Canada's Economic Situation and Policy Analysis in the Current Inflation

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Abstract. Since 2022, the global energy prices have been increasing, leading to a rise in the price index. This has resulted in inflationary pressures in major economies such as Canada, leading national governments to implement interest rate hikes as a coping strategy. This paper focuses on the Canadian economy and analyzes its inflation performance, strategies for raising interest rates, the price level, and the labor market. Using economic data from Canada, the Commonwealth of Nations, and past literature, the study finds that Canada's inflation performance is not satisfactory. The paper argues that inflation cannot be fundamentally curbed by using a single monetary policy instrument, such as interest rate hikes, and that an effective economic response requires a combination of monetary and fiscal policies. Additionally, the paper suggests that Canada should develop and improve industrial policies consistent with its national endowments, labor and immigration policies that match industrial policies, and trade policies that are effective in fighting inflation.

Keywords: Canadian economy; economic policy; inflation.

1. Introduction

Inflation has become a pressing issue worldwide. In May 2022, headline inflation in the U.S. surged to 8.6%, resulting in an 8.8% global equity market decline in June of the same year [1]. The primary drivers of inflation were supply chain problems and increasing prices of food and energy. While the U.S. and European central banks pursued employment-first monetary policies and adopted relatively high tolerance levels for inflation, they only implemented tightening measures when inflation exceeded their targets in the first half of 2022. In June, the U.S. consumer price index (CPI) rose by 9.1% year-over-year [2]. In response to inflationary pressures, the Bank of Canada has raised interest rates eight times since last year, reaching the highest policy rate level in 15 years at 400 basis points. However, excessive tightening measures could negatively affect economic growth, the job market, and financial stability if inflationary pressures continue to escalate or if the economy faces external risks and uncertainties. This paper will analyze Canada's economic performance on a global scale and suggest potential improvements to economic policies by evaluating Canada's performance in inflation and the corresponding economic policies utilized.

2. Literature Review

Over time, the prices of goods and services increase broadly throughout the economy, decreasing the purchasing power of distinct groups [3]. In a healthy economy, annual inflation is usually within 5 percent, which policy makers consider a standard for low inflation and a healthy economy [4]. It can be advantageous to manage inflation within a predictable range. This can encourage spending when the economy needs a boost, increasing demand and productivity. Conversely, inflation outstripping wage growth may be a sign that the economy is in trouble. Inflation is driven by a combination of supply and demand-side factors [5]. The disruption of global supply lines and soaring commodity prices during the COVID-19 outbreak has led to the Bank of Canada decreasing the interest rate to 0.25% to address the disease. This has produced a situation in which inflation remains unchecked despite numerous interest rate rises in Canada today. It is critical to develop optimal policies to control inflation with rational expectations. Lovett suggests possible policies such as neo-

Keynesian, conservative, socialist, etc. [6]. Each policy concept has its own benefits and limitations. This paper argues that only by combining the advantages of each policy can the current inflation problem in Canada be truly controlled. Addressing inflation will require an integrated policy approach that considers both supply-side and demand-side factors and emphasizes policy flexibility and experimentation. Although the literature has thoroughly examined the formation of inflation and theoretical policies, there is little comprehensive analysis of inflation in Canada today. This paper will analyze the current state of the Canadian economy and feasible economic policies to deal with inflation from a macro perspective.

3. Analytical Framework and Discussion

3.1. Canadian Inflation Performance and Rate Hike Strategy

Canada is currently experiencing an inflationary shock that has not been witnessed in almost four decades, resulting in a significant instability in prices. The inflation index shows a sharp increase in prices. At the onset of the COVID-19 pandemic, Canada took measures to control the spread of the virus by limiting non-essential economic activities, resulting in an economic slowdown and inflation deviating from the central bank's target range. Based on Figure 1, as economic activities gradually resume, inflation starts to rise, gradually moving away from the target range by 2021. In 2022, inflation rose even more rapidly, increasing from approximately 5.1% at the beginning of the year to a new record high of 8.1% in June. This marks the first time in nearly forty years that inflation has exceeded 8%.

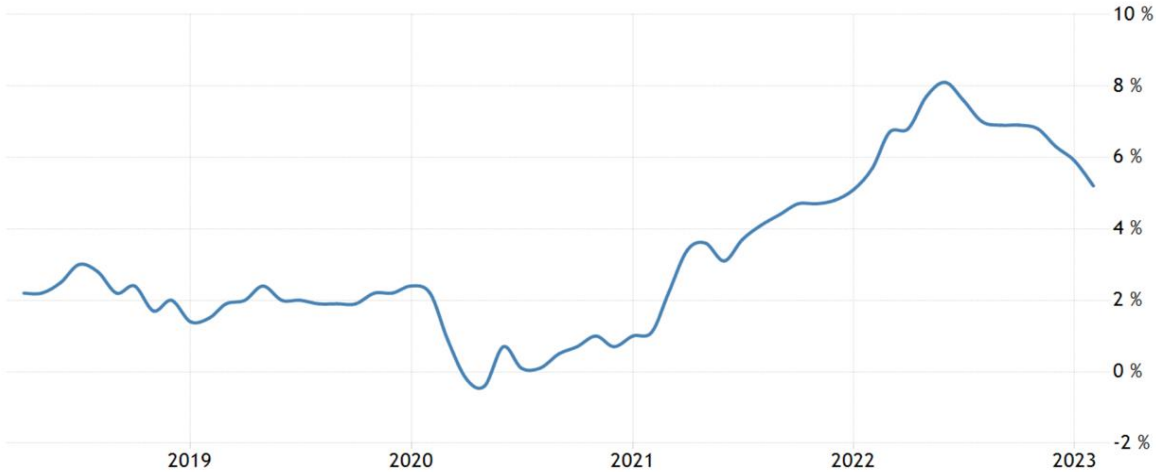

Fig 1. Canada inflation rate from 2018 to 2023.
Data source: Bank of Canada

3.2. Price Level

Canada is a resource-rich country, boasting oil, gas, timber, rare earths, coal, and more. However, recent data from Figure 2 shows that in 2022, Canada's Consumer Price Index (CPI) experienced an average month-over-month increase of 6.8%, marking the highest rate of increase in 40 years. In contrast, according to Bank Canada, Canada's CPI only rose by an average of 3.4% and 0.7% month-over-month in 2021 and 2020, respectively. If the impact of energy-based prices is excluded, the average monthly CPI increase in 2022 was 5.7%, compared to 2.4% in 2021. This increase was especially pronounced for nondurable goods. Energy prices were the biggest driver of higher headline inflation last year, with gasoline prices rising by 28.5%. Additionally, retail food prices rose by 9.8%, hitting their highest level since 1981. These figures indicate that despite Canada's abundance of resources, the structural problems of its indigenous industries are contributing to the high CPI increase. Figure 3 shows that since the beginning of the pandemic in 2020, the central bank's liabilities have skyrocketed above $500,000, while Figure 4 reveals that although New Zealand is also a resource-

based country, its liabilities remained controlled at around $100,000 despite being affected by the pandemic. These balance sheets further highlight Canada's issues with its industrial structure.

Fig 2. Canada Consumer Price Index from 1995 to 2023.
Data source: Bank of Canada

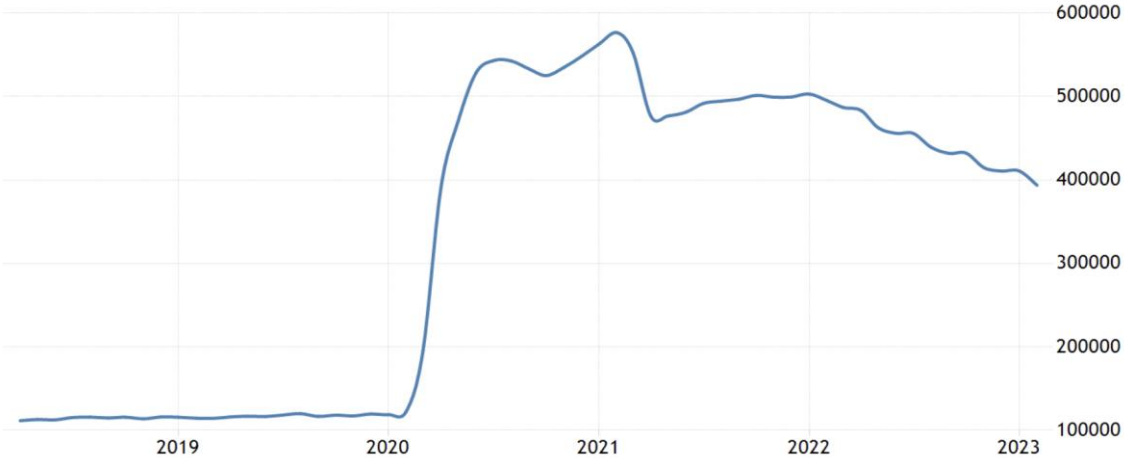

Fig 3. Canadian Balance Sheet from 2018 to 2023.
Data source: Trading Economics

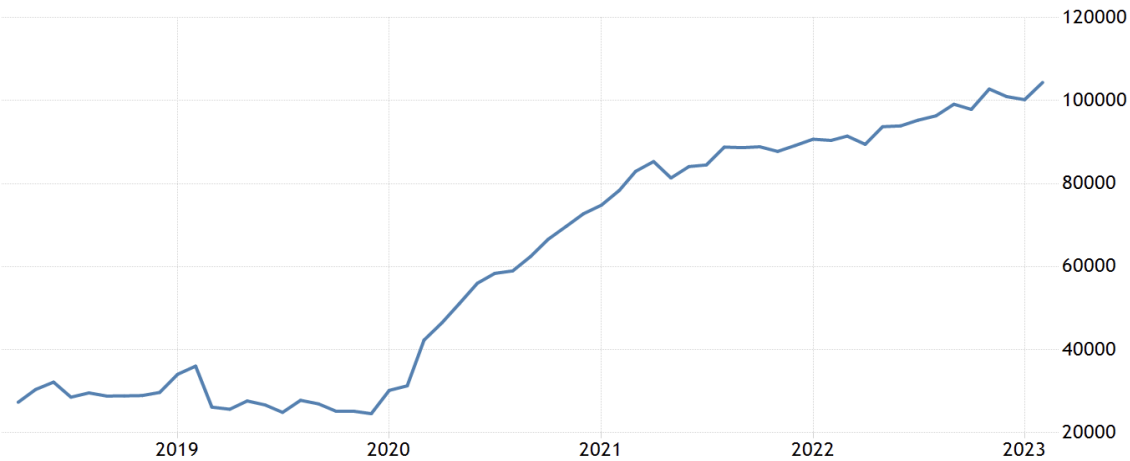

Fig 4. New Zealand Balance Sheet from 2018 to 2023.
Data source: Trading Economics

3.3. Labor Market

The labor market is susceptible to inflation's impact on structural issues. Research has shown that the influence of import prices, productivity, and unemployment on inflation reduces as labor market coordination increases, both in the first year after a shock and over longer time horizons [7]. Canada's economy relies heavily on natural resource-based industries, particularly the energy sector. According to Canada's Economic Strategy Table report, the country has the world's third-largest per-capita natural resource endowment, supporting 1.82 million jobs and contributing 17% to the GDP. However, other sectors lag, resulting in a lack of diversity in Canada's economic structure. During the global COVID-19 outbreak, the recession and the drastic fall in energy demand caused a historic drop in energy prices. The energy market is volatile, and changes in international markets, policy, and natural factors, such as weather, can cause fluctuations. The unstable market can affect employment and investments in related businesses. The paper argues that Canada needs a large workforce, such as truck drivers and miners, to support its energy markets. The country is sparsely populated, and some areas are unsuitable for railroad construction. Therefore, a significant number of truck drivers are required to ensure smooth transportation operations, particularly in natural resource industries such as oil, gas, forestry, and mining. These industries require large-scale logistics transportation and distribution that depend on truck drivers. Moreover, Canada needs abundant manpower for development and subsequent processing in areas such as metals and minerals. To increase the labor force in the secondary industry, Canada should adjust its immigration policies to attract more immigrants with relevant skills. For instance, sponsorship of immigrant mentoring and internship programs in the workplace can be increased [8].

4. Countermeasure and Feasible Solution

Based on the previous analysis, it is clear that Canada's global inflation performance has not been up to par compared to other Commonwealth countries. It is difficult to curb inflation using only a single monetary policy method, such as raising interest rates, and an effective economic policy should involve a combination of monetary and fiscal policies. According to Figure 5, although the crude oil price index has decreased in 2023, it is still higher than it was in 2020 and previous years [9]. This paper suggests that Canada can take advantage of the rising energy prices during this time period and leverage the potential of the energy industry to offset the inflationary losses of the domestic public.

The Canadian government has identified Canada as a resource-based country, rich in resources such as oil, minerals, and forests. Canada is third in the world in terms of crude oil reserves, with 173 billion barrels, and is the world's third-largest mining country with over 60 kinds of proven minerals, including 6.6 billion tons of mineable coal resources. Canada should take advantage of the rising energy prices and use the benefits gained in the energy industry as capital to implement more economic policies that benefit the people and curb inflation. This can be achieved by developing an industrial policy that matches its national endowment, a labor and immigration policy that matches its industrial policy, and a trade policy that can effectively fight inflation.

Canada should increase wages in the energy industry and the secondary industry chain to attract more workers. Additionally, it should increase immigration policies to attract immigrant workers in related industries. In terms of trade, the United States-Mexico-Canada Agreement (USMCA) has been successfully renegotiated, reducing some risks to the Canadian economy. Economic growth within NAFTA countries is uneven [10]. Canada should increase trade exchanges with Mexico to increase economic income and curb inflation.

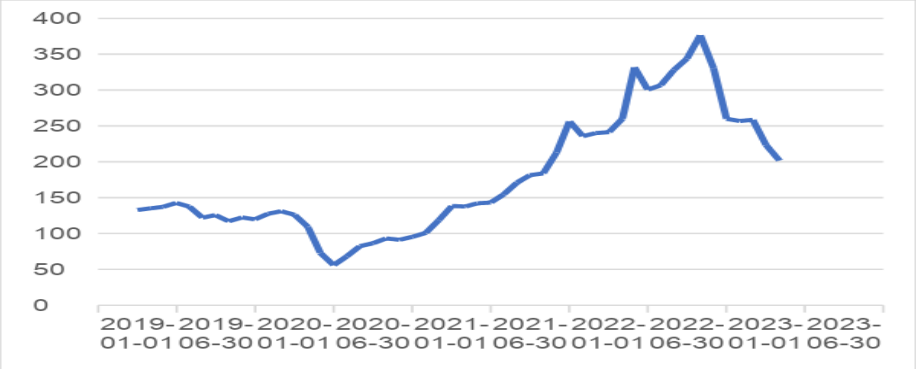

Fig 5. Global price of energy index from 2019 to 2023.

5. Conclusion

This article explores the current economic situation in Canada amidst inflation and analyzes various economic policies that can help to reduce it. Canada stands to benefit from the upward trend in energy prices, and these gains can be used as capital to implement more economic policies that benefit the population while curbing inflation. In order to achieve this, Canada needs to adopt a comprehensive approach that includes an industrial policy that aligns with the country's national resources, a labor and immigration policy that complements the industrial policy, and a trade policy that effectively combats inflation. One of the key actions that Canada should take is to increase wages in the energy industry and the secondary industry chain to attract more workers. Additionally, Canada should expand its immigration policies to attract skilled workers to related industries. On the trade front, Canada should prioritize increasing trade exchanges with Mexico under the U.S.-Canada-Mexico agreement to boost economic income and reduce inflation. This paper argues that a combination of monetary and fiscal policy measures is necessary to effectively deal with the pressures brought on by inflation. Under the current trend of rising energy prices, Canada can leverage the potential of its energy industry to subsidize domestic losses on inflation while promoting economic development, increasing wages, attracting immigrant workers, and expanding foreign trade, among other measures, to effectively address the challenge of inflation.

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