HIGHER FOR LONGER: STRUCTURAL INFLATION AND REAL RATE TRENDS IN THE 2020S

MARCH 2023

Author: James K. Stewart , *Executive In Residence, Global Risk Institute*

EXECUTIVE SUMMARY

Financial markets are understandably focused on the next steps for the Bank of Canada (BoC) as it continues its conditional pause after 425 basis points (bps) of rate hikes, and the US Federal Reserve (Fed) as it continues with rate hikes after 450 bps of increases. Headline inflation in both countries is well below its mid-2022 peak but remains far above 2% despite decelerating faster in Canada and with a mixed picture in the US. Economic growth has slowed, yet labour markets remain robust in early 2023. Examining the structural trends in inflation and real (inflation-adjusted) interest rates is timely for setting future policy. Surging prices in 2021 and 2022 resulted from cyclical forces, global shocks, policy stimulus, and secular factors. This paper explores an array of secular drivers putting upward pressure on inflation and real interest rates. These longer-term, slower-moving factors create an upward bias to inflation and real rates during 2023-2026 and, potentially, beyond.

While overall inflation decelerated in the second half of 2022 and early 2023, albeit more in Canada than the US, multiple structural factors are ongoing, negative supply shocks. They will likely keep average inflation at 2%-plus through the mid-2020s, apart from during recessions or sharp economic slowdowns. The demographic-driven shift in savings and the multiple crises spurring large-scale spending and investment create an upward bias to real rates. These are fundamental changes from the 1990s-2010s for Canada and other advanced economies. In our analysis, these factors will likely push real rates into the 1.0-2.0% range, subject to monetary policy. Using the BoC's 2% inflation target with a 1-3% range, our analysis suggests that Canadian policy rates could have a central tendency in the 3.0-4.0% area within a broader range of 2.0-5.0% for 2023-2026.

INFLATION AND REAL RATES

The end of large-scale labour surpluses worldwide, as well as regionalism and resiliency supplanting globalization in a range of goods industries, are two secular drivers of inflation pressures. In Canada and the US, structural labour supply weaknesses continue to raise costs. Other adverse supply shocks, such as the increasing frequency and intensity of climate events, are causing rising inflation pressure. Short and medium-term Canadian and global demand factors, including Canada's fiscal policy support for consumption and the boost from US industrial policy to investment and job growth, are further bolstering these pressures.

Aging populations in advanced economies and China as well as the end to excess worldwide savings are crucial shifts for real rates. Even more important is the greater public and private sector demand for funds from large-scale spending and investment in Canada and globally to address multiple crises. This demand for funds includes the huge investment needed to address climate mitigation and adaptation and much greater military spending in the wake of the Ukraine War.

The funding needed is in addition to longstanding and new large-scale requirements for investment in healthcare and infrastructure. Higher real policy rates in the 1.0-2.0% range would reflect lessons from the negative side effects of ultra-low real rates during the 2010s, and the dramatic re-pricing of asset markets as policy normalized in 2022.

IMPACT OF MONETARY REGIMES

Although monetary policy's role in containing inflation is widely accepted, its ongoing impact on real and neutral rates is also critical. Empirical studies show that monetary regimes materially influence real and neutral rates, and the financial cycle. Accordingly, the impacts of BoC and Fed policy bear emphasis. The BoC's policy rates decisively influence shorter-term interest rates in Canada, while Fed policy has an outsized and, at times, dominant influence on long-term Canadian and global yields. The sharp escalation in the BoC's and Fed's policy rates from mid-2022 through early 2023 marked the end of the ultra-easy policy after the Great Financial Crisis (GFC) and is a fundamental change in the financial cycle.

OUTLOOK FOR POLICY RATES

The combination of (i) structural forces creating an upward bias to inflation and real rates and (ii) monetary policy will be critical to how much higher inflation and real yields will be this decade relative to the 1990s-2010s. The secular factors pushing inflation to the BoC target of 2% and potentially higher and the merits of 1.0-2.0% real rates support materially higher policy rates relative to the post-GFC decade.

Our analysis of inflation and real rate pressures suggests Canadian policy rates with a central tendency in the 3.0-4.0% area for 2023-2026 within a broader range of 2.0-5.0%. Rates below 3.0% would occur during substantial growth slowdowns (well below that during major recessions) when inflation is less than 2%. Rates above 4.0% would reflect excess demand conditions and well above-target inflation. With the BoC policy rate at 4.5% in early 2023, policy normalization would be complete with 1.0-2.0% real rates if inflation declines to less than 3% before or by year-end. US rate hikes appear to be in their late stage, but not yet finished. The Fed Chair and various Fed Governors have stressed that policy rates at 4.5-4.75% will need to increase further, given excess inflation and robust US labour demand in early 2023.

INITIAL POLICY NORMALIZATION SUCCESS AND FUTURE RISKS

The BoC and the Fed rapidly shifted to policy normalization from mid-2022 through early 2023. To date, this normalization has been successful. Yet, interest rate changes have their full impact over 1½-2 years. The largest rate hikes in four decades and quantitative tightening that began in mid-2022 will have greater cumulative effects throughout 2023 and the first half of 2024. The open question is whether the BoC and/or the Fed will be able to sustain 1.0-2.0% real policy rates given financial system concerns and political pressures if the economy slows sharply in 2023 or falls into a major recession.

Continued success with policy normalization faces at least two other significant risks. Martin Wolf has highlighted the potential for monetary policy to repeat the 1970s error of loosening too quickly and by too much in response to lower inflation, causing a future rebound in inflation. William White has explored the risks of inflation not returning to target. If this occurs, central banks will be faced with either holding down nominal rates and letting inflation rise, thus depressing real rates, or letting nominal rates rise, causing inflation to fall and real rates to increase. In this case, allowing nominal rates to rise is the right choice. Yet, this approach would face financial and fiscal instability risks and greater political pressure.