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Inflation in Canada—the causes, consequences and beneficiaries

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VANCOUVER—The Bank of Canada this week raised its interest rate to combat inflation, which has reached levels not seen in decades, and yet the causes, consequences—and crucially, the beneficiaries—of inflation remain largely unknown to many Canadians, argues a new study released today by the Fraser Institute, an independent, non-partisan Canadian public policy think-tank.

"It's hard to overstate the economic effects of today's higher inflation on Canadians across the country, but because inflation has been relatively low and stable for more than 30 years, most Canadians don't understand the basics of the issue," said Steven Globerman, professor emeritus at Western Washington University, resident scholar at the Fraser Institute and author of ***A Primer on Inflation***.

Since 1991, the Bank of Canada kept the annual rate of inflation at around 2 per cent, but in February 2022, the inflation rate hit 5.7 per cent and will likely continue to climb. In an effort to combat higher inflation, the Bank of Canada raised its policy interest rate by 0.5 percentage points on Wednesday to 1 per cent.

Here are some common questions about inflation.

What is inflation?

Simply put, inflation occurs when the average price of goods and services increases.

What triggers inflation?

There are many potential causes of today's higher inflation including the Bank of Canada's recent penchant for financing government spending by printing more money—when there's more money in the economy, but the same level of goods and services, the price of those goods and services increases.

Who suffers from inflation?

When average prices rise (food, gasoline, etc.) Canadian families must pay more or reduce their consumption. And crucially, if inflation rises faster than incomes, living standards decline.

Who benefits from inflation?

Governments benefit from inflation in two main ways. First, because inflation increases the price of goods and services, the value of money effectively declines—as does the value of debt. When the value of debt declines, the cost of debt interest payments also essentially declines. Second, inflation tends to increase the nominal value of assets such as real estate, which increases the capital gains tax liabilities of Canadians who sell those assets, thereby pushing some Canadians into higher tax brackets. Consequently, government tax revenues will increase even though the "real" incomes and wealth of most Canadians may remain constant or even decrease.

Why would the Bank of Canada—or any central bank—raise its interest rate to combat inflation?

When the central bank raises its interest rate, it affects other interest rates in the economy (mortgage lending, for example). Typically, higher interest rates prompt more saving, less borrowing and less spending. When spending on goods and services declines, sellers of goods and services (grocery stores, for example) lower prices—or at least increase prices more slowly—to encourage consumers to buy. As such, the rate of inflation declines.

"Clearly, today's inflation conditions are much worse than many experts predicted at the beginning of the pandemic and the Bank of Canada believes it's time for a more aggressive monetary policy," Globerman said.

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