THE BURST OF HIGH INFLATION IN 2021-22: HOW AND WHY DID WE GET HERE?

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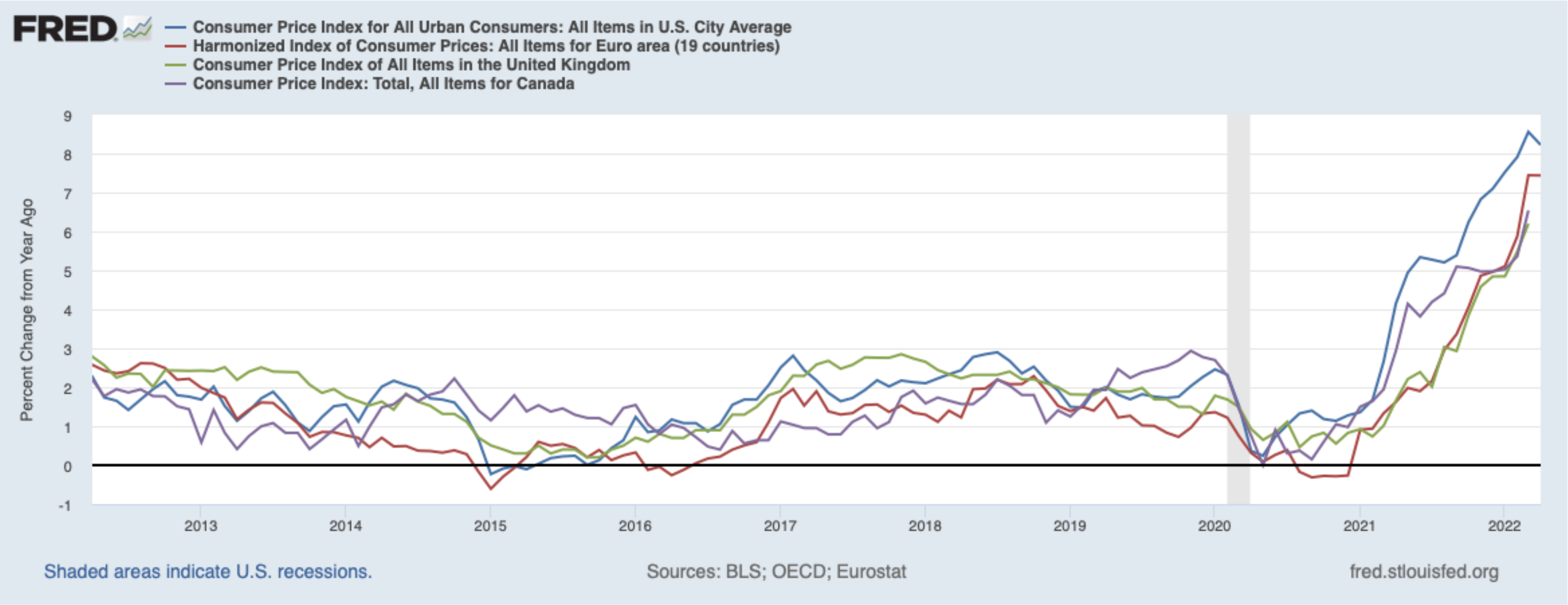
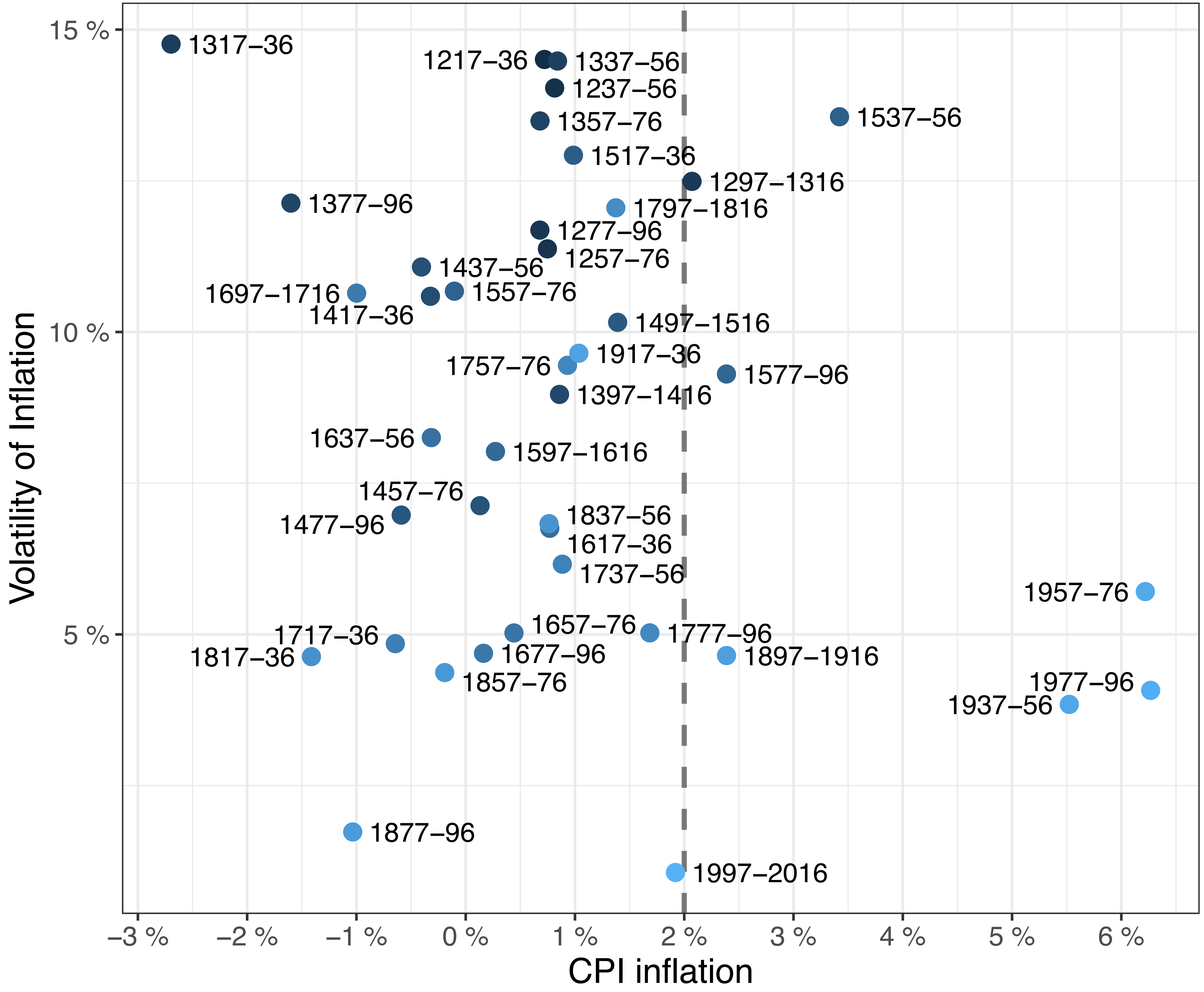
BIS annual conference, Basel

Why are (or should be) hairs on fire?



"*Imagine that inflation was running at 5 percent against our inflation objective of 2 percent. Is there a doubt that any central banker worth their salt would be reacting strongly to fight this high inflation rate? No, there isn't any doubt. They would be acting as if their hair was on fire.*" Charlie Evans, January 2011

The context: 25 years of price stability



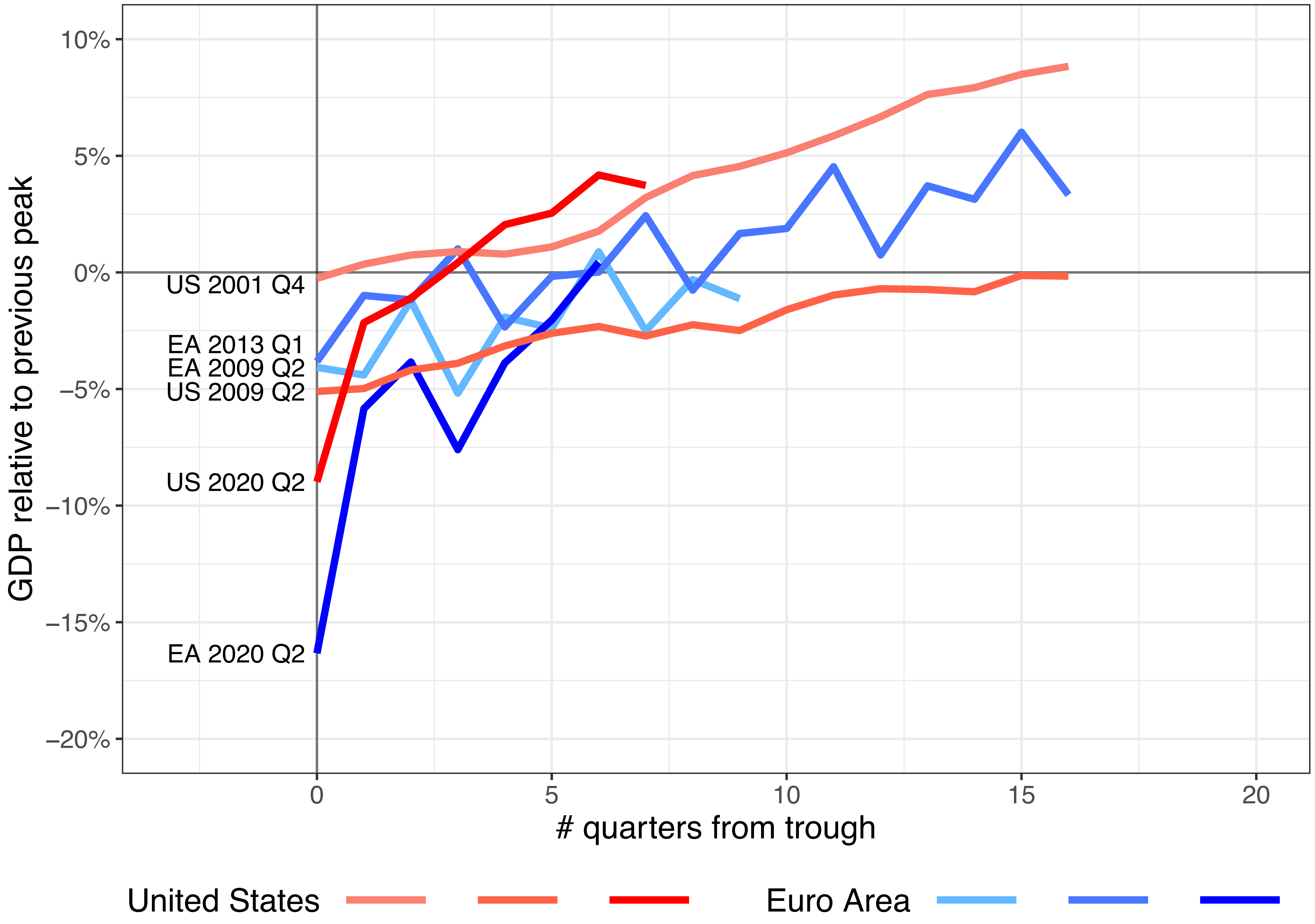
Three pillars of this success

- Central bank independence
- Inflation targeting
- Primacy of the short-term interest rate as the policy tool, set in transparent and predictable way

What went wrong?
Shocks and misdiagnoses

A good problem: very fast recovery

$$\pi = \pi^e + \beta(y - y^*) + \varepsilon$$



- Three drivers of inflation
- 2020 policies end up being excessive
- Benefit of hindsight
- But why did not revert course earlier? Forward guidance?

A tougher problem: supply bottlenecks

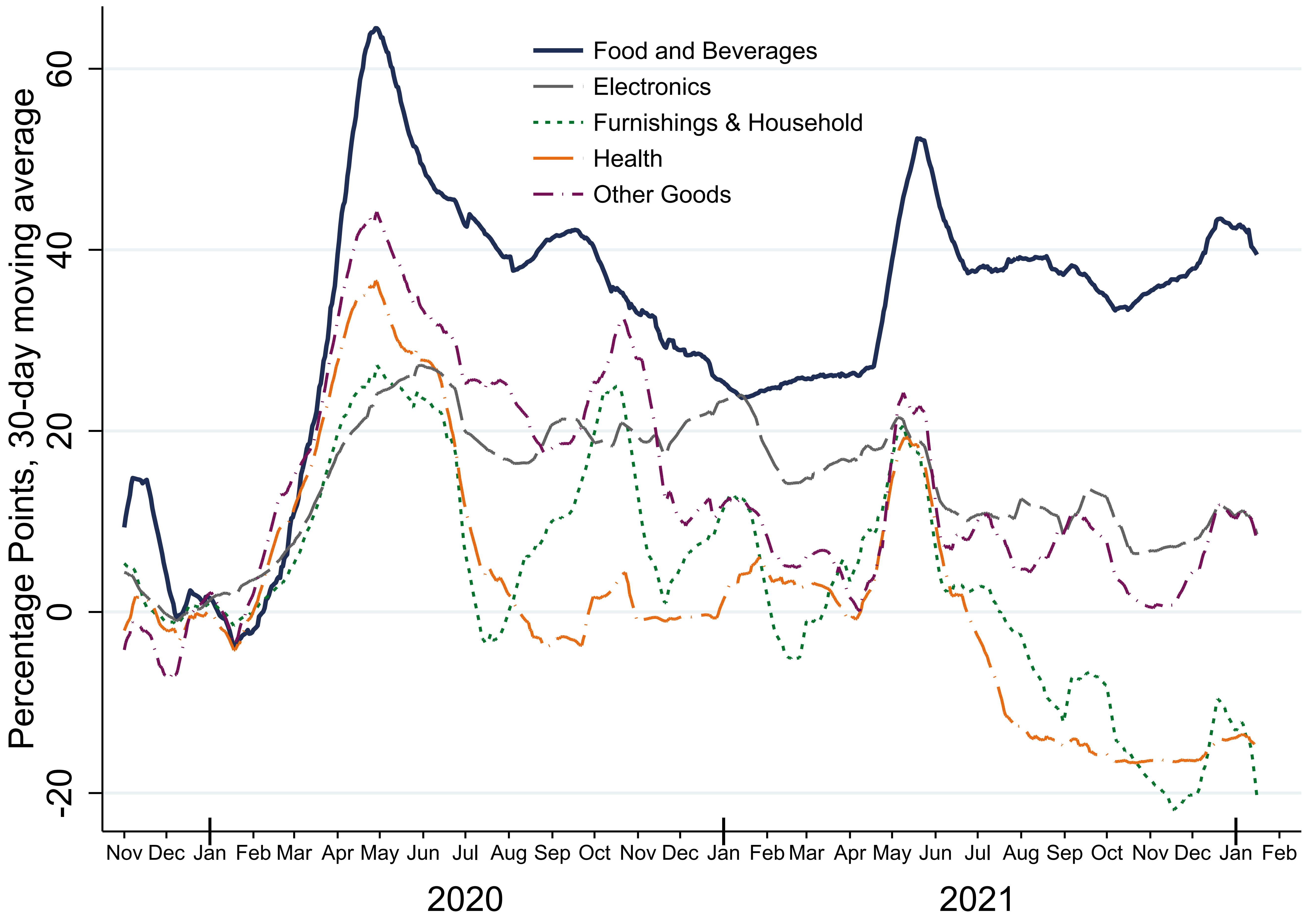


Figure 3: All Stockouts in U.S. Sectors

$$\pi = \pi^e + \beta(y - {\color{red} y^*}) + {\color{blue} \varepsilon}$$

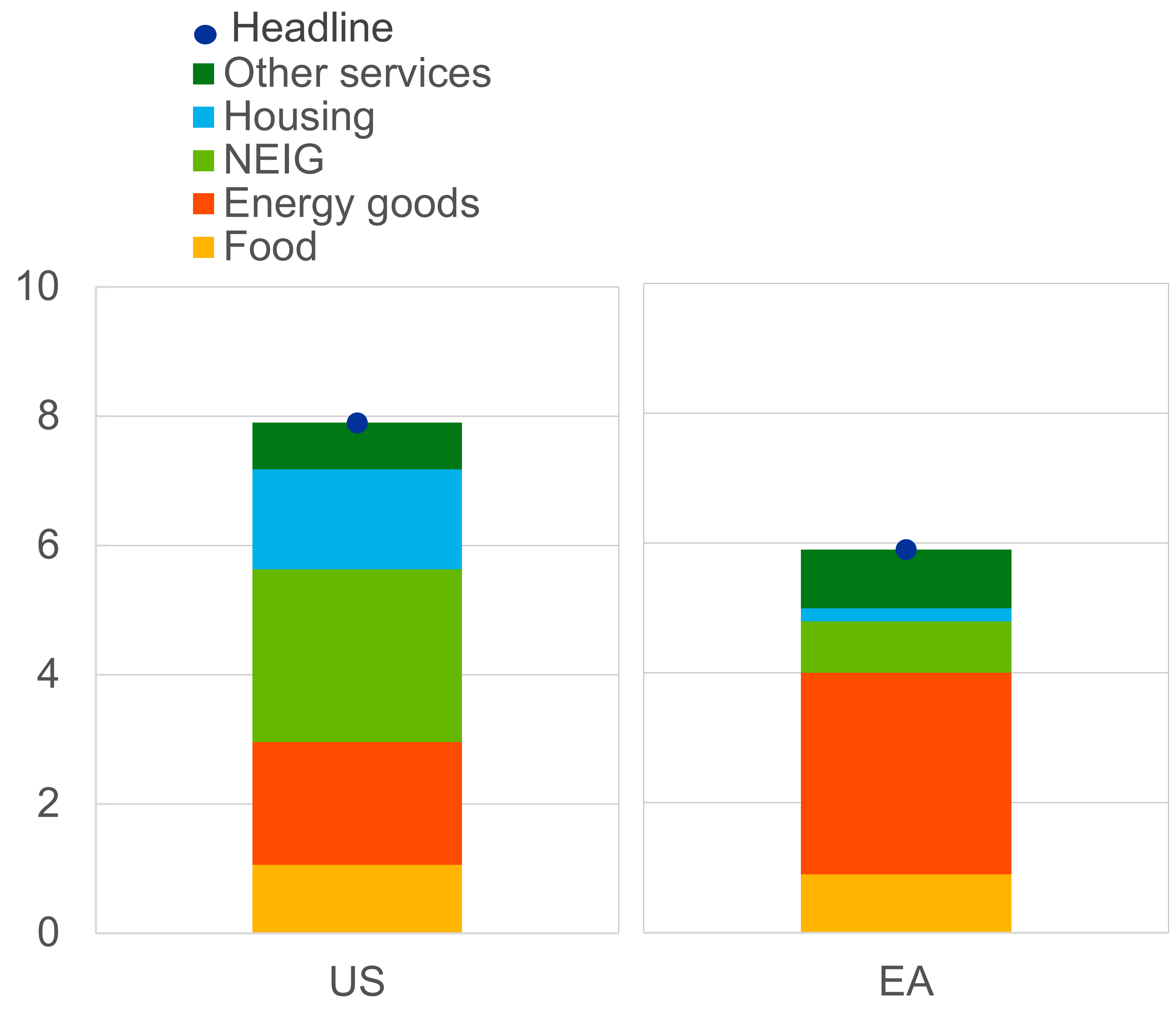
- Policy interpreted all of them as temporary markup shocks
- Ports, global supply chains, globalization: may be declines in the potential output.
- Allow deviations from target, or divine coincidence

Sources: Cavallo Krystov (2022)

Next: energy and same reaction

Inflation drivers in February 2022

(annual percentage changes, percentage point contributions)

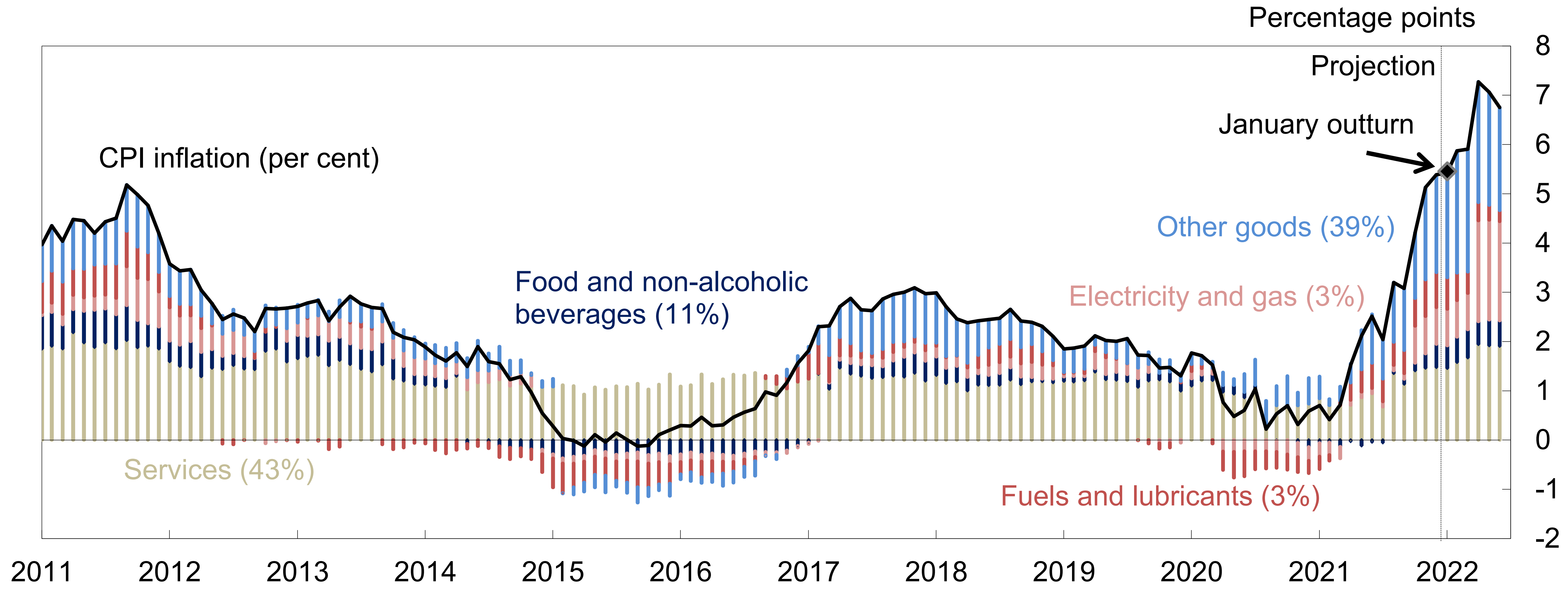


Source: Haver DLX and Eurostat.

$$\pi = \pi^e + \beta(y - y^*) + \varepsilon$$

- Same interpretation as markup shock
- See through valid only if expectations anchored

Chart 1 – Contributions to CPI inflation



Sources: Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, ONS and Bank calculations.
Notes: See notes to Chart 2.19 in the February 2022 *MPR*. January 2022 outturn shown for aggregate CPI inflation only, all other data from January to June 2022 are Bank staff's projection at the time of the February *Report*.

Sources: Schanbel (2022), Tenreyro (2022)

What went wrong?
expectations

Expectations well anchored, if anything too low

August 27, 2020

New Economic Challenges and the Fed's Monetary Policy Review

Chair Jerome H. Powell

At "Navigating the Decade Ahead: Implications for Monetary Policy," an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming (via webcast)

"adverse cycle of ever-lower inflation and inflation expectations"

August 27, 2021

Monetary Policy in the Time of COVID

Chair Jerome H. Powell

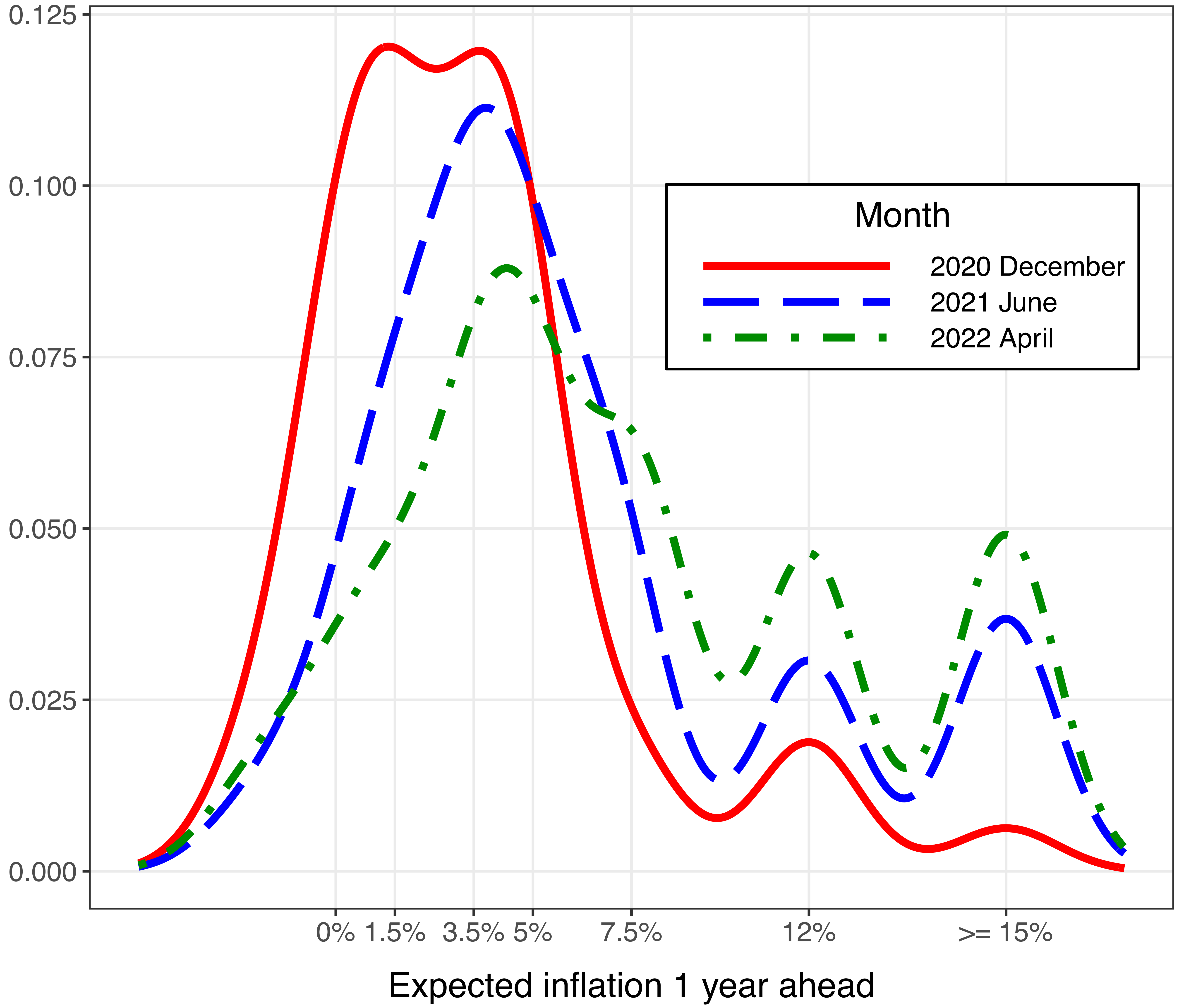
At the "Macroeconomic Policy in an Uneven Economy," economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming (via webcast)

"Households, businesses, and market participants also believe that current high inflation readings are likely to prove transitory and that, in any case, the Fed will keep inflation close to our 2 percent objective over time."

Consequences:

- Expectations constant, major factor driving inflation up removed
- Welcome a rise in expectations if fear is rather a deflation trap
- Temporary inflation shock will not become persistent.

Expectations beyond means

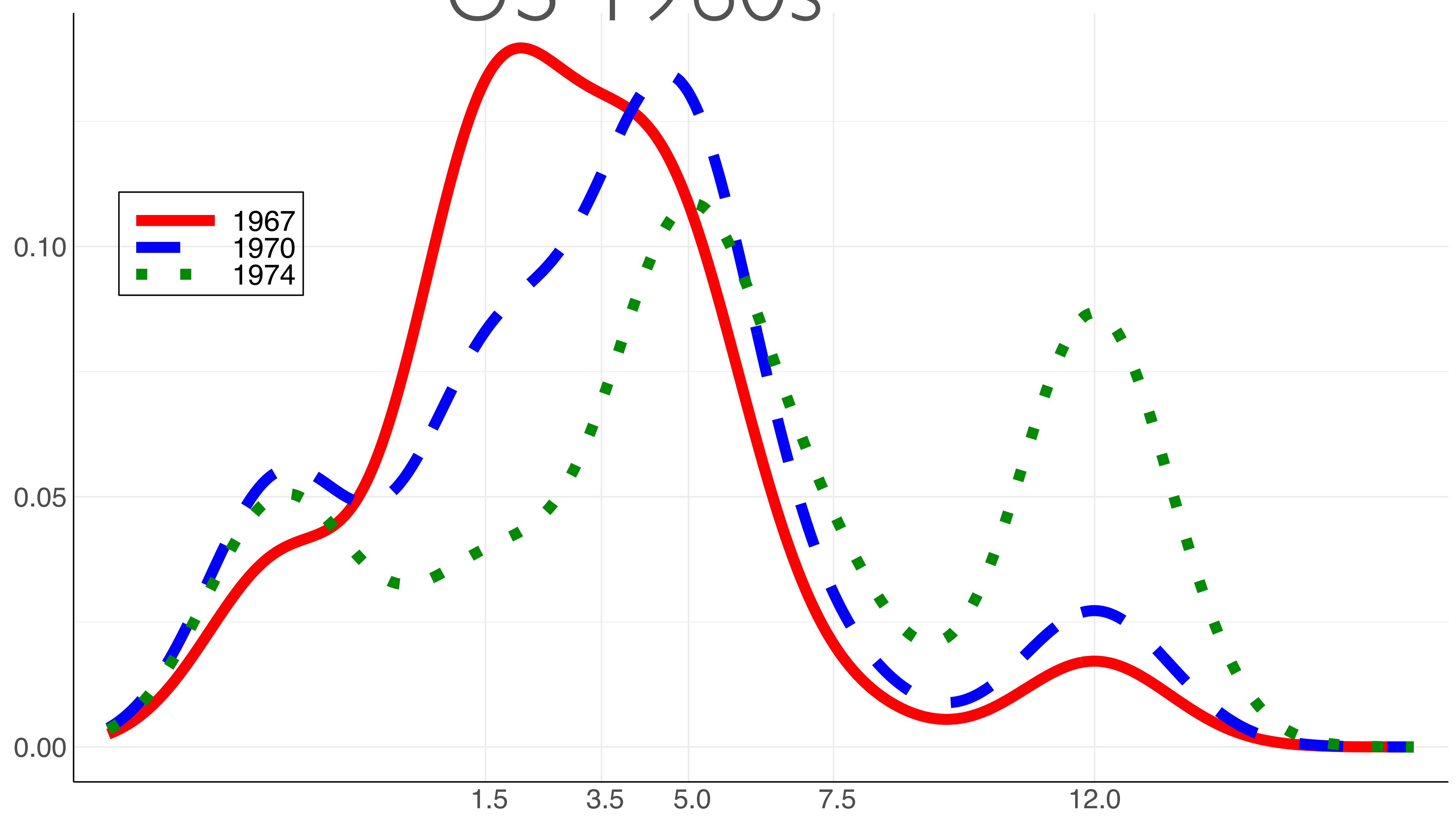


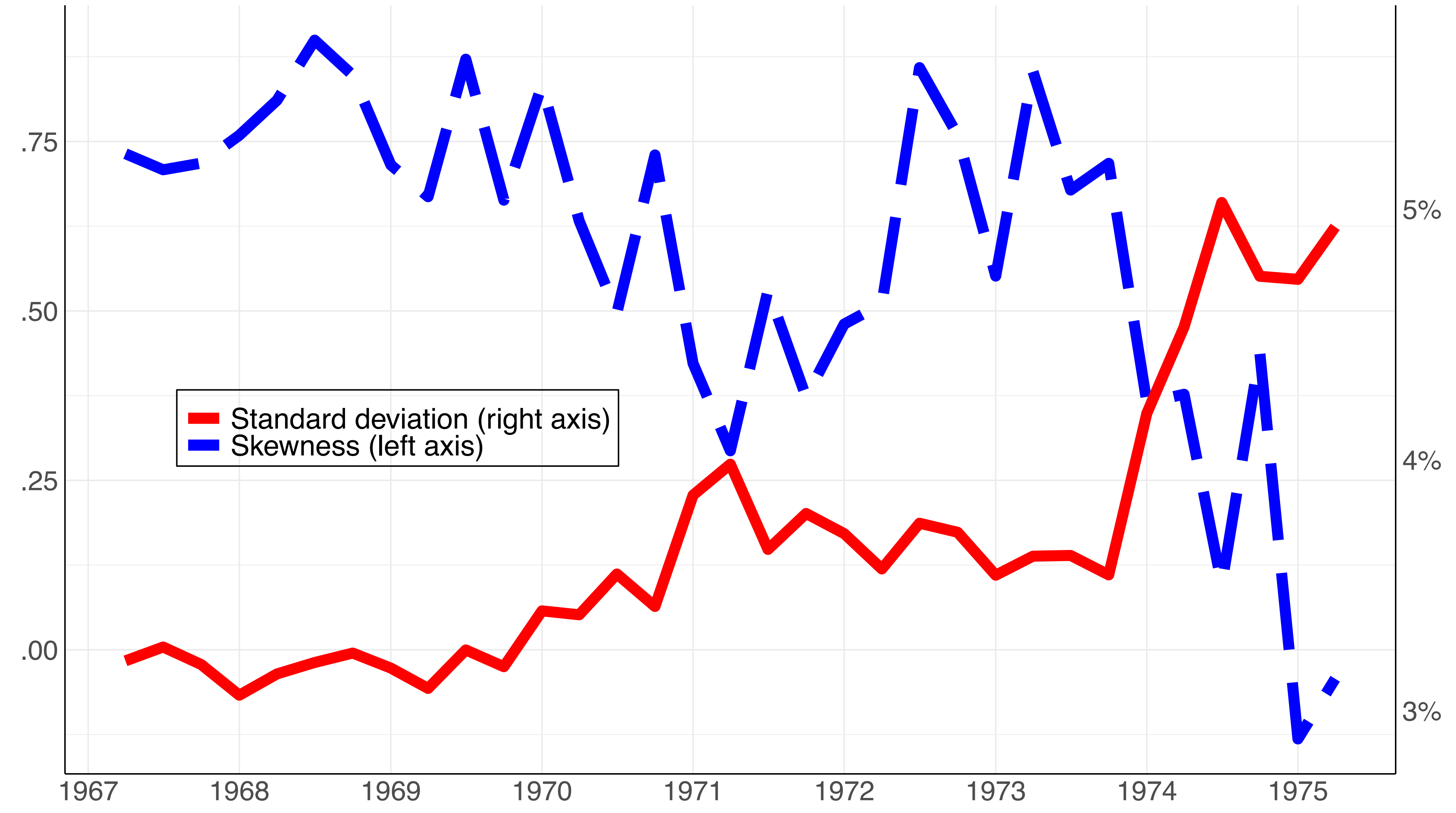
How survey expectations tend to shift:

- First get skewness
- Then get variance
- Then both decline, and the mean has definitely shifted
- Temporary inflation shock becomes persistent.

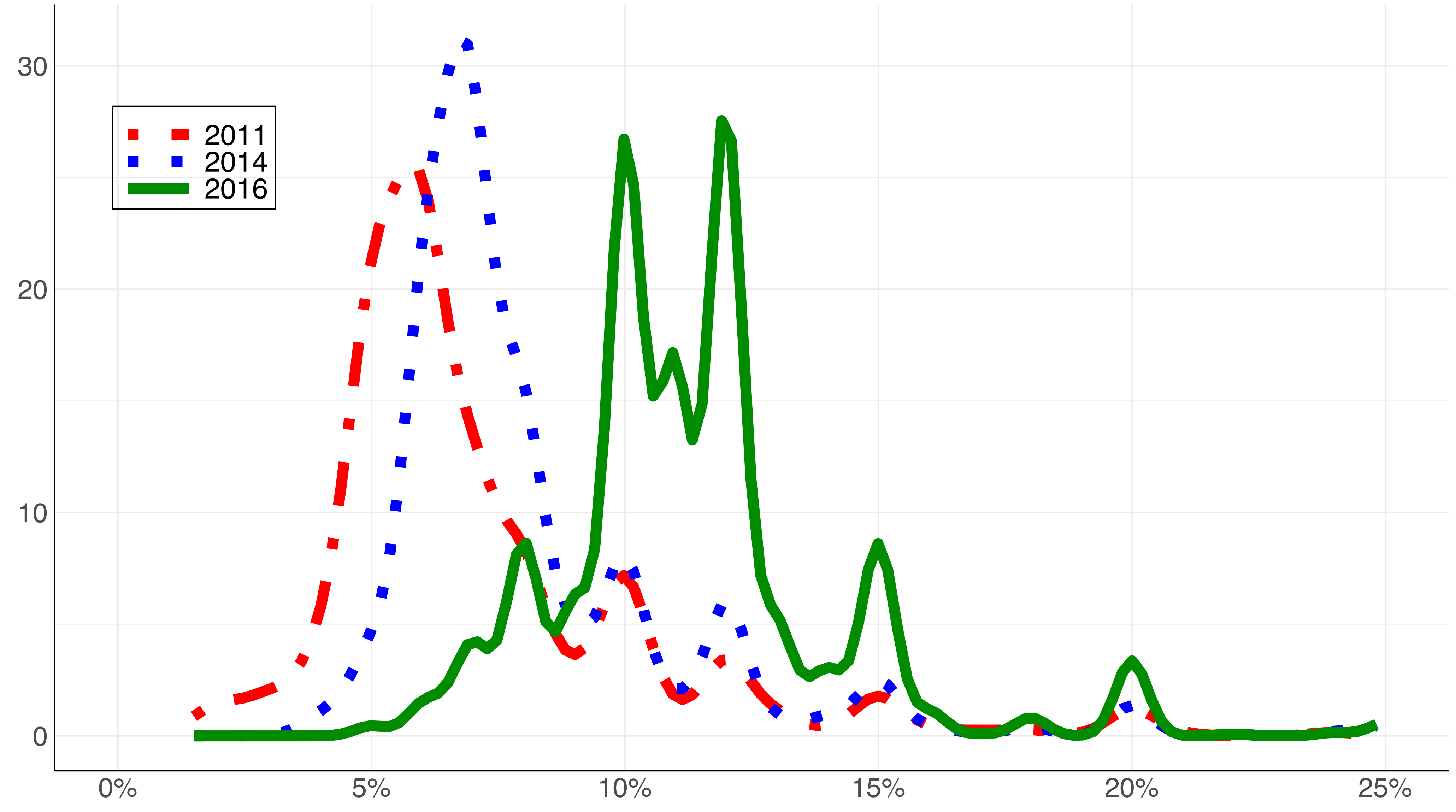
Happened before…

US 1960s

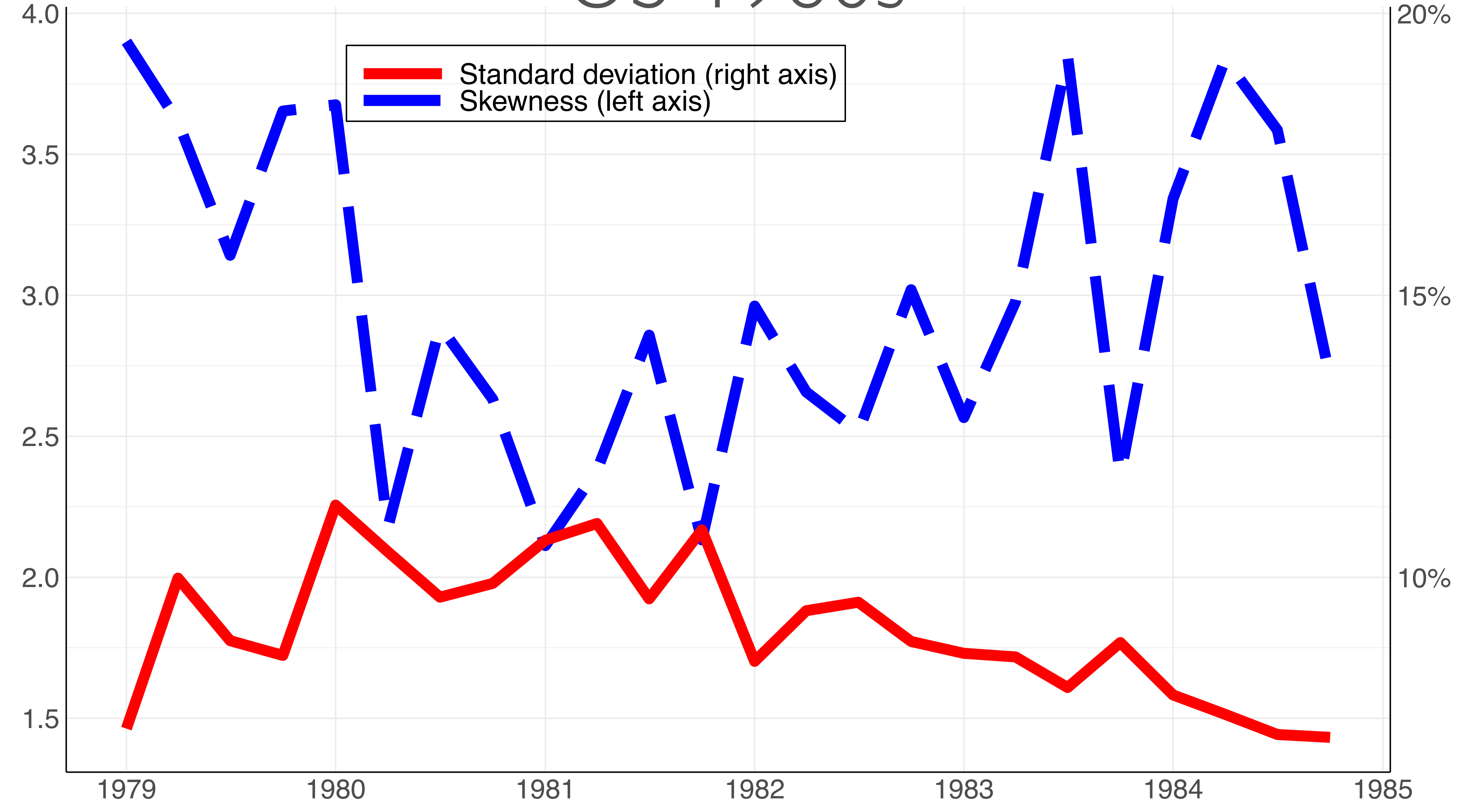




Brazil 2010s



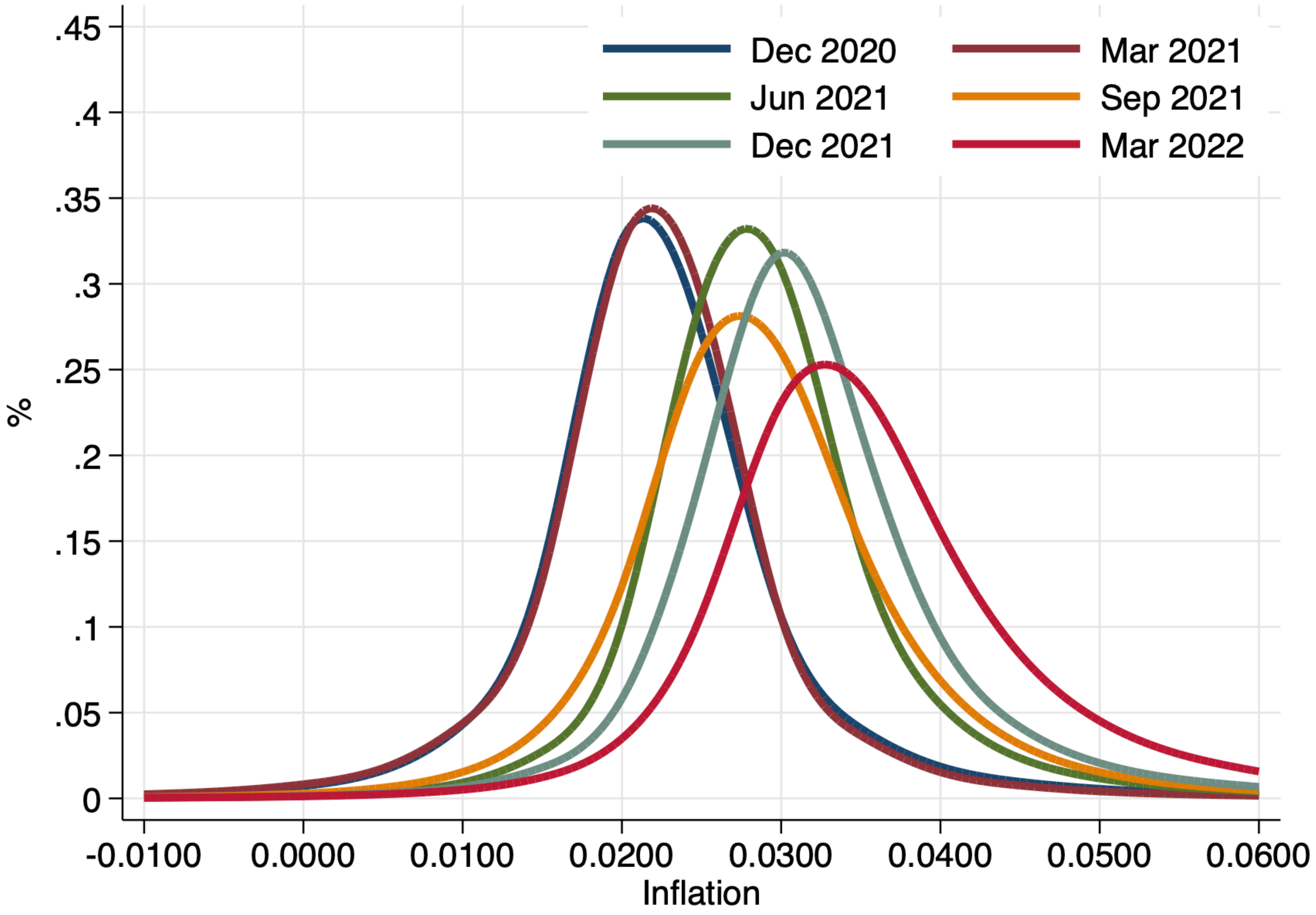
US 1980s



Source:: Reis (2022)

What went wrong?
credibility

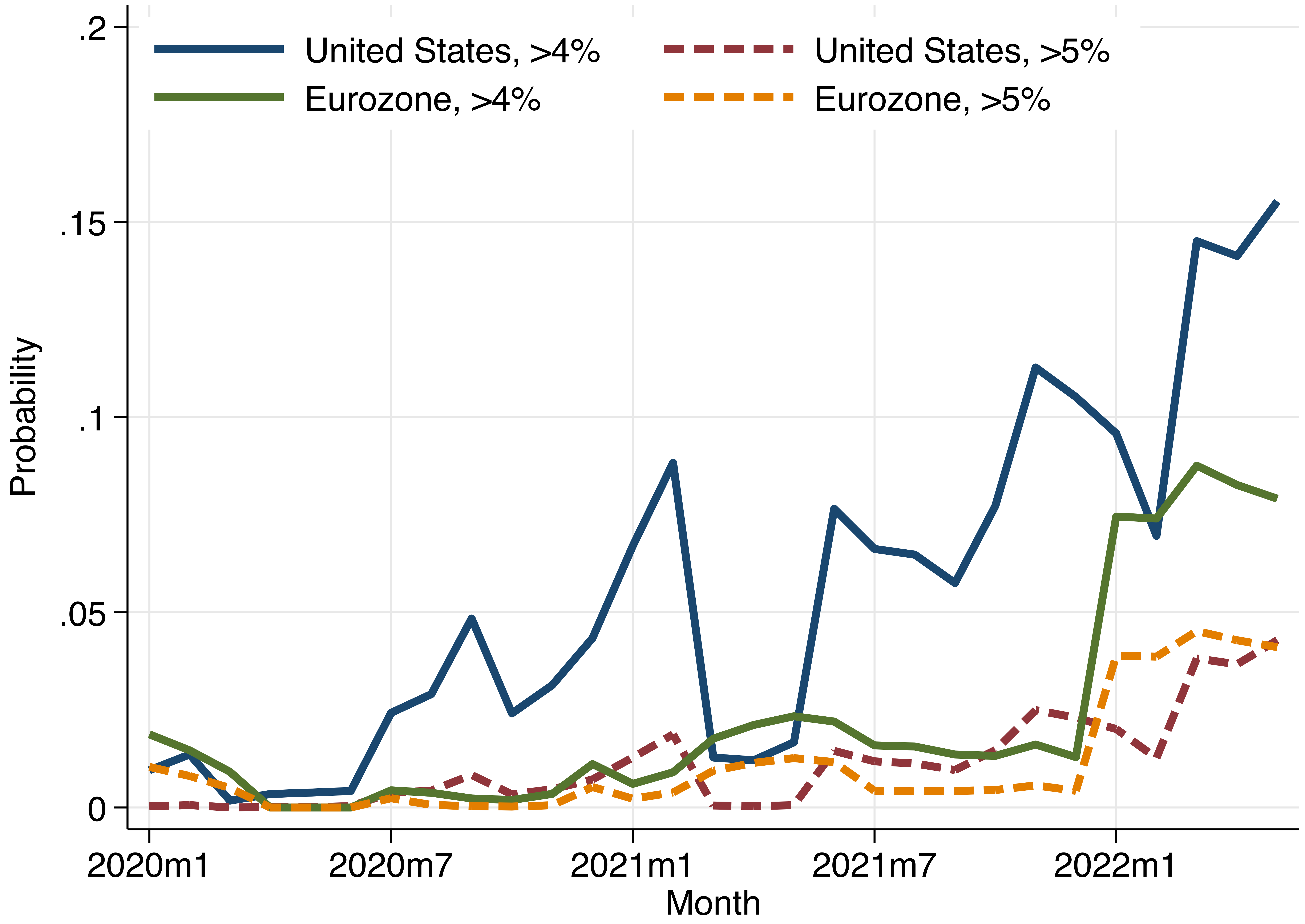
Credibility: look further ahead, 10 years



$$\pi = \pi^e + \beta(y - y^*) + \varepsilon$$

- Capital of inattention
- If stable, exploit trade-offs with real activity, flat curve doveish. Otherwise inflation
- From August on, the emergence of a thicker right tail

Back out from insurance prices (options)



What is the current date market-perceived probability that average inflation will be above 4% 2027-2032?

A serious lack of faith in monetary policy, not seen before.

Relying on credibility to offset shocks is bold

What went wrong?
r* and the tolerance of inflation

The focus on r*

"…fall in the equilibrium real interest rate, or "r-star" …". Powell (2020)

"structural developments have lowered the equilibrium real rate of interest" ECB (2021)

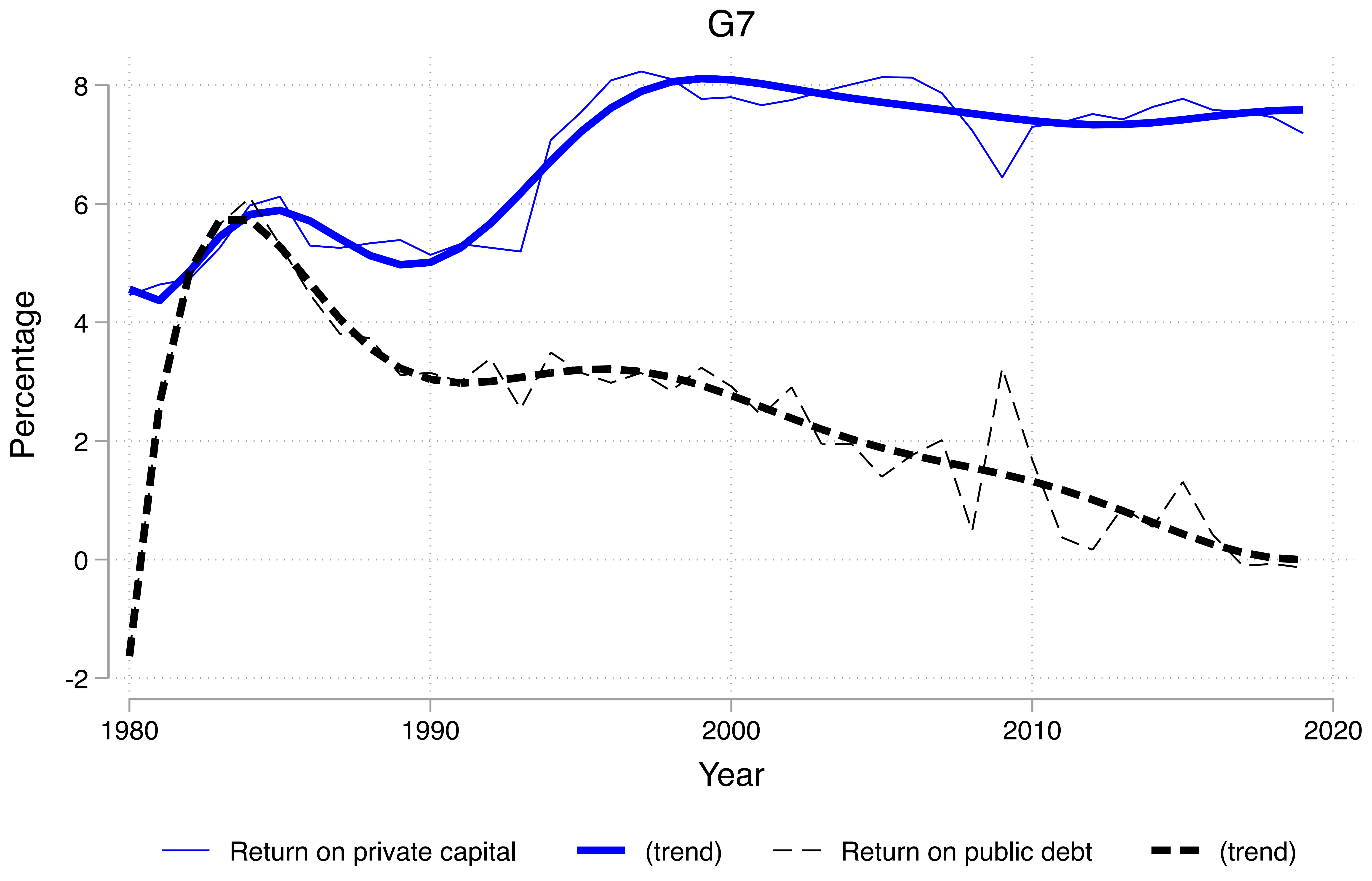
Focus on low r*, natural or neutral real interest rate

- investment=savings and output is at potential or long-run steady state

Why it matters?

- More likely policy is too tight once hit ZLB
- Deflation trap, insufficient demand, ZLB, commit to be irresponsible
- Focus on aggregate demand
- Likewise for fiscal policy, also as more relaxed about debt sustainablity

Because return to capital high, to debt low



- r* has fallen: returns on public debt
- r* has stayed constant: returns on private capital
- Big increase in specialness of debt, in the wedge
- In neoclassical model, it is the return on private capital that matters for potential output

Different focus for monetary policy

- Promising higher inflation no longer crowds in investment, less appealing
- Escaping ELB not as central, especially if do not close the gap
- Aggregate supply focus on capital allocation
- Inflation can hurt debt sustainability

Delivering on price stability mandate is more important

Conclusion

Conclusion and policy priorities

Presumption: central banks can always rein in inflation, deviations are a choice.

Last 12 months are a significant deviation from 25-year success. Why?

1. Misdiagnosed shocks, always in same direction. Accept lower potential
2. Steadfast belief that expectations would stay anchored, underestimate persistence. Act vigorously and sharply to re-anchor
3. Over-reliance on credibility, surprised by how much inflation rose. Focus on primacy of price stability
4. Estimates of falling r*, tolerance of inflation. Look at aggregate supply, revise up relative costs of inflation