine, ended up being a more persistent problem than originally thought, and in hindsight, the Bank might have acted earlier to reduce inflation.

Mr. Tombe, Mr. Kavcic, and Mr. Macklem noted that the prices for oil and various resources have eased from their peaks in June 2022, when inflation was just over 8%. Ms. Rogers and Mr. Macklem also pointed out that transportation costs for companies are declining and that the data indicates that shipping costs and delivery times are improving as well.

Witnesses also spoke also about the energy price shock that occurred after the Russian invasion of Ukraine. Mr. Kavcic highlighted that before the Russian invasion of Ukraine inflation was well above target, and that the invasion added to the existing inflationary pressures through supply restrictions. Mr. Hanke argued that the sanctions that the West imposed on Russia after the invasion, including restricting the importation of Russian oil and gas into Europe, disrupted the international oil market and caused energy prices to increase. According to Mr. Tombe, Mr. Kavcic and Mr. Greenwood, energy and food-related supply-side disruptions were experienced by many countries, and these prices are beyond the control of the Bank of Canada.

With respect to energy, Mr. Hanke argued that oil price increases do not cause inflation in themselves. For example, the Bank of Japan accommodated the 1973 oil price shock by allowing the money supply to grow more rapidly to ease the pain on the Japanese economy and inflation rose as a result. However, during the 1979 oil price shock, the Bank of Japan decided not to accommodate those oil price increases, and inflation did not rise.

As a quicker way to lower inflation, Mr. Stanford offered that the government should consider implementing price controls on petroleum products.

Global Fiscal and Monetary Stimulus

David Dodge, Senior Advisor at Bennett Jones LLP and former governor of the Bank of Canada, told the committee that the pandemic created huge global supply shock in the spring of 2020, and that governments and central banks around the world responded appropriately in the spring of 2020 with extraordinary fiscal and monetary support. With respect to the effect global fiscal and monetary stimulus had on Canada, most witnesses discussed the effect of U.S. fiscal and monetary policy decisions on Canada.

> Mr. Perrault stated that two-thirds of the increase in Canadian inflation that has occurred since the end of 2019 is due to international factors, including U.S. inflation. Mr. Mintz told the committee that the very large fiscal stimulus in the United States not only increased U.S. inflation but Canadian inflation as well, since countries tend to import inflation from other countries with which they trade.

Mr. Macklem explained that if the United States and other countries were able to control their inflation, the Bank of Canada would not have to tighten its monetary policy as much as it would otherwise need to bring Canada's inflation back to target. Mr. Macklem also stated that nearly all central banks are raising their interest rates, with Canada and the United States raising rates more rapidly than Europe. He pointed out that if all countries tightened their interest rates at the same time, the spillover risk of raising rates would be higher than if just Canada or the U.S. had raised rates themselves. Mr. Perrault also touched on the fact that when the U.S.

economy slows, the Canadian economy slows, which would help lower inflation in both countries.

Exchange Rate Pass-Through to Import Prices

Mr. Giroux, Mr. Tombe, Mr. Kavcic, Mr. Perrault and Mr. Stanford explained that the depreciation of the Canadian dollar relative to the U.S. dollar can increase Canadian inflation through the imported price channel.

Mr. Tombe noted that gasoline prices are about 20% higher in Canadian dollars than they would have been if the exchange rate between Canada and the United States had increased with oil prices as it has historically.

Mr. Kavcic estimated that every 10% depreciation in the Canadian dollar relative to the U.S. dollar adds about 0.5 to 0.6 percentage points to Canadian inflation, while Mr. Stanford described the impact of the exchange rate on inflation as quite modest.

Mr. Giroux argued that the Bank of Canada has little scope to decouple its monetary policy from that of the Federal Reserve because doing so would have major impacts on the exchange rate, capital flows and trade. Mr. Kavcic warned that the Bank of Canada's inability to significantly decouple its monetary policy from that of the Federal Reserve means that there is a risk that the Bank of Canada may have to overtighten its monetary policy if the Federal Reserve needs to increase its policy rate significantly above Canada's ideal overnight interest rate in order to bring U.S. high inflation under control.

Deteriorating Canadian and Global Economic Outlook

On 25 January 2023, the Bank of Canada increased its policy interest rate to 4.5%. Since 2 March 2022, the Bank has increased its policy interest rate eight times, in increments ranging from 0.25 % to 1.0%.[13] Due to the increase in interest rates, Mr. Macklem indicated that he expects growth to be close to zero in the next few

[13] Bank of Canada, *Policy interest rate*.

quarters but believes it will pick up again after the slowdown as the benefits of low and predictable inflation are restored. In annual numbers, this means that gross domestic product growth will decline from about 3.25% in 2022 to just under 1% in 2023, and then rise to 2% in 2024.

Mr. Fortin stated that it is difficult to predict how long and deep the slowdown will be. He noted that the most recent data shows that the growth rates of GDP, jobs and job vacancies have begun to slow down and that due to the lags in effects of monetary policy, growth rates are likely to slow even more. He points out that the data suggests that disinflation is already happening and expressed concern that the Bank of Canada may increase its policy interest rate even higher at the risk of overtightening its monetary policy. According to Mr. Stanford, Canada could be on the brink of a significant and potentially lengthy and harmful economic downturn, as the rapid increase in interest rates has resulted in falling asset and real estate prices and higher household debt service charges.

Regarding the global economic outlook, Mr. Macklem said that the slowdown in Europe would likely be worse than in Canada due to the supply-chain disruptions occurring as a result of the Russian invasion of Ukraine and Europe’s need to import many commodities, such as oil, gas, wheat and potash. Mr. Perrault noted that from a U.S. market perspective, there has been a tremendous amount of uncertainty about inflation, particularly regarding how high the U.S. needs to raise interest rates to control inflation. He said that the higher the U.S. interest rates go, the weaker the U.S. economy, which results in lower earnings and volatile markets.

Mr. Macklem asserted that the slowdown in Canada would be less severe than in other countries, due to Canada’s geographical distance from the Ukraine war and Canada’s production of commodities that are in short supply. Mr. Carney said that Canada’s strong labour market, financial sector and trade agreements would keep Canada in better shape than other countries. According to Mr. Kavcic, there is evidence that the Canadian economy may be more sensitive to interest rates, so it will probably start to slow down sooner and probably a little more abruptly than the United States.

Regarding labour, both Mr. Kavcic and Mr. Fortin indicated that, because there is still high demand for labour, they expect that the economic slowdown will hopefully decrease job vacancies more than it increases layoffs and unemployment.

Encouragingly, Mr. Giroux, Mr. Page, Mr. Hanke and Mr. Ambler stated that the data appears to show that inflation in Canada has peaked and that it should start to decrease. Mr. Ambler said that core inflation measures of inflation, which was 7.8% in May 2022, was down to 3.4% in October 2022, which is not far from the upper end of the Bank of Canada's target range. Mr. Page further added that if there is a slowdown in the economy, no one will be talking about inflation in a year's time, particularly in the presence of depressed global energy prices.

POLICY CHALLENGES

Low Business Investment and Productivity Growth

Many witnesses spoke about Canada's low levels of business investment and weak productivity growth. Mr. Mintz noted that from 2015 to 2019, Canada was one of the only four countries in the world that had a reduction in total capital investment by households, governments and businesses.

Mr. Giroux and Mr. Stanford noted that rising interest rates cool demand from both households and businesses and thus can act as a disincentive for businesses to invest in new capital. However, Mr. Kavcic stated that to attract capital and business investment to Canada for the long-term, low and stable inflation is needed even if it creates significant losses in certain industries in the short-term. Mr. Tombe also pointed out that relatively low global oil prices in recent years have caused large declines in business investment in the Canadian oil and gas sector.

According to Mr. Dodge, digitalization, robotization, and the increased use of artificial intelligence could raise productivity in both the goods and services sectors, but it would require increased investment by both the private sector and governments. He contended that the federal and provincial governments should be investing in infrastructure and human capital as well as providing ways to facilitate private sector investment, which could be done through tax incentives. Similarly, Mr. Perrault argued that governments could use tax policy to dramatically reduce the cost of business investment, such as matching a certain percentage of private sector investment over a short period of time, as this could provide a rapid increase in productivity growth.

Andrew Sharpe, Executive Director, Centre for Study of Living Standards, noted that productivity growth is the only sustainable source of increases in the standard of living of Canadians, and that Canadians' living standards are advancing at a much slower pace than in the past. He indicated that Canada is in the upper third of OECD countries with respect to standards of living. Like Mr. Dodge, he suggested that productivity growth is largely driven by technology, and Canada's weak productivity growth is likely due to a slower pace of technological change. He stated that because the United States has a much larger economy and is a world leader in technology, it

would be difficult for Canada, with its low levels of business investment, to close the Canada-United States productivity gap. In his view, while Canada does appear to have a positive business climate, governments cannot force businesses to invest; rather, businesses have to see the opportunities to want to invest.

Mr. Tombe pointed out that in addition to increasing business investment to improve productivity, governments should focus on improving businesses' ability to produce and sell goods across provincial borders and making progress on interprovincial trade. According to Mr. Fortin, other ways to improve Canada's productivity include accelerating post-secondary education in Canada, encouraging businesses to listen to their employees' productivity solutions and having a competitive Canadian economy. Janet Lane, Director, Human Capital Centre of the Canada West Foundation, indicated that increased productivity can come from an increase in workers' basic skills, such as literacy, numeracy, communication, thinking and digital skills.

Both Mr. Perrault and Mr. Sharpe said that over the past few decades, the Canadian government has generally not been successful in addressing Canada's weak productivity growth, with Mr. Sharpe suggesting that government policies may not be the solution to fundamental structural problems of productivity gaps in the economy.

Regulatory Burden

> Witnesses drew attention to businesses' regulatory burden and how government policies can undermine economic efficiency and productivity.

Mr. Mintz stated that federal and provincial regulatory policies with respect to permitting have a negative effect on Canada's productivity, and that this will be of particular importance during Canada's energy transition. He argued that Canada's slow permitting process is a significant barrier to business investment. He also suggested that Canada's corporate and personal tax rates be reviewed, as they may be a disincentive to capital flowing into the country and for entrepreneurs and others to work in Canada.

In the view of Mr. Ambler, Canada's regulatory climate is frustrating investment in major infrastructure projects, while high capital taxes are discouraging overall business investment. He stated that economic growth and efficiency need to be prioritized, with the government focussing on lower spending, ensuring a more certain investment climate, investing in the resource sector, having a modest carbon tax and removing costly and inefficient regulations.

Mr. Page said that in thinking of the public sector's role in the post-pandemic economy, the government needs to look at regulation and its role as a fundamental policy instrument to structure the markets.

Population Aging and Labour and Skills Shortages

> *Shortages of workers and shortages of skills stifle economic growth. There are only two immediate answers to the labour shortage: immigration and increased participation in the workforce.*
>
> Janet Lane, Director, Human Capital Centre, Canada West Foundation. [14]

Many witnesses spoke about Canada's tight labour market and low unemployment rate.

Mr. Fortin noted that from 2016 to the first half of 2022, the employment rate in Canada went down by 1.5 percentage points, while the job vacancy rate went up by 3 percentage points. Both Mr. Kavcic and Mr. Sharpe stated that there are 1 million job vacancies and roughly 1 million unemployed, which is indicative of full or maximum employment. Mr. Sharpe mentioned that having full employment was recognized as a priority by the Department of Finance Canada and the Bank of Canada in the renewal of the Bank's inflation targeting agreement and that there are many benefits in having full employment, including more employment income for the population, less poverty, better quality of life, workers having better bargaining

[14] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 3 November 2022 (Janet Lane, Director, Human Capital Centre, Canada West Foundation).

power and higher government revenues. Mr. Fortin added that full employment means that not only are almost all workers employed, but that businesses are at their maximum capacity and using all the human and material resources available to them. Mr. Stanford also spoke about how a low unemployment rate benefits marginalized groups who typically have challenges finding work, which is a reason why keeping the unemployment rate low is a central macroeconomic goal.

Mr. Dodge noted that Canada’s aging population and the resulting labour shortage is a challenge that will put upward pressure on prices and interest rates and slow down productivity growth. Moreover, Mr. Tombe pointed out that 1.5% of workers over the past year left their job due to retirement, which is higher than the 1% of workers that left for retirement a decade ago, and that falling labour participation due to retirement will cut economic growth by 0.3% each year between 2022 and the early 2040s.

Witnesses had different views about how the government should address labour shortages. Mr. Macklem acknowledged that there are widespread job vacancies and that every province is experiencing labour shortages; however, there will be an increase in the supply of labour due to increased immigration levels in the next few years. Ms. Lane stated that there is both a labour shortage and a skills shortage, and that both problems contribute to businesses not being able to fill job vacancies and meet customer demand. She suggested that increasing immigration and increasing participation in the workforce are the answers to the labour shortage. She noted that more needed to be done to recognize foreign credentials, given that there is a global competition for talent, and suggested that assessment centres be used to evaluate foreign-trained individuals’ competencies against Canadian standards. Similarly, Mr. Mintz highlighted that many countries are facing aging populations over the next decade and as result, international markets for labour are going to be more competitive.

In contrast, Mr. Fortin thought that the proposed increase in immigration levels announced by the federal government was too high, almost double the immigration rate of Australia, which is the country with the second-highest level of immigration in the world. He noted that existing research has found that the effect of immigration on labour shortages, population aging, and standards of living is small, and that

exceeding the economic and social capacity of Canadian society to welcome and integrate newcomers could result in a rise in anti-immigration sentiments. He suggested that immigration levels need to be determined based on discussions between the federal and provincial governments.

Regarding workforce participation, Ms. Lane argued that more of the aging population is needed to participate in the workforce, not necessarily to do the same type of work, but to provide training to new workers. She also mentioned that accommodations should be provided to aging workers, such as shorter work hours, to keep them in the workforce. Mr. Stanford suggested that support should be provided to increase the labour force participation of marginalized groups, such as women, and that the national childcare plan will help achieve this. He also thought that setting wages and benefits in a planned and systemic manner would help stabilize the labour market when there is low but sustained unemployment. Mr. Dodge also felt that there should be more emphasis on ensuring that people already in Canada make the maximum contribution to the economy. Mr. Page stated that he did not feel that the labour market was as tight as other economists and thought that labour participation rates likely have not yet recovered to pre-pandemic levels.

Witnesses also talked about skills shortages and the need for workforce training. Mr. Sharpe indicated that one of the strengths of the Canadian economy is the level of post-secondary education of its labour force, but that Canadian employers provide much less training per worker compared to other countries. Ms. Lane suggested that the funding provided through the Labour Market Development Agreements, which are bilateral agreements between the federal and provincial/territorial governments, should include specific recommendations on skills training for the workforce. In her view, businesses should hire people into the workforce and then train them for those jobs. She said that personal learning accounts would be a good idea for individuals to fill gaps in their training, but expressed concern that some individuals may not know what type of training they need. Mr. Carney suggested that business investment in human capital, such as training and skills development, should be treated as a tax-deductible expense in a similar manner as physical capital investment. As well, Mr. Dodge noted that self-regulatory organizations (e.g., provincial and territorial medical associations or skilled trades regulatory bodies) tend to constrict the supply

of workers and suggested that the government introduce requirements for these organizations with respect to the development and training of the people that they are regulating.

Mr. Sharpe told the committee that if high inflation persists, then wage demands and prices may continue to increase, which can lead to an upward wage spiral. In his view, it is not clear whether this is happening in the Canadian economy at the moment. Mr. Tombe indicated that wages should grow or shrink for reasons related to labour productivity or supply and demand for workers in different sectors at different skill levels, and that wage growth due to high inflation is risky. Diarra Sourang, Director of Economic Analysis, Office of the Parliamentary Budget Officer, said that considering the level of inflation and the time it takes for wages to catch up with inflation to maintain the standard of living, although wages have increased, Canada does not have a wage spiral.

Mr. Stanford also felt that there is no evidence of a wage spiral in Canada and thought it was inappropriate for the Bank of Canada to focus on the potential risk of a wage spiral rather than on excess profits collected by businesses. In response to questions about his public comments that employers should not build the current high inflation rates into their employees' wage increases, Mr. Macklem clarified that he only meant that Canadian workers and businesses should not be planning for inflation staying high. He said that although wages have been moving upwards, he does not currently see a wage spiral, but he is concerned that companies are quickly passing on higher prices to consumers and that consumers may begin to accept these prices. According to Mr. Sharpe, if labour costs increase, employers may substitute machinery for workers.

Risk of a Housing Market Crash

Mr. Perrault noted that there has been a tremendous growth in house prices principally because of the imbalance between housing demand and housing supply, which was exacerbated by low interest rates. According to Mr. Perrault, there will be a temporary correction of 20% to 25% in home prices before home prices start to rise again because of Canada's high immigration targets amid limited housing supply.

Mr. Kavcic argued that the Bank of Canada can address the excess demand for housing relative to supply that contributed to housing inflation by increasing interest rates. For example, he noted that the Canadian housing market went quiet immediately after the Bank of Canada first raised the overnight interest rate by 25 basis points in March 2022. Mr. Kavcic then explained that strong household balance sheets, excess labour demand and macroprudential regulations such as stress tests whereby households need to qualify for mortgages at higher interest rates than those available in the market, may limit the impact of declining home prices on the real economy or spread it over a longer period. Mr. Kavcic also said that, although households will be tested in the coming quarters, these buffers should limit mortgage delinquencies, which have historically been low in Canada because Canadians generally pay their mortgage first, Canadian full-recourse mortgages grant lenders the right to seize any additional assets of the borrower beyond their home, and Canadian lending standards are more rigorous than those in other countries. Mr. Page agreed that households and businesses’ strong balance sheets at an aggregate level will make the Canadian economy more resilient to the upcoming growth slowdown or recession.

Ms. Rogers explained that up until 2021 most mortgages in Canada were fixed-rate mortgages. However, commercial banks recently told the Bank of Canada that many of the variable mortgages that were taken in 2021 had since been converted to fixed-rate mortgages, which means that many Canadians’ mortgages are locked in at lower interest rates. Ms. Rogers also explained that although the Bank of Canada and commercial banks are not seeing an uptick in mortgage defaults at the moment, which are a known lagging indicator, commercial banks are proactively working with their borrowers who are financially stressed by higher interest rates because avoiding mortgage defaults is in the interest of both borrowers and lenders.

Housing Shortage

Mr. Tombe expressed concern that raising interest rates could exacerbate Canada’s housing shortage by lowering residential investment at a time when we need to build more homes to meet the needs of our growing population.

Mr. Kavcic explained that when analyzing the housing sector, one needs to make a difference between housing as an investment asset and the underlying supply and demand fundamentals of housing for shelter purposes, which are more demographically driven. While higher interest rates are removing a lot of the froth and speculative activity that was built on the fact that home prices were rising, Canada has a demographic need to continue to build and supply residential properties because of millennial households and immigration flows to Canada. As noted by Mr. Dodge, the more than 400,000 immigrants that are coming to Canada each year need to be housed in Canada's existing housing stock.

Mr. Stanford called for more federal investments in affordable housing, including significant investments in the supply of non-market housing of all sorts, such as co-ops, public and social housing, community housing trusts and others.

Low Level of Competition in Some Sectors

> *Competitive intensity at home is what enables companies to be more competitive abroad.*
>
> Anthony Durocher, Deputy Commissioner, Competition Promotion Branch, Competition Bureau Canada[15]

Witnesses discussed how in an environment with high inflation and excess demand relative to supply, some businesses in sectors that have low levels of competition may engage in anti-competitive behaviour with respect to pricing.

Mr. Macklem explained that with high inflation, price changes happen more rapidly, and it becomes easy for businesses to pass through all of their input costs to their customers. Mr. Stanford further argued that some businesses, such as grocery stores

[15] Standing Senate Committee on Banking, Commerce and the Economy, Evidence, 3 November 2022 (Anthony Durocher, Deputy Commissioner, Competition Promotion Branch, Competition Bureau Canada).

and telecommunications, are increasing their prices above and beyond what is required to cover their input costs and thus are boosting their profits.

Anthony Durocher, Deputy Commissioner, Competition Promotion Branch, Competition Bureau Canada, also shared his concerns that today's inflationary environment may provide incentives for businesses to engage in anti-competitive conduct or that inflation may act as a "cover" for those businesses already participating in anti-competitive activities. He spoke about how the Competition Bureau is undertaking a market study of the Canadian grocery sector to determine the reasons for rising grocery prices and to make recommendations for the government on how to enable more competition in that sector. It plans to produce a report with its findings by June 2023. He also indicated that the Competition Bureau is part of a working group with its counterparts in the United States, the United Kingdom, Australia and New Zealand to examine supply chain disruptions and to determine whether companies are taking advantage of these disruptions to increase prices and engage in activities such as price fixing.

Both Mr. Kavcic and Mr. Durocher stated that while competition would not be a significant short-term anti-inflationary tool, increased competition among businesses would dampen inflation over the longer term and could help in boosting productivity.

Mr. Perrault mentioned that barriers to competition, such as interprovincial trade barriers or protections provided by the federal government to the Canadian economy internationally, are major problems for Canada. He argued that rather than just opening up markets through free-trade agreements, the government should be focussed on policies that increase competition and improve Canada's productivity, which would help Canadian companies compete and take advantage of international markets.

Deglobalization

Witnesses spoke about challenges related to the deglobalization of trade, also referred to as reshoring or friend-shoring.

Mr. Tombe noted that global trade as a share of global GDP has been declining since 2010, with geopolitical tensions seen in the trade war between United States and China, Brexit in the United Kingdom, and the aversion of some countries to engage in large free trade agreements. In addition to geopolitical risks, Mr. Carney indicated that companies are also thinking about exposure to extreme weather, trade restrictions, technology restrictions, data restrictions and financing restrictions, and therefore it makes sense for companies to have the most important part of their supply chains on the shores of friendly countries. Mr. Macklem said that regardless of what governments do, companies are not going to make investments to deepen trade relationships in countries associated with geopolitical uncertainty.

Mr. Dodge explained that because of deglobalization, businesses will establish less efficient factories closer to home due to the higher risks of using current supply chains, which will result in increased prices and slower productivity growth.

Mr. Macklem said that simplifying and diversifying supply chains and holding more inventory may result in a system that is more resilient but less efficient, and therefore more costly, which could create some inflationary pressures. In his view, the longer global supply chain disruptions last post-pandemic, the more likely these production costs will be permanently higher.

Mr. Tombe asserted that putting more weight on supply chain resilience is not a fundamental change in how companies manage themselves, as disruptions in global supply chains have a cost as well. Mr. Sharpe highlighted that the decline in real wages for many years was due to jobs moving to countries with lower labour costs, and that that deglobalization will favour workers, as there will be less downward pressure on wages as companies begin to move production back to North America.

Mr. Carney indicated that Canada has the proper environment to play a role in new supply routes and be a source of manufacturing and services, due to its trade agreements with all of the G7 countries and most of Asia through the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), its strong workforce, its competitive corporate tax system and its clean energy grid. Similarly, Mr. Perrault stated that Canada has a huge opportunity to capitalize on its trade

agreements, its forward-thinking immigration policy, its mining capabilities, and the stability in its economic, banking, political and judicial systems to address current global supply shocks.

Decarbonization

Lastly, witnesses mentioned some of the challenges Canada faces as it transitions towards a net zero emissions economy. Mr. Carney stated that the most important way to drive green investment is for the government to be clear about the direction and purpose of its climate policy. As an example, he mentioned that the Carbon Contract for Difference initiative provides certainty for future carbon prices, which encourages investors to support businesses developing low-carbon technologies. With respect to green investment by institutional investors, he noted that there is a diversity of strategies among Canadian pension plans, with some having a combination of green assets, which are related to renewable power, and transition assets, which are assets that produce carbon emissions but investments are being made to lower those emissions, which is occurring in the steel and auto sectors. Mr. Stanford suggested that Canada may need to accelerate the transition to renewable energy, as it would be insulated from speculative shocks in the world oil futures markets.

Mr. Tombe stated that there are economic costs associated with any action on climate. He noted that increasing carbon taxes through 2030 may decrease economic growth by about 0.1% per year. Mr. Mintz noted that Canada has a much higher carbon tax than most countries, at almost 20 euros per tonne compared to less than five euros per tonne for most other countries. He also said that Canada's manufacturing and forest sectors in particular are facing higher costs associated with the carbon tax, but there is little relief for businesses as lump-sum transfers of the carbon tax are only provided to households, which makes these sectors less competitive. Mr. Fortin also indicated there are limits to the carbon tax strategy: firstly, that there is some uncertainty to whether Canadians will accept significant increases in the carbon tax in the upcoming years; secondly, in comparison to the carbon tax, the United States' *Inflation Reduction Act* appears to provide more positive incentives to fight climate change; and thirdly, other options to reduce the

production of greenhouse gases, such as exporting energy produced from wind technology, have become much less expensive in recent years. As well, Mr. Dodge identified the decarbonization of energy production and energy use as a potential challenge for the Canadian economy that could slow down productivity growth.

According to Mr. Ambler, a carbon tax should be used to replace regulations; however, in Canada, none of the inefficient policies and regulations were removed before the implementation of the carbon tax. Furthermore, he suggested that Canada should ensure that other countries commit to reducing their carbon emissions before making drastic emission reductions itself.

With respect to the United States' *Inflation Reduction Act*, Mr. Mintz explained that while there are some carbon pricing and cap-and-trade systems at the state level, the federal level is focused on providing generous subsidies for green energy, with particular focus on carbon capture utilization and storage. He said that the Canadian investment tax credit for carbon capture will not be nearly as competitive as the U.S. subsidies, so businesses in that sector will likely choose to operate in the United States. He also pointed out that if a business is considering opening a lithium refining plant, mining taxes in Arizona and Nevada are as competitive as Canadian mining taxes and they could be a more attractive option due to the absence of a carbon tax in the United States.

APPENDIX A – Witnesses

Thursday, September 22, 2022

David A. Dodge, Senior Advisor, Bennett Jones LLP, and former governor, Bank of Canada, As an individual

Tuesday, September 27, 2022

Yves Giroux, Parliamentary Budget Officer, Office of the Parliamentary Budget Officer

Diarra Sourang, Director, Economic Analysis, Office of the Parliamentary Budget Officer

Thursday, September 29, 2022

Trevor Tombe, Professor of Economics, University of Calgary, As an individual

Jim Stanford, Economist and Director, Centre for Future Work

Thursday, October 20, 2022

Mark Carney, Vice Chair of Brookfield Asset Management Inc. and Head of Transition Investing, As an individual

Steve H. Hanke, Professor of Applied Economics, Johns Hopkins University, As an individual

Tuesday, October 25, 2022

Robert Kavcic, Senior Economist and Director, Bank of Montreal

Andrew Sharpe, Executive Director, Centre for the Study of Living Standards

Tuesday, November 1, 2022

Tiff Macklem, Governor, Bank of Canada

Carolyn Rogers, Senior Deputy Governor, Bank of Canada

Thursday, November 3, 2022

Janet Lane, Director, Human Capital Centre, Canada West Foundation

Leila Wright, Deputy Commission, Digital Enforcement and Intelligence Branch, Competition Bureau Canada

Anthony Durocher, Deputy Commissioner, Competition Promotion Branch, Competition Bureau Canada

Thursday, November 17, 2022

Jean-François Perrault, Senior Vice-President and Chief Economist, Scotiabank

Pierre Fortin, Emeritus Professor of Economics, University of Quebec at Montreal, As an individual

Thursday, November 24, 2022

Jack Mintz, President's Fellow, University of Calgary's School of Public Policy, As an individual

John Greenwood, Chief Economist, International Monetary Monitor Ltd., As an individual

Steven Ambler, Associate Professor, Université du Québec à Montréal, and David Dodge, Chair in Monetary Policy, C.D. Howe Institute, As an individual

Thursday, December 1, 2022

Kevin Page, President and CEO, Institute of Fiscal Studies and Democracy

Printed by Senate Printing /

Imprimé par le service des impressions du Sénat Service

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