Managing the new inflation

__William Allen__ explains why there needs to be the first serious tightening of monetary policy since before the financial crisis and looks at what that is likely to involve

Inflation in most of the world was subdued by monetary policy in the late twentieth century and ceased to be a problem. After the financial crisis of 2007-08, the threat of deflation was more of a worry and central banks resorted to what they called 'unconventional' expansionary policy instruments to counter it. When Covid came along, they doubled down on those instruments to sustain demand. goods and shipping. Central banks initially regarded higher consumer price inflation as no more than the pass-through of lockdown influences and expected the period of elevated inflation to be temporary. Some even expected it to be followed by a period of depressed inflation, as some of the cost increases were reversed.

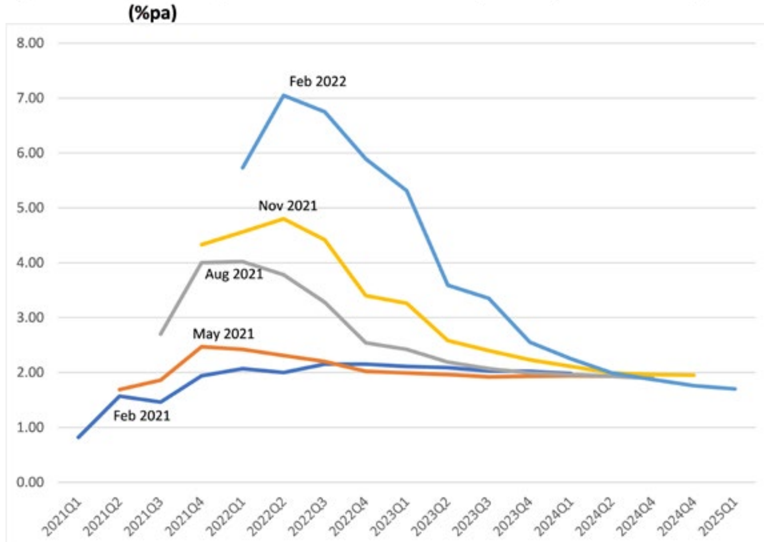
They were surprised when, in Europe and the US, inflation started to rise in spring and summer 2021. Central banks initially described it as 'transitory' and forecast that it would drop back, without much need for monetary policy to be adjusted. The use of the word 'transitory' was unfortunate. Inflation has consistently exceeded central bankers' expectations and they have had to raise the profile of inflation forecasts steadily during the past year. (Figure 1 illustrates successive Bank of England (BoE) forecasts). Following the invasion of Ukraine and the sanctions on Russia, the BoE expects inflation to be around 8% this spring.

Central banks' credibility has been seriously damaged. Implied expectations of inflation derived from bond yields have risen, not just for the near term but for five years ahead (see Figure 2 for the UK).

(Note: for reasons of index construction, retail price inflation (RPI) in the UK is higher than consumer price inflation, for which the official target of 2% pa is set. On average between 2005 and 2021, inflation was 0.7% percentage points higher on the RPI measure, so RPI inflation of 2.7% would have been compatible with the target.)

There have been large post-lockdown increases in the prices of specific products, notably energy, durable

Figure 1 **Bank of England mean inflation forecasts, February 2021 – February 2022 (%pa)**



Source: Bank of England Monetary Policy Reports, February 2021 – February 2022

Figure 2 **Expected retail price inflation in the U.K. five years in the future (% pa)**

This cost-based explanation neglected aggregate demand. Incomes had been supported during the pandemic by programmes financed by government deficits, which in turn, thanks to quantitative easing, had been mainly financed by money creation. Households and companies, constrained from spending during lockdowns by restrictions on movement, had, in aggregate, accumulated a large overhang of liquid assets and unused borrowing facilities. Meanwhile, production had also been constrained by lockdowns.

> *It's impossible to know how much interest rates will have to rise if price stability objectives are to be met*

It's not surprising that after the lockdowns, spending went up, excess demand developed, and prices in general rose, albeit not uniformly. Central banks have come to appreciate this, but only gradually. The situation is rather like that which prevailed in the US and the UK after the end of the second world war, when pent-up demand was released and prices rose: the history of that period is highly relevant now.

The loss of credibility and the rise of inflation expectations matter a lot. Inflation expectations affect actual inflation. Whatever the reason for the initial rise in inflation and the misforecasting, the simple fact that inflation expectations have become dislodged means that the upsurge in inflation is not purely transitory. Just waiting for inflation to go away, and promising to act if it doesn't, is not now a viable option for central banks: they need to act to bring inflation expectations back into line with their targets and some have begun to do so.

The future

The first serious tightening of monetary policy since before the financial crisis is needed in Europe and the US. The era of cheap money is over. The effects of such a big change after such a long time are potentially large and inherently unpredictable. The policy change is likely to take two forms: higher short-term interest rates and a reversal of quantitative easing.

The process of raising short-term interest rates has already begun in the US and the UK, but it has further to go.

Higher short-term interest rates will affect household and company finances. They will also have a large adverse effect on public finances. Roughly 40% of bonds issued by the UK government are now owned by the BoE as a result of its successive quantitative-easing programmes. Their purchase was financed by the BoE crediting the reserve balances of commercial banks.

Those balances bear interest at floating rates, the payment of which is guaranteed by the UK Treasury. In effect, quantitative easing has radically shortened the maturity of government debt, and made the public finances highly sensitive to increases in short-term interest rates. A percentage point increase in short rates would mean, within a year, an increase in government debt servicing costs equal to 0.5% of GDP. Central bank monetary policy and government fiscal policy are entangled, and not only in the UK.

Reversal of quantitative easing

Quantitative easing was employed during the financial crisis and re-engaged during the Covid pandemic. The BoE's programme was completed in December 2021 and the central bank had already, in August 2021, set out plans for reversing it. In accordance with this, when its Base rate reached 0.5% in February 2022, the BoE said it would stop reinvesting the proceeds of maturing bonds, so that its stock of assets would fall gradually. It would also consider beginning active sales but only after the Base rate had reached 1%. It's not likely to be long before that happens. The Fed, too, plans to start reversing QE.

In the eurozone, quantitative easing is still going on, although it's likely to stop and perhaps go into reverse this year. That might present problems for the borrowing of some member governments, much of which is thought to be financed directly or indirectly by the central bank.

Just as quantitative easing amounted to a shortening of the maturity of government debt, so its reversal will lengthen debt maturities and enable short-term interest rates to be adjusted without such heavy repercussions on public finances.

Central bank independence

It's impossible to know in advance how much interest rates will have to rise if price stability objectives are to be met, and it's not a time for making confident forecasts of future interest rates or for forward guidance. The ending of cheap money will be unpopular because it will put more pressure on government and household finances at a time when they are already under strain. But it is the only way to reduce inflation.

The 'independence' of central banks is heavily circumscribed and has sometimes been abused, but they were made independent precisely in order to preserve price stability in such situations.

Their first priority is to demonstrate that they understand the nature of the inflation and to take action to bring inflation expectations down. They should act in such a way as to minimise the unavoidable disturbances to the finances of citizens and governments but, above all, they should act resolutely. ■

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