Changing Central Bank Pressures and Inflation

Hassan Afrouzi  Marina Halac  Kenneth Rogoff  Pierre Yared

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Motivation

- Significant uncertainty regarding the long-term path of inflation

- Prevailing view: Inflation falls back to target. Stays there on average
  - Supported by CB forecasts in advanced economies and EMs

- Alternative view: Inflation stays higher on average and more volatile
  - Articulated in Goodhart and Pradhan (2020)
  - Structural changes. Reversal of disinflationary forces in Rogoff (2003)
    - E.g., globalization, demographics, fiscal restraint in EMs
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What does New Keynesian framework say about long-run inflation?

- Current approaches cannot answer this question
  - Either study transitory dynamics around zero-inflation steady state
  - Or assume CB commits to infinite policy sequence, yielding zero inflation
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- We assume neither zero inflation nor CB commitment
  - Economic factors interact with CB discretion
  - Endogenous and exogenous political economy pressures on CB
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- Framework delivers fresh perspective on past and future inflation
Model

- **Standard New Keynesian Model**
  - Monopolistically competitive firms set prices under Calvo-style rigidity
  - Households make consumption, labor, and savings decisions
  - Two potential inefficiencies:
    - Equilibrium monopoly distortions (i.e., labor share \( \neq 1 \))
    - Equilibrium price dispersion and misallocation

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- Departures from standard model
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- Full non-linear model in Afrouzi et al (2023). Today simple setting
  - Linearization around solution to full model, holding labor share fixed
Graphical Representation of Steady-State Inflation

LRAS

saddle path

LRAD

\( \pi \)
Long-Run Steady State

- Equilibrium at LRAS-LRAD intersection given labor share
  - Firms optimize prices given real wages
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- No CB commitment $\rightarrow$ constant labor share, indexes CB dovishness
  - CB chooses interest rates taking firms’ price-setting process as given
Effect of Increase in Monopoly Power
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Effect of Increase in Central Bank Hawkishness
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Effect of Increase in Monopoly Power
Historical Global Decline in Inflation

Year

Inflation

Advanced Economies
Emerging Markets
Low Income Economies
Reduction in Endogenous and Exogenous Pressures

- Globalization
  - Lower monopoly power $\rightarrow$ LRAS curve shifts right $\rightarrow$ Lower inflation
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- **Washington consensus**
  - Privatization and liberalization $\rightarrow$ Lower monopoly power
  - Lower fiscal pressures reduce pressure for CB expansionary policy
    - Lower labor share $\rightarrow$ LRAS shifts right, LRAD shifts left $\rightarrow$ Lower inflation
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- De-unionization
  - Labor market power in NK model works like monopoly power
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- **Expansion of CB independence (exogenous)**
  - Reinforcing factor: Emergence of ZLB induces hawkish tilt
  - Lower bias $\rightarrow$ LRAS shifts right, LRAD shifts left $\rightarrow$ Lower inflation
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Some examples

- Lat Am deterioration of CB independence between 2000s 2010s
- Inflation decline in economies far away from ZLB
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Cross-sectional evidence
- Negative correlation between long-run inflation and CB independence
- Openness, public debt also explains variation (Campillo and Miron, 1997)
Future Path of Inflation?
Increasing Endogenous Central Bank Pressures

- Deglobalization trends
  - Decline in global trade and FDI to GDP since 2008
  - Fragmentation of global capital flows by geopolitics
  - Lengthening of global value chains (especially to China)

- Higher debt/GDP projected in every country group
- In fact, current fiscal forecasts potentially too optimistic
  - Given expansion of green spending and industrial policy
  - Given increase in defense spending if geopolitical tensions continue

- Long-term real rates likely returning to centuries-old trend
- Movement away from ZLB reduces hawkish tilt of CB
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Taking Stock

- Endogenous political economy pressures on CB to inflate in the 2020s
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Caveat: Economic forces described might be short-lived
  • Deglobalization could reverse, geopolitical tensions could dissipate
  • ZLB could continue to constrain CBs
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- Moreover, forces could be counteracted by renewed CB reforms
  - Would need to work in opposition to, not in tandem with economic forces
  - Success more likely if supported by fiscal reforms
Summary

- Introduce simple LRAD-LRAS framework for long-run inflation
  - Inflation reduces *aggregate* (monopoly) distortions
  - Inflation raises *idiosyncratic* (price dispersion) distortions
  - CB has single instrument $\rightarrow$ tradeoff due to staggered price-setting
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- Reasons why delivering low inflation in the future more challenging
  - More successful with strengthening of CB independence, fiscal reforms