BoC faith in Friedman economic model belies the Canadian reality

By Andrew Jackson
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On July 12, the Bank of Canada began to tighten monetary policy, arguing the economy would be operating at full capacity by the end of this year. This action was guided more by the economic dogma of a "natural" unemployment rate crafted by Milton Friedman back in the 1970s than by hard evidence of a looming increase in inflation.

The natural-rate model holds that wage-driven inflation will take off rapidly if unemployment is allowed to fall below a level set by the structure of the national job market. It is estimated by many economists to be about 6 per cent.

To be sure, the Bank of Canada is right to be concerned that ultralow interest rates have helped to stoke a dangerous increase in household debt along with a housing bubble. But the bank is supposed to set interest rates to control inflation, not threats to the financial system that would better be handled by more closely targeted tools such as taxes and regulation of lending and borrowing.

The bank argues the "output gap" has almost closed, meaning that inflation is set to rise above the target rate of 1 per cent to 3 per cent. While acknowledging that capacity is more than just a labour market measure, the underlying view is that we are closing in on the natural rate of unemployment.

While most economists accept that there is some trade-off between unemployment and inflation, no one really knows how low unemployment can fall before wages begin to rise at a faster pace than productivity so as to push inflation above the target level.

We have had no experience of wage-driven inflation since the 1980s, when the job market was hugely different from today. Even the Bank of Canada accepts that the economy has operated with considerable slack in the job market since the global financial crisis hit a decade ago.

If the economy were indeed allowed to operate at capacity in terms of very low unemployment, it could well be that companies would respond by making new investments in capital and skills to raise productivity. More output per hour limits upward pressure on consumer prices and allows for gains in real wages, as we saw in the United States under former president Bill Clinton when close to full employment co-existed with stable inflation owing to strong productivity gains.

Acting pre-emptively to secure low inflation as counselled by Mr. Friedman hurts workers and can be self-defeating in terms of limiting our economic potential since higher interest rates squeeze overall demand as well as private and public investment.

Further, far from taking off sharply at a low unemployment rate, inflation is likely to rise slowly such that monetary policy could respond gradually to a real, rather than imagined, threat. Allowing unemployment to fall below inherently uncertain estimates of the natural rate is not like falling off a cliff.

The main point is that the model of low unemployment inevitably leading to high and rising inflation is based on a lot of debatable assumptions that have not been tested against reality in many years.

This observation is all the more disturbing when one considers the lack of empirical evidence for the bank's argument that our economy is closing in on capacity.

- Point No. 1 is that all of the bank's own preferred measures of inflation show no sign of a pickup. Indeed, we are still firmly at the lower end of the target range.
- Point No. 2 is that there is still a lot of slack in the job market, meaning there are many more persons seeking hours of work than are available. While the national unemployment rate in July hit a near-decade-long low of 6.3 per cent, Statistics Canada's R8 unemployment rate, which takes account of discouraged workers and involuntary part-time work, still stands at 9.7 per cent.

Moreover, the proportion of the working-age population with a job, any job, was 61.6 per cent in July, still much less than the level of 10 years ago, before the recession, when it was 63.4 per cent. The rate for youth and for core-age men remains well below prerecession levels.

- Point No. 3 is that there is zero evidence of rising wage pressures in the Canadian economy. To the contrary, the average hourly wage in July was up just 1.3 per cent, or a meagre 33 cents an hour, from a year earlier.

Not only is there still slack in the job market, the low unemployment number disguises the poor quality of recent job creation. Over the past year, more than one in three of the net new jobs were in the lowest-paid category of sales and service workers, and job creation has been heavily tilted to temporary positions.

The Bank of Canada says it is acting to limit the risk of higher inflation that arises from closing in on capacity. The reality is it is acting on a model that lacks strong theoretical and empirical support, and in the face of overwhelming evidence that there is still a lot of slack in the Canadian job market.

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