Tim Phillips [00:00:00]:
Today on VoxTalks Economics, what do we learn from the monetary policy responses to post pandemic inflation? Welcome to VoxTalks Economics from the Center for Economic Policy Research. My name is Tim Phillips, and every week we're bringing you the best new research in economics. Remember, subscribe, follow us on Instagram as well at VoxTalks Economics. After COVID demand rebounded more rapidly than we expected and this combined with supply side shocks and Ukraine war commodity price hikes to make inflation spike. In response, central banks around the world tightened monetary policy. New ebook from CEPR Press explores what they did and how well that worked and suggests some lessons that will maybe help policymakers cope with the next inflationary episode. Bill English of Yale is one of the authors. He joins me now.

Tim Phillips [00:01:06]:
Bill, welcome to VoxTalks Economics.

Bill English [00:01:08]:
Thanks very much, Tim. Happy to be here.

Tim Phillips [00:01:11]:
Bill, you collect a lot of data together in this ebook. How many of these economies and responses did you manage to analyze, and who's doing the analyzing?

Bill English [00:01:20]:
The analyzing is being done for the most part by central bankers in the countries. Economists from 15 countries were involved. So we had, for example, Chris Waller, Governor of the Federal Reserve, Phil Lane, Chief Economist at ECB. So a range of people. But we wanted to get policymakers from the institutions to write up while it was still fresh, the issues that they faced and the decisions that they made and why they made the decisions that they made.

Tim Phillips [00:01:47]:
And I see you split those responses between emerging economies and advanced economies. Broadly speaking, what was the difference in response between these two groups of central banks?

Bill English [00:01:58]:
One of the most interesting things we found in the book was that the emerging market central banks usually moved more quickly to raise rates once inflation began to surge. I think that was because they were less confident that they had the credibility to look through the inflation surge. They thought that inflation expectations would rise. In some cases, their currencies did in fact fall pretty substantially. So for them, the challenge was more immediate, and their response, for the most part, was more immediate. There are special cases. There's Turkey, which went its own way, for example. But for the most part, that was true. By contrast, in the advanced economies, central banks were more confident about their credibility that they've built over the

last generation or so for delivering low and stable inflation. And so they thought they could look through the inflation for a while. In some cases, they were also constrained by their forward guidance, by their asset purchases, the US, the ECB, they kind of had to unravel some of their communication before they could start raising rates. And we think that also pushed them back by perhaps six months or so relative to what they might have done otherwise based on the economic conditions they were facing.

Tim Phillips [00:03:13]:
There is so much detail in this, and as you say, it's so interesting to have it written by the people who were there making the decisions. But I note that you've distilled seven lessons from this. So we're going to have a look at those in a moment.

[Voiceover] [00:03:32]:
When the Federal Reserve raised rates, some feared it would cause crises in emerging markets. But this time was different. Why? Listen to Sebnem Kalemli-Ozcan explain in our episode on Global Transmission of Fed Hikes from January this year.

Tim Phillips [00:03:55]:
Okay, Bill, seven lessons. First one, improve inflation forecasting. I think that's something that's quite easy to say. I imagine it's extremely difficult to do. What new data or new methods should we employ to do this?

Bill English [00:04:09]:
Just stepping back for a moment, I think it wasn't surprising that forecasts were bad in the face of a pandemic. This was something that we hadn't seen since the post World War I era, really the first global pandemic in the modern global economy. We had no experience with shocks like that. So if you're in the business of estimating models and you have an event that wasn't something that happened during the period that you were using the data that you were using to estimate your models, it's not surprising that you missed that. And so the difficulties with forecasting, I think, weren't all that surprising. The question is, what do we learn? How can we do better in the future? I think we learned a few things. We learned about nonlinearity of the Phillips curve, that when output got significantly above what was the sustainable level of output, given the shocks from the pandemic, inflation went up a lot. And I think that nonlinearity is a lesson and is something that people will want to incorporate into their forecasting and their thinking. I think we learned about the interactions between supply shocks and slack, those economies that were really tight. When the supply shocks hit, they had bigger effects. And so there was a dynamic there that I think we can learn from. We also learned about, as you were suggesting, new data and new ways of thinking about inflation. And that may be helpful. So, for example, the use of information on the frequency of price changes, that proved helpful in models that people write down. The frequency of price changes matters, but you usually think of it as kind of exogenous. It's just a thing. It's a parameter. But that moved. That changed. When inflation was going up quickly. Firms moved more rapidly to adjust their prices. That contributed to the higher inflation, and I think information on that will be a greater focus of attention in future

inflationary periods. But again, to think a little more broadly about forecasting. I think the single biggest question that central banks faced about the high inflation was whether it was mostly about supply shocks that would go away over time so long as inflation expectations didn't get out of hand. Or was it mostly about excess demand and that was going to get built into wage and price setting and give you ongoing high inflation. In that case, policy really would have to tighten a lot. I remember some commentators saying unemployment will have to go to seven and a half percent for two years to bring this inflation down. The judgment at most of the central banks was it wasn't really that it was more about supply shocks, it was more about disruptions from the pandemic. A lot of it would pass. They didn't need to aim for a big recession to bring inflation down. And that judgment, at least for now, definitely looks right. And that was really important for the policy outcomes that we've seen.

Tim Phillips [00:06:51]:
Relatedly, second lesson, you can't just look through supply shocks. As you point out, this is a textbook assumption. Why is the textbook assumption wrong?

Bill English [00:07:02]:
Looking through supply shocks and not responding to them with policy is reasonable if you're confident that inflation that you get won't undermine confidence in the central bank's willingness and intention to move inflation back to target over a reasonable time, so expectations remain well anchored, inflation goes up, but then it comes back down again and you're back more or less where you started. I think the problem was that large enough and a long enough series of shocks like the ones that we saw in the end do undermine that confidence and they cause bigger inflation problems. So we saw movements in inflation expectations. In some places those were actually welcome. Inflation expectations had fallen too low. Think of Japan, for example. But nonetheless, if the shocks are big enough and last long enough, that can cause a big inflation problem and that requires a move to tighter policy. And that's where we ended up of course. Another key point that I think, again, maybe is a lesson coming out of this experience is that leaving inflation shocks aside, you have to think about what would be the appropriate adjustment to policy. Looking through an inflation shock doesn't mean doing nothing. It doesn't mean policy doesn't change. That means that policy behaves as it would if the inflation were going to go away. But if the economy is overheating in some underlying sense, that still means you've got to tighten. It means you've got to slow things down. And I think some central banks were looking through the inflation, not making any adjustment, and that's a mistake. You need to still respond to the fact that labor markets were getting very tight. Inflation is therefore some of it will be more sustained because of that very tight labor market and higher margins. And so you need to respond to that even if you're looking through the inflation.

Tim Phillips [00:08:45]:
So lesson three, that interest rates are still the primary way to bring down inflation. And we've seen this demonstrated. Why weren't the tools that we've seen employed for easing as useful when it came to tightening?

Bill English [00:09:01]:
It's a great question, Tim. When the pandemic hit, central banks rapidly got to the lower bound. Some of them were already there, of course, and then they followed up with other ways of providing accommodation. They used forward guidance, they used asset purchases and so on. That guidance was phased out, naturally, as they came to the point of wanting to withdraw accommodation. But when it came time to tighten policy, central banks turned first to raising rates. And rates were the tool that they emphasized. They subsequently one of the points we make in the book is they moved more quickly than you might have expected and more aggressively than you might have expected to. Quantitative tightening QT. But the QT tended to be boring. It was kind of in the background. They ran off securities that they'd accumulated just by allowing them to mature and run off the balance sheet. And in a few cases, that was reinforced by sales. But for the most part, the QT was passive. It was a very quiet kind of in the background thing. The interest rate was the active tool. That was the thing that they were talking about, focusing on raising faster, raising more slowly, and so on, while the QT just chunked along in the background. So why is that? I think the reason is that central banks have long experience using interest rates as a policy tool. They have a reasonable idea for how it works. They have a pretty good experience with how to communicate about rates, and they weren't as confident that they knew the effects of QT, so it's harder to calibrate. And they also weren't confident that they could communicate successfully about changes in QT. Everybody remembers the taper tantrum from back in 2013 and how hard it can be to communicate. So I think they judged it was safer to just go with rates as the active tool and let QT percolate along in the background.

Tim Phillips [00:10:52]:
Now, our next lesson is that central banks need to demonstrate flexibility. But surely some of the tools that central banks employ only really work if they are inflexible if they're saying, we're going to do this and we are not going to be dissuaded or moved from it.

Bill English [00:11:13]:
That's absolutely right, Tim. And I think a lesson from this experience is that there's a trade off there. So the tools I think you have in mind are forward guidance and asset purchases.

Tim Phillips [00:11:24]:
Yes. Exactly.

Bill English [00:11:24]:
If forward guidance is going to be powerful, you want to be seen as, at least to some extent, if not completely firmly committing to keeping rates low for quite a while. That's what gives it power and asset purchases. Similarly, it's not that you bought a few securities today, it's that you're expected over some trajectory to buy a large amount of securities. Policymakers face a trade off. You can make those tools more powerful by making them more of a commitment, saying, we are going to keep buying very firmly for a long time, give a date, as the ECB did, for example. Forward guidance, similarly is more powerful if you commit to it more strongly. But of

course, if they're more of a commitment, then you're not going to be able later on easily to back away from it and do something else if the economic outcome is different than the economic outcome you thought. Coming into the pandemic, particularly in advanced economies, there had been a weak recovery from the financial crisis. Inflation had stayed low, and central banks valued the additional power they got from making their guidance more commitment like, the Fed did, the ECB did. Certainly the Reserve bank of Australia did. That commitment made it harder to turn when things didn't come out as they expected, when inflation went up and they needed to raise rates. We argue in the book that that delay wasn't that costly. Central banks moved pretty fast to catch up, and in the end, the outcome seems to have been pretty good. That said, if a similar situation arises in the future, I think central banks will be more careful about their forward guidance. I think they're less likely to make it as strong as commitment like as they did this time, because they're more aware now that they can get caught out and that that's a problem.

Tim Phillips [00:13:19]:
Next, you recommend that central banks need to discuss the impact of fiscal policy choices. If they talk about the scenarios that would arise from these policy choices, are they crossing a line here, that line between the conduct of monetary policy and fiscal policy?

Bill English [00:13:39]:
I think it's really a broader question than just about fiscal policy. The way you posed it, the pandemic caused a lot of uncertainty, but a lot of central bank communication tends to focus on the modal outlook, the most likely outlook. But central banks knew there was a lot of uncertainty. They hadn't seen a pandemic like this. Nobody quite knew how it was going to play out. And so one way to communicate that uncertainty to the public would be if you offered some different scenarios around your modal outlook. So this is done internally at central banks. They look at a range of scenarios. What I have in mind is providing those scenarios to the public to help show the public how policy might adjust in different circumstances. So back in late 2020, a scenario saying, well, of course, this could pass faster than we think, the economy could rebound more strongly than we think. Inflation could pick up. In that case, we're going to have to adjust policy relatively quickly. I think that would have been helpful subsequently to be able to point back and say, well, we said that if things went this way, that we might well have to tighten policy sooner. Now, in terms of fiscal policy specifically, central banks like to stay out of fiscal policy for the most part. They don't want to be that involved in fiscal policy. But on the other hand, another one of the lessons in the book, there's a very nice chapter by economists at the IMF on the use of fiscal policy as an anti inflation tool, providing basically an offset to higher energy prices. And that was done in many economies, and it seems to have been reasonably effective. And in that case, if you thought policy like that maybe was in the wind, then providing a scenario that would say, yes, inflation is high, but these sorts of fiscal policy tools could suppress inflation, at least for a while, and what would that look like? That seems like a potentially useful tool, again, just to try to explain to the public how the central bank would respond in different circumstances.

Tim Phillips [00:15:34]:

What you realize from the last answer you gave me and those experiences around it plays into our next lesson, that there's going to be more political pressure on central banks. During this episode, central banking became very politically exposed, and I'm sure that some of your authors have experienced that. Can the central banks maintain their independence? As you point out, there's going to be higher rates, higher debt to GDP. Rate setting, then has a huge influence on the conduct of fiscal policy. Is central bank independence going to be in the future what it was in the recent past?

Bill English [00:16:07]:
I agree there is a risk here. The interactions between monetary and fiscal policy are getting harder to ignore. Ordinarily, we think of monetary policies on one track, fiscals on another. There's always some interaction, but we're inclined to try to leave that aside. But as you say, debts are getting very high, movements in interest rates impose big costs on governments and government budgets. And this gets attention, there's no question. And it could lead to political pressure to keep rates low. That sort of political pressure is damaging. One of my favorite chapters in the book actually is one by Hakan Kara and Cagri Sarikaya about the recent experience in Turkey. And there of course, the government was very, very heavily involved in monetary policy and pushing monetary policy to ease instead of tighten in a period of high inflation that turned out badly post election, they've moved in a much more conventional direction, but nonetheless that was very costly. So central bank independence matters, as we see in the Turkish example. But I do think central banks are going to be more in the political discussion now just because their effects on budgets are so much bigger. I think that, at least in most countries, politicians do understand in the end that it would be bad to have the parliament or the Congress take too big a hand in monetary policy. So I think central bank independence will be protected, but it's a risk and it's something that I do worry about.

Tim Phillips [00:17:38]:
One of your colleagues said to me that the lesson for central banks is to look at what Turkey did in recent years and do the opposite.

Bill English [00:17:47]:
Exactly.

Tim Phillips [00:17:48]:
Our final lesson, bill, is support financial stability whilst achieving their goals is for central banks. Should central banks have an explicit mandate for financial stability? Because on occasions I would imagine that supporting financial stability and conducting their monetary policy goals might imply different policies.

Bill English [00:18:11]:
One way to think about this is that central banks have as mandates maximum employment and stable prices for the Fed, stable prices in some other cases with employment and output goals a secondary objective. But that already means in some sense that they care about financial

stability. Financial crises, as we saw in 2007, eight, nine are terrible for those objectives. And so I'm not actually sure that you need a financial stability mandate to take actions to address financial stability risks because they have implications for your other mandates. But it's probably clarifying and that's useful as long as everybody understands that a mandate for financial stability doesn't mean a mandate for asset prices that don't move. You want to have stock prices moving around and interest rates moving around and so on. You can't suppress the volatility in asset markets. Having asset prices that move around isn't financial instability, it's only financial instability if institutions are threatened. But again, I think a mandate can provide clarity, and clarity is useful. The way central banks would like to think about these things is a separation principle. You have monetary policy tools over here to achieve monetary policy objectives. You have financial stability tools over here to achieve financial stability objectives. But that tidy separation is very hard to maintain. In some cases, the tools overlap. So think of the UK. When they had big problems with their liability driven investment sector, the bank of England had to step in to support functioning in the gilt market. They were buying gilts to do that. This is right as they were about to begin QT. So it's a bit confusing to say, well, for monetary policy reasons, we want to do QT, but on the other hand, for financial stability reasons, at least for a little while, we're going to be doing the opposite. In Korea, they raised rates somewhat earlier than they would have otherwise because of concerns about building imbalances in the housing sector. It wasn't an inflation concern initially, it was a financial stability concern and they were raising rates. So these two spheres of policy overlap, the tools overlap, and I think what that means is that central banks need to think in advance about how they might handle situations where these two different policy questions are pulling policy in different directions. And I'm not sure you can solve that problem. It's just a structural problem, but you can think about how can you set up the use of your tools so it's less confusing. I think it was helpful in the UK that they had a monetary policy committee and a financial policy committee, and they could say this decision to become market maker of last resort for a while is a financial policy committee decision. And the monetary policy committee was consulted. They think it's okay, but they're going to do their monetary policy thing later on. It clarified the communication about it, but some planning in advance about how you're going to structure things, how you're going to communicate in these situations, I think is useful. You want to be better prepared and not have to do this communication and make these sort of policy decisions on the fly.

Tim Phillips [00:21:21]:
Bill, listening to you reminds me just what an extraordinary few years we've been through for the conduct of monetary policy. Do you think we're ever going to have an inflationary episode like this one again, to test out whether central banks have taken on your lessons?

Bill English [00:21:40]:
I think one lesson from this experience is that big shocks are possible. We went through a long period, the great moderation, from the mid 80s up until the financial crisis, and things were operated very smoothly. Since then, we've had two huge shocks. We've had a financial crisis and we've had a pandemic. In the period after the financial crisis, through the 20 teens, we had persistent low inflation and weak economies. People just didn't worry very much about high

inflation. That seemed like such a remote thing. Big shocks in both directions are possible, and central banks need to be sure they're ready to respond to both kinds of shocks. We call for central banks to be a bit more symmetrical in their thinking. Things could get too hot, things could get too cold. You want to be ready to handle shocks in both directions, potentially with a lot of speed and a lot of force, as we've seen. Will we ever see an inflationary episode like this again? I hope not, but we'll see, other situations will arise where inflation will be high or inflation will be low and central banks will have to respond. I think some of these lessons will help. The economy is never completely smooth. There are always going to be shocks.

Tim Phillips [00:23:13]:
Bill English, thank you very much.

Bill English [00:23:15]:
Thanks very much, Tim. Happy to do it.

Tim Phillips [00:23:25]:
We've been talking about the CEPR Press book, Monetary Policy Responses to the Post Pandemic Inflation: Challenges and Lessons for the future. The editors, Bill English, Kristin Forbes and Angel Ubide. There is also a Vox column published on the 14 February which sets out some of the findings from the book.

[Voiceover] [00:23:55]:
This has been a VoxTalk from the Center for Economic Policy Research. Join us every week to hear about the best new economic research. Next week, the long shadow of the Spanish Civil War.