ECONOMIC VIEWPOINT

Are There Other Ways to Lower Inflation besides Continuing to Raise Interest Rates?

By Hendrix Vachon, Principal Economist

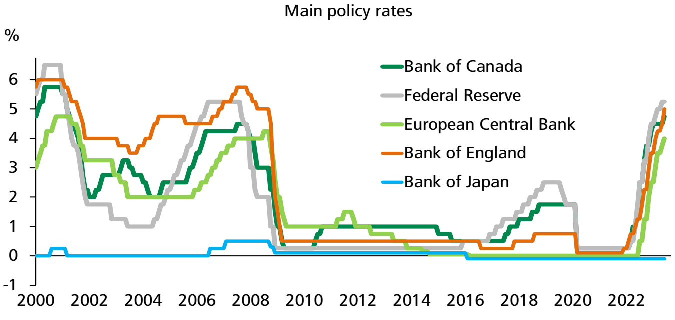
With many central banks still signalling possible further rate hikes, we keep getting asked if there are other ways to combat inflation. The short answer: yes. Governments could curb demand to help bring down inflation by adjusting their spending or tax policy. But they couldn't easily take over the whole job of the central banks, which enjoy a high degree of independence specifically so that they can focus on inflation. Plus, with their ability to adjust interest rates, central banks have a powerful tool for influencing demand and inflation. The role of governments could above all be a complementary one. Their interventions could also help make the fight against inflation more equitable for society.

Slow to See Results

The past year has seen many central banks go all out to try to bring down inflation. Policy interest rates were quickly raised to around pre-2008 crisis levels (graph 1). But so far it hasn't done enough to tame inflation. Stripping out food and energy prices, inflation remains well above the 2% target widely adopted by central banks (graph 2).

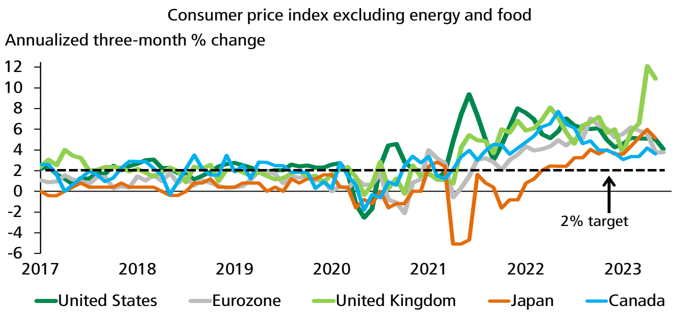
That raises some questions. Is raising interest rates still the best tool for tackling inflation? Is it taking longer to flow through to the economy and do we just need to sit tight? While it's true that it can take several quarters for the full impact of monetary policy to be felt, other explanations have been offered, for instance that pent-up pandemic savings are now fuelling spending (graph 3 on page 2).

GRAPH 1
Many policy rates were quickly raised to near pre-2008 crisis levels



Sources: Datastream and Desjardins Economic Studies

GRAPH 2
Not enough progress has been made on inflation



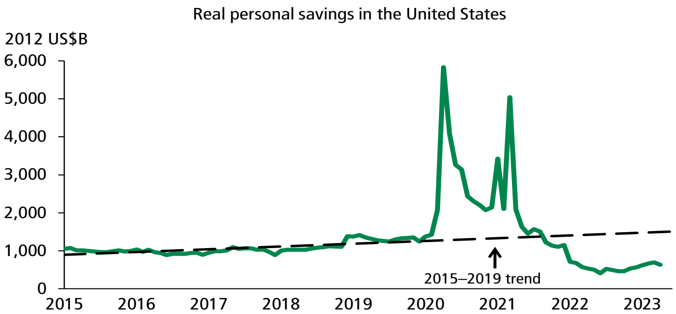
Sources: Datastream and Desjardins Economic Studies

Further Rate Hikes Could Exacerbate Inequality

Central banks will likely continue on the same path until they're convinced inflation is on its way back to target. While we do expect inflation to ease in the coming months, the risk that it won't be enough remains high. We also can't rule out further inflationary shocks.

But if interest rates continue to rise, we could start to see growing social inequality. Rate hikes don't affect everyone in the same way. Young potential homebuyers are having to

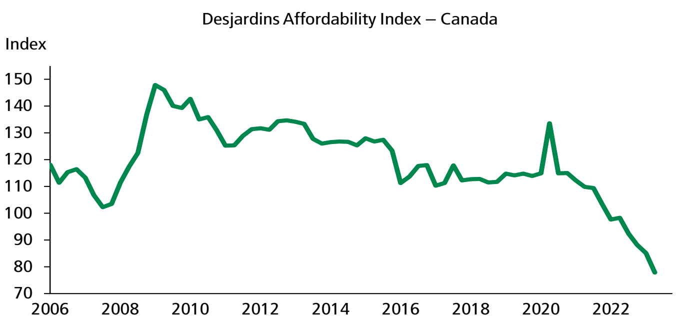
GRAPH 3
Considerable savings were built up during the pandemic, which then supported spending



Sources: Bureau of Economic Analysis and Desjardins Economic Studies

alter their plans, with high interest rates making it considerably more difficult to get on the property ladder (graph 4). Fewer buyers also means higher demand for rental housing—but it's lower-income households that will suffer most if rents rise too quickly. And existing homeowners aren't safe, either, with higher mortgage payments coming their way sooner or later. The hardest hit will be those carrying the most debt. That tends to be young homebuyers or people who've gone through something difficult like divorce or health problems.

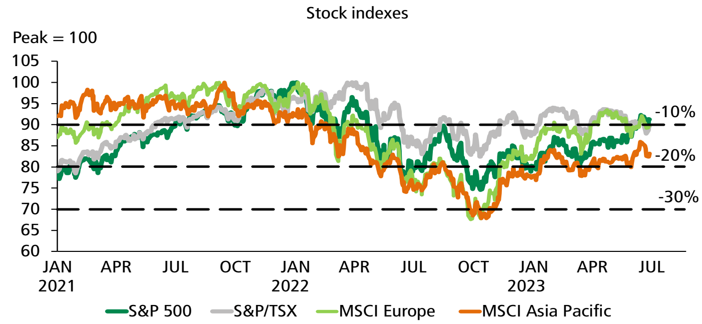
GRAPH 4
Home ownership has fallen sharply, particularly in Canada



Source: Desjardins Economic Studies

It might become increasingly difficult for central banks to convince people that raising interest rates is the right move. The public's trust in them could start to wane, making them a growing source of frustration and division. There are, of course, some people who are happy to see interest rates go up. It's been years since savings rates have been this high, allowing investors to reallocate some of their investments to get better returns with less risk. Households carrying little to no debt with substantial savings will have an easier time maintaining their current lifestyle. And the rate hikes don't seem to have bothered the stock markets too much, with the major indexes up for the year so far and most of last year's losses already recovered (graph 5).

GRAPH 5
Stock markets have recovered most of last year's losses



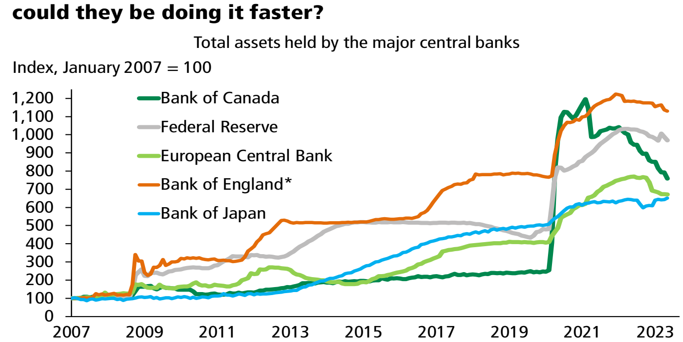
Sources: Datastream and Desjardins Economic Studies

Should Central Banks Be Moving Quicker to Shrink Their Balance Sheets?

In addition to adjusting key interest rates, central banks can also make changes to the assets they hold and the amount of money they inject into the financial system. During the pandemic, many central banks bought up huge quantities of securities, particularly government bonds, to pump more liquidity into the financial markets and keep them stable. That also had the effect of stimulating the economy by lowering long-term yields and chasing investors into riskier asset classes.

Most central banks have already started to trim their balance sheets (graph 6). The Bank of Canada is ahead of the pack as others are taking a more gradual approach for now. It's not something central banks have a lot of experience with. If they move too quickly, it could have unwanted consequences that would be difficult to control, particularly for the larger central banks that contributed most to global liquidity. For instance, it could spark outsized market volatility and weaken the financial system, with the same households affected by rising interest rates the ones that would take a hit. And higher long-term yields and risk premiums wouldn't help make the housing market any more accessible or improve conditions for anyone needing to renew their mortgage.

GRAPH 6
Central banks have started shrinking their balance sheets, but could they be doing it faster?



* Partial data availability as of 2014 corresponding to 90% of assets
Sources: Datastream and Desjardins Economic Studies

A Better Option: Central Bank and Government Coordination

During the inflation crisis in the late 1970s and early 80s, when Paul Volcker was appointed Chair of the US Federal Reserve (Fed), he had the support of President Jimmy Carter, which continued under the Reagan administration. Both presidents were concerned with setting fiscal and regulatory policy that didn't add fuel to the inflationary fire.

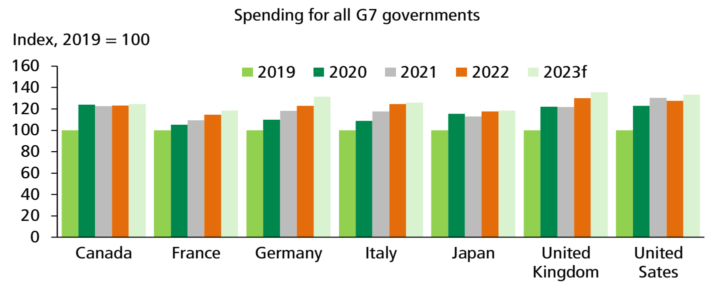
Although today's inflation isn't as bad as it was 40 years ago, the Fed and other central banks would probably have an easier time if governments opted for policies that would curb demand. Governments could limit spending growth in some areas or temporarily raise certain taxes. Raising sales taxes, however, would put upward pressure on prices, which could look counterproductive in bringing inflation down. In fact, inflation should be tracked exclusive of taxes. Government could also contribute through regulations designed to increase competition, reduce costs for businesses or counter overconsumption, for instance by addressing planned obsolescence and guaranteeing the right to repair.

This type of action from government could be seen as simply returning a favour to the central banks, which were quick to coordinate their monetary policy with governments' expansionary fiscal policy during the pandemic. Even with the crisis now behind us, government spending is still very high in many countries (graph 7). Significant structural deficits remain, suggesting that spending is too high compared to revenues (graph 8).

Government intervention could also help more equitably distribute the burden of fighting inflation among the population, as suggested in an article published by the International Monetary Fund in April. Using a model for the US economy, the authors demonstrate that relying on interest rate hikes alone to combat inflation could be more detrimental to vulnerable households compared to reducing government spending. But to close the inequality gap even further, they suggest combining lower spending with larger transfers to low-income households.[1] Of course, this is based on a simulation using a model. While the reality is much more complex, with more unpredictable knock-on effects, this kind of simulation still offers a good starting point for discussion.

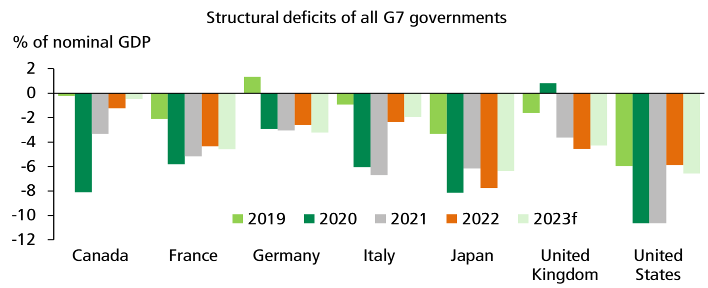
In addition to demand, governments also have the ability to influence supply. Inflation could be reduced by increasing supply, something that could take several quarters—or even years—to materialize. This would take the form of measures to grow the size or number of businesses, introduce new technologies or production methods, increase the housing supply, upgrade infrastructure, improve worker training and health, etc. Government itself could also look for efficiencies in the way it provides services to the population. Increasing supply is a continuous process. It's something many governments regularly do, but enhanced tracking and reporting could help to better inform future decision making. Another consideration: if additional measures to stimulate supply over the long term were to require a sharp short-term increase in spending and investment, it could push inflation higher before it eventually falls.

GRAPH 7
Government spending remains well above pre-pandemic levels



f: International Monetary Fund forecast, April 2023
Sources: International Monetary Fund and Desjardins Economic Studies

GRAPH 8
Public finances are still facing a significant structural deficit in many countries



f: International Monetary Fund forecast, April 2023
Sources: International Monetary Fund and Desjardins Economic Studies

Interest Rates Remain the Main Tool but There's a Lot That Can Be Done to Help

In conclusion, although interest rate hikes are an effective tool for tackling inflation, there are different ways for government to contribute to the effort. There's also no easy way for central banks to address the inequality caused by steep rate hikes. That's an area better suited to government, which could use targeted interventions to better protect the vulnerable, for example combining restrictive spending measures with larger transfers to low-income households. Alongside this, continued efforts to increase supply and improve resilience to shocks would help keep inflation low and stable over the medium and long term.

[1] Vitor Gaspar et al. "Fiscal Policy Can Help Tame Inflation and Protect the Most Vulnerable," IMF Blog, April 3, 2023.

It remains to be seen whether a helping hand is really needed from government. For now, we're forecasting a gradual decline in inflation over the coming months. According to our baseline assumptions, it should be enough to reassure most central banks, and we may even see interest rate cuts in 2024. However, if inflation proves too sticky or we're hit by further inflationary shocks, then we'd like to see better coordination between government and central bank policy to help bring supply and demand into balance.