# The Best Way to Fight Inflation

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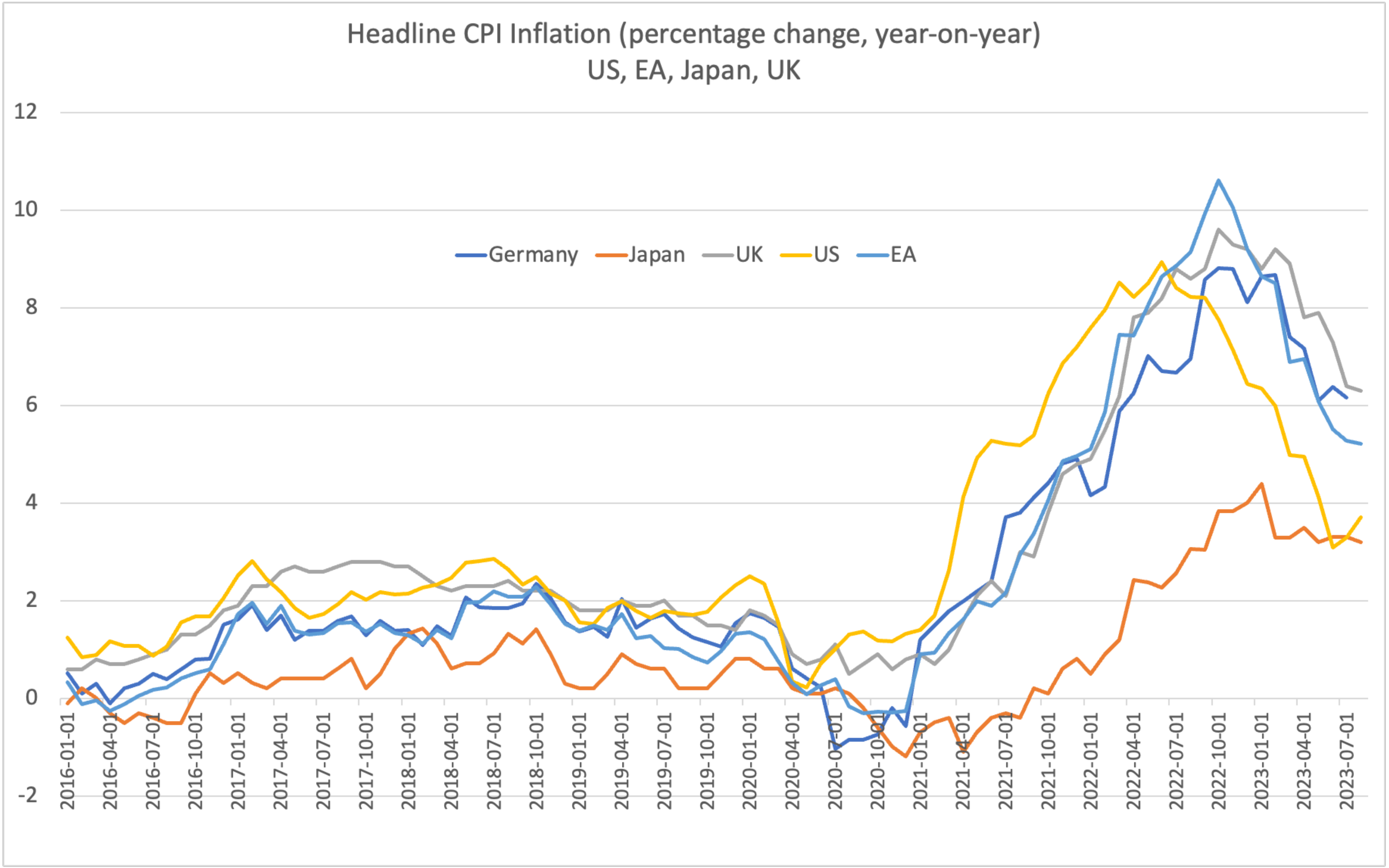

Headline CPI Inflation (percentage change, year-on-year)
US, EA, Japan, UK
Germany
Japan
UK
US
EA
12
10
8
6
4
2
0
-2
2016-01-01
2016-04-01
2016-07-01
2016-10-01
2017-01-01
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2022-10-01
2023-01-01
2023-04-01
2023-07-01

# Overview

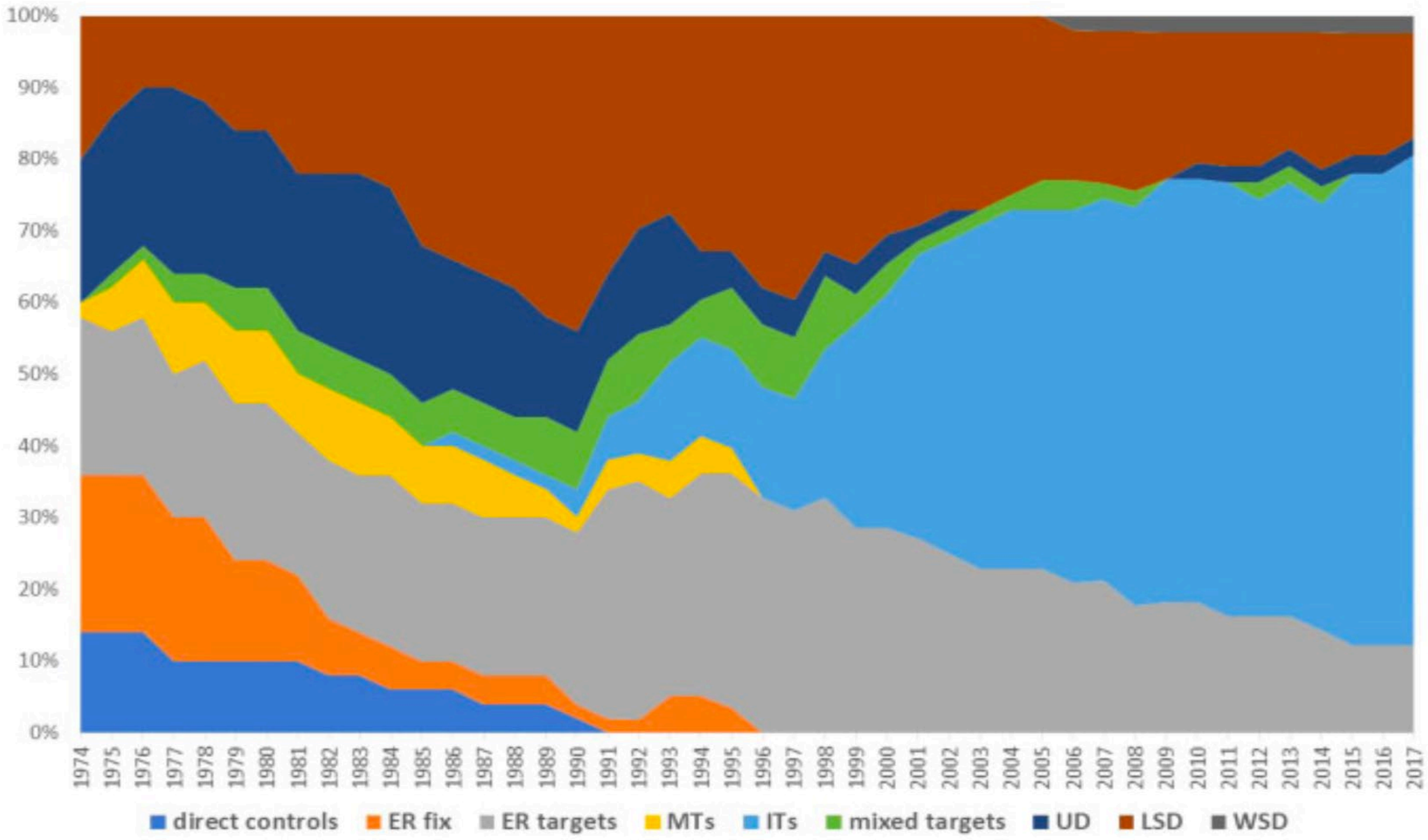
Three Questions:

What caused the global inflation shock in 2021-23?

How should we update the consensus monetary and financial stability framework in the light of this?

What other trends should be factored into a review of the current monetary framework?

# Figure 4: Incidence of Monetary Policy Frameworks Over Time (all countries)




Source: Cobham (2021) (ER=exchange rates; MT=monetary targeting; IT=inflation targeting; UD=unstructured discretion; LSD=loosely structured discretion; WSD=well-structured discretion)

# Key features of consensus framework

- Independence/operational autonomy of monetary policy and financial stability authorities;

- Inflation targeting framework with symmetric 2% target;

- Transparent policy process combined with forward communications;

- Short term interest rate as principal MP instrument (supplemented by UMP such as QE since GFC);

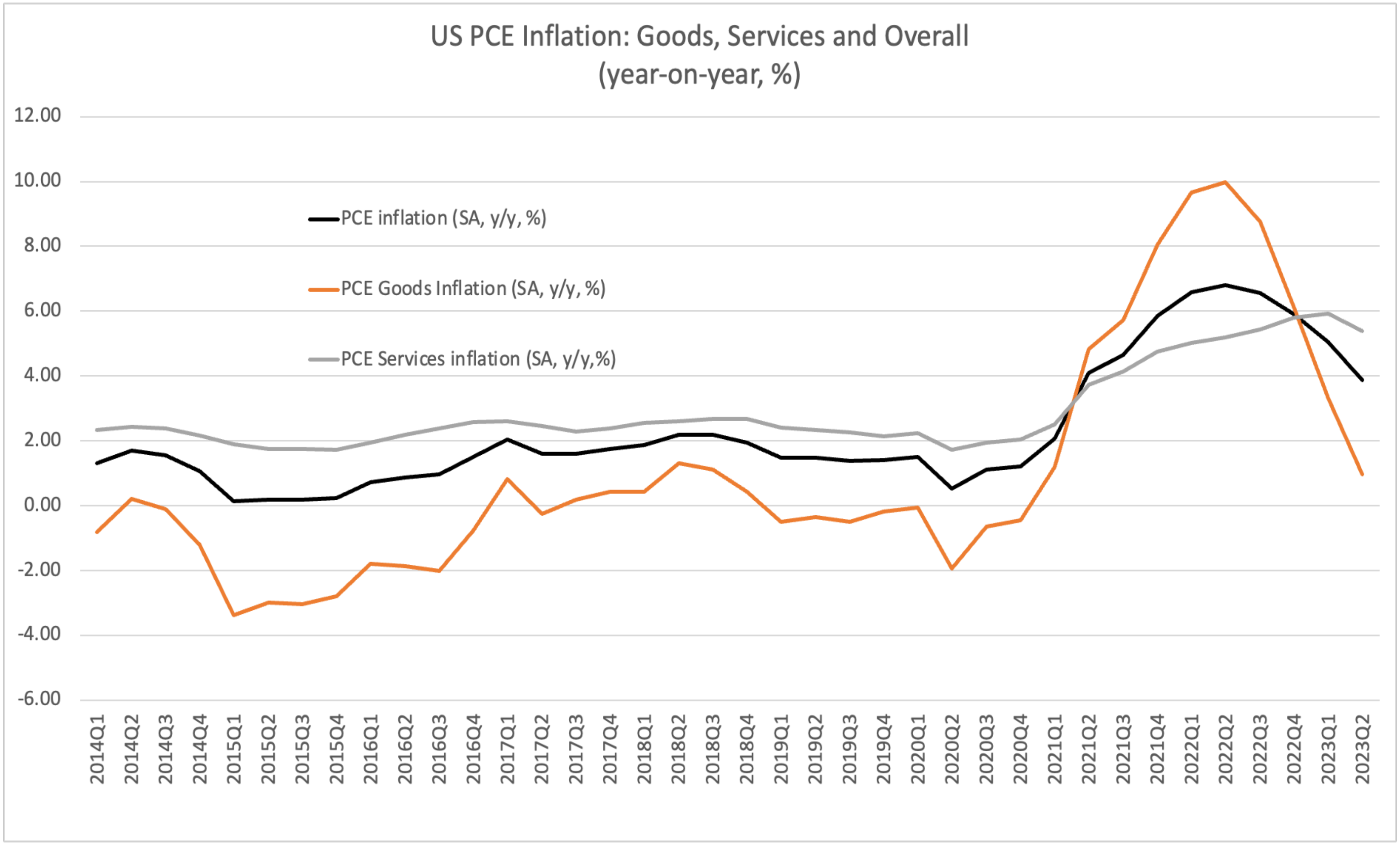
- Macro-prudential measures to underpin financial stability (also since GFC)

# Causes of the 2021-23 Inflation Shock

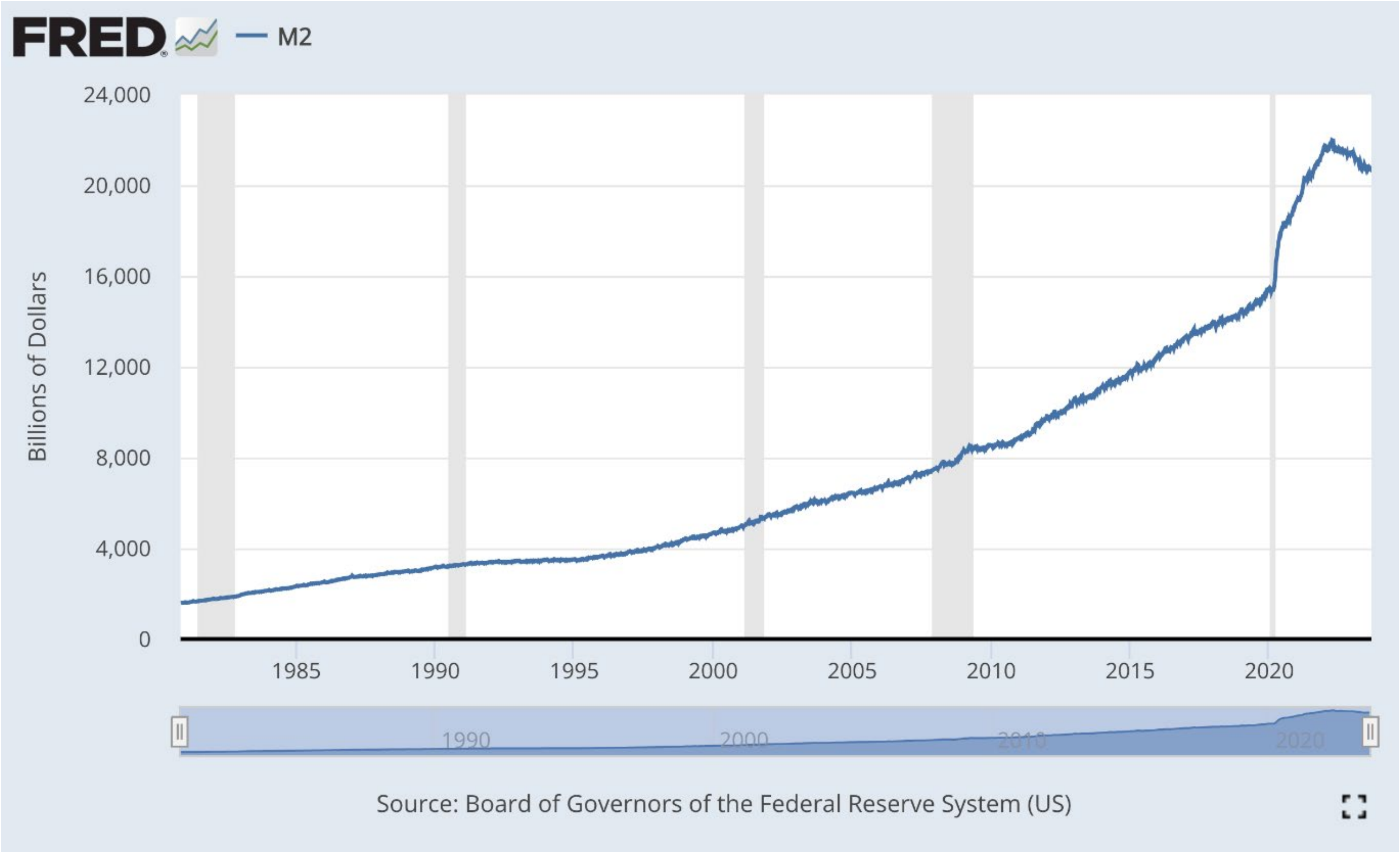
Several ways to view a very complex set of events

- Greater than expected <u>demand</u> growth with constrained <u>supply</u>
- Excess <u>monetary growth</u>
- Rapid closure of <u>output gap</u>

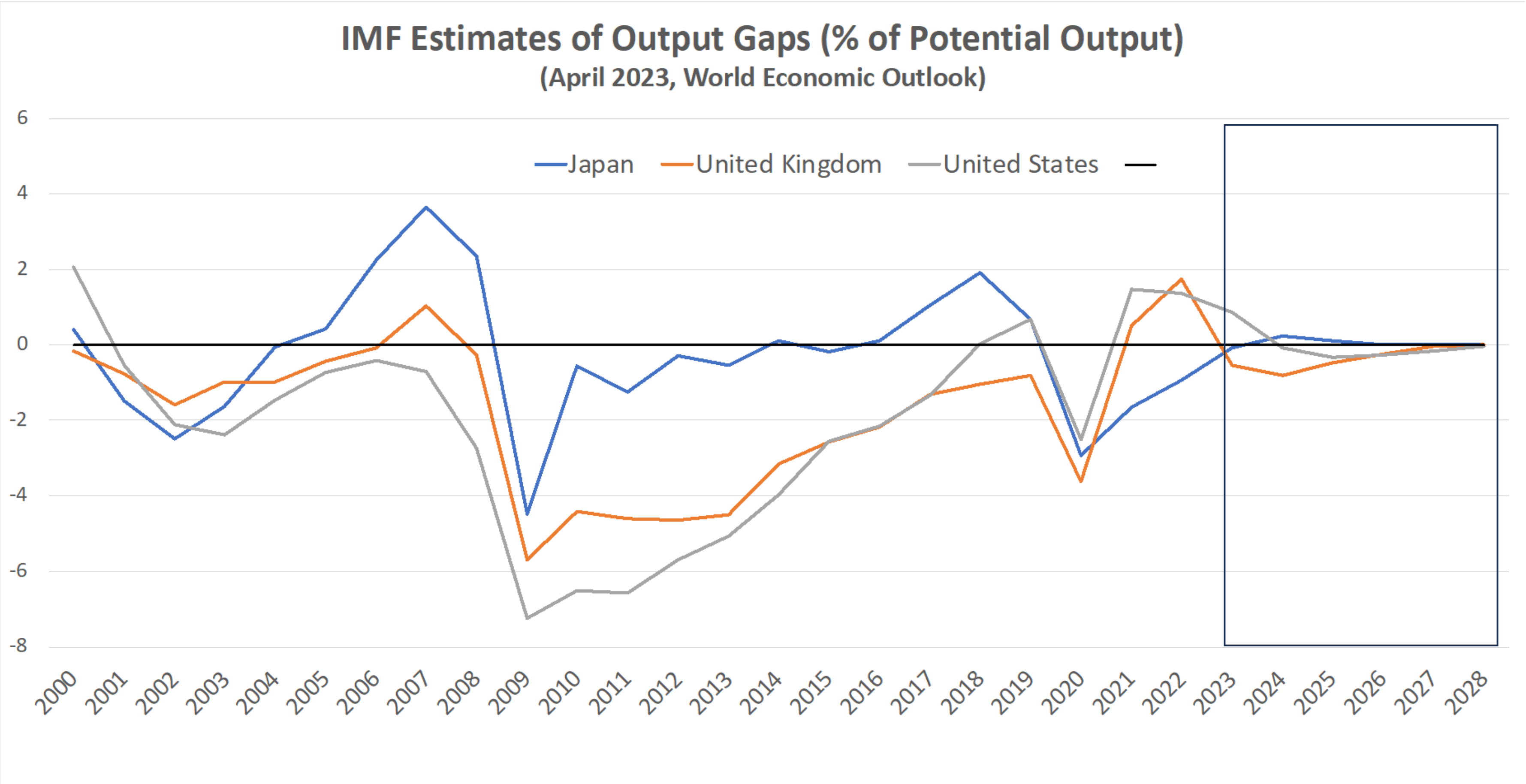
# Unexpected demand, constrained supply……



# Excessive monetary growth .... US M2



# Rapid closure of the output gap….



# Chatham House Monetary Policy Panel

11th September 2023

The best way to beat inflation (chathamhouse.org)

- **Bronwyn Curtis** (NE Board Member, Office for Budget Responsibility, former Head of Research HSBC)
- **Chris Giles** (Economics Editor of the FT)
- **DeAnne Julius** (former member of Bank of England Monetary Policy Committee)
- **Gerard Lyons** (former Chief Economist of Standard Chartered)

# What went wrong?

Three criticisms of central banks (recognising highly complex situation)

Continued with ultra loose policies in 2021 H2 despite rapidly emerging inflation threat (not risk averse enough, trapped by “forward guidance”?)

Compounded earlier error in keeping monetary policy too loose for too long post-GFC……

… and combined with unnecessary/damaging public intervention to guarantee *all* depositors in SVB, Credit Suisse (not same as pandemic, Ukraine energy shock etc )

# Reviewing the monetary and financial stability policy framework

- Learning lessons - Bank of England reviews of data, forecasting.   Other countries?

- Don’t make changes until the crisis is over

- Three questions:

Is there anything we should change about the way the consensus framework is operated?

Is there anything we should change in the framework itself?

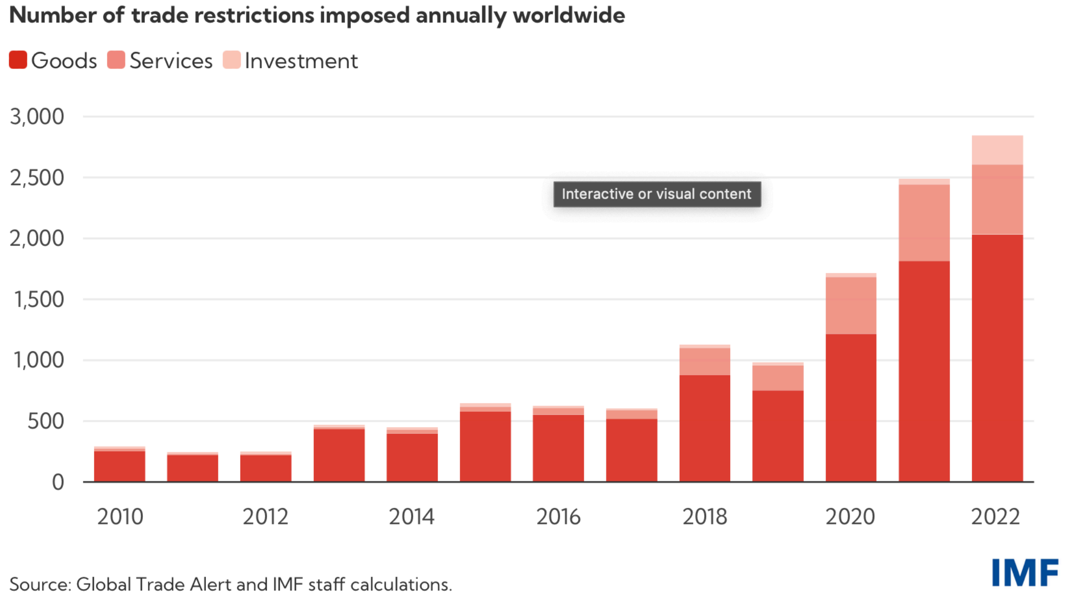
Should we anticipate the impact of other major trends at the same time?

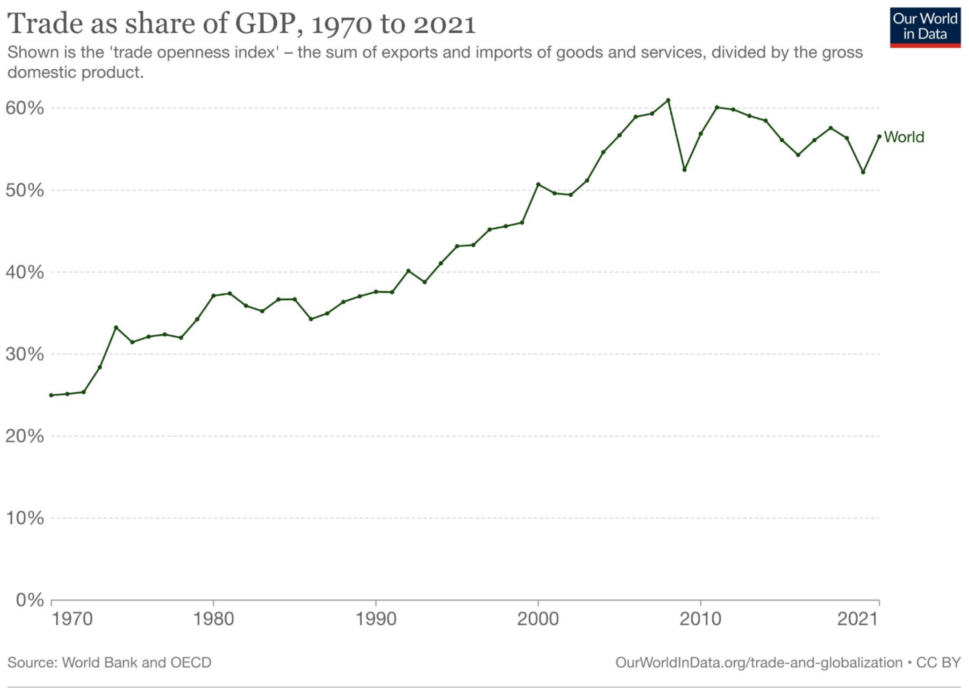
# Four structural trends that CBs should anticipate

- Fragmentation in global markets for goods, services , capital and labour
- Trend towards much bigger, more frequent global shocks
- Possibility of much higher borrowing as countries attempt to close global investment gap
- Threat to operational autonomy from polarisation in politics

# Fragmentation in global markets

Restrictions on trade have greatly increased in recent years.



# Much bigger, more frequent shocks…..

Future pandemics…. and AMR

Extreme weather shocks linked to climate change

Biodiversity loss

Potentially amplified by  current “disconnect” between scientific and market views

# Global investment gap

- To meet the SDGs by 2030, we need an additional $4tn (6% of world GDP) pa of which $2.2tn (3.5% of GDP) is for energy transition
- A substantial part of this is "existential" to mankind (i.e. it cannot be delayed)
- IMF Autumn 2023 Fiscal Monitor proposed "balanced approach"
- But what if countries borrow instead?
- Liz Truss UK experience replayed, or something different? Role of central banks

# Polarisation in politics

What has already happened - Brexit 2016, President Trump 2016, Liz Truss 2022?

What could happen next – Trump II, Marine Le Pen, AfD?

Can you further "hard wire" monetary policy framework into democracies – humility, competence, transparency, coordination mechanisms?

# Conclusions

Change way the consensus monetary and financial stability framework operates:

- deepen CB expertise (geopolitics, climate change, biodiversity loss, health etc) and avoid “group think”;
- increase risk aversion, reform forward guidance, strengthen transparency;

Reform the framework:

- update macro-prudential component to deal with more frequent massive shocks and related fiscal interventions;
- prepare for possibility of greater public borrowing to close the investment gap;