Changing Central Bank Pressures and Inflation

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Motivation

- Significant uncertainty regarding the long-term path of inflation
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  - 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

This Paper

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  - Economic factors interact with CB discretion
  - Endogenous and exogenous political economy pressures on CB

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  - Economic factors interact with CB discretion
  - Endogenous and exogenous political economy pressures on CB
- 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 $\neq 1$)
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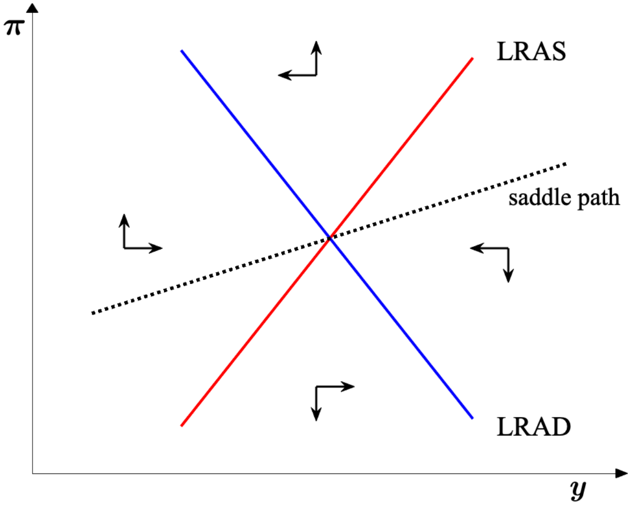
- Full non-linear model in Afrouzi et al (2023). Today simple setting
  - Linearization around solution to full model, holding labor share fixed

Graphical Representation of Steady-State Inflation



Long-Run Steady State

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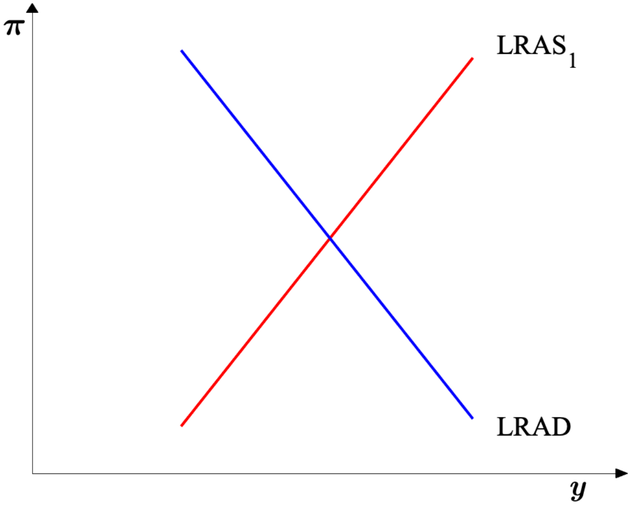
  - CB framework $\rightarrow$ Process for labor share
- No CB commitment $\rightarrow$ constant labor share, indexes CB dovishness
  - CB chooses interest rates taking firms' price-setting process as given

Effect of Increase in Monopoly Power



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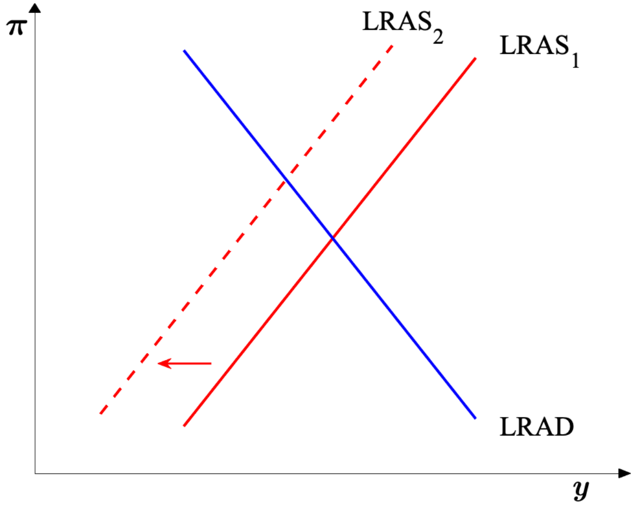

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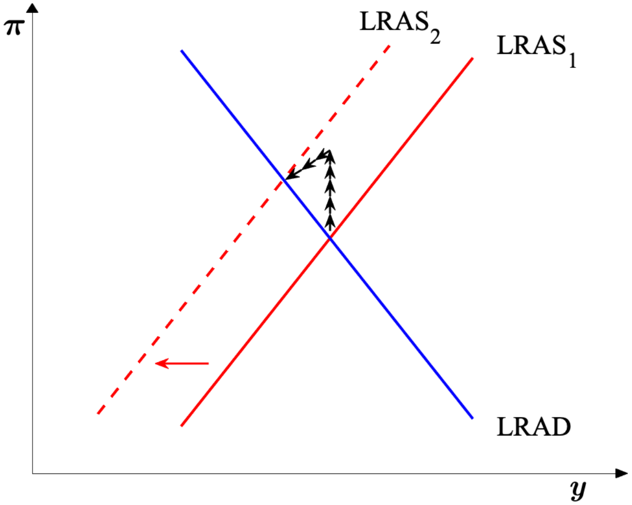
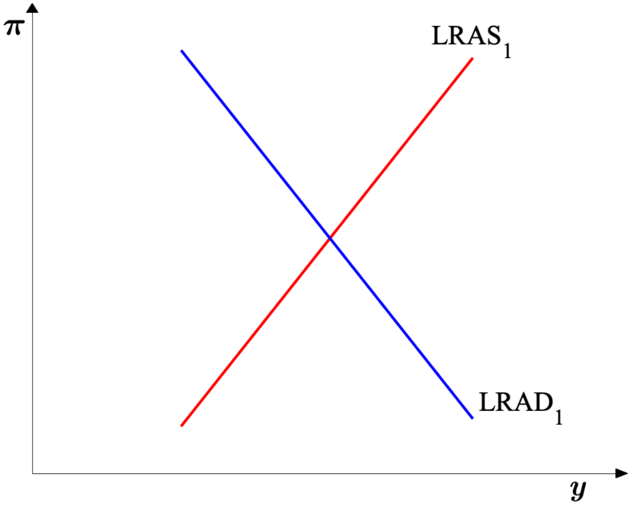


Effect of Increase in Central Bank Hawkishness



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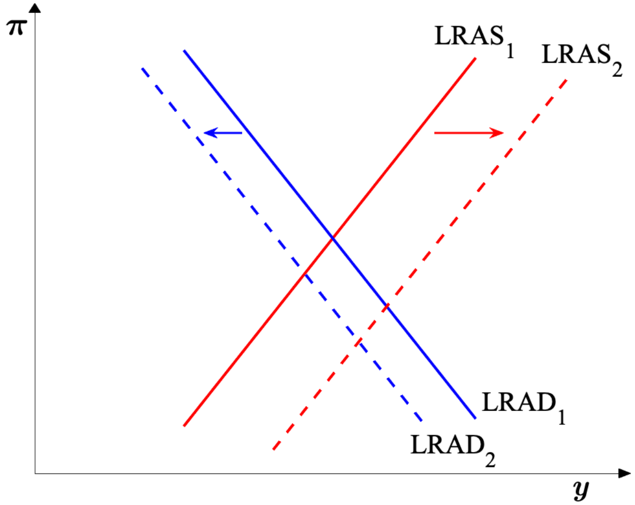

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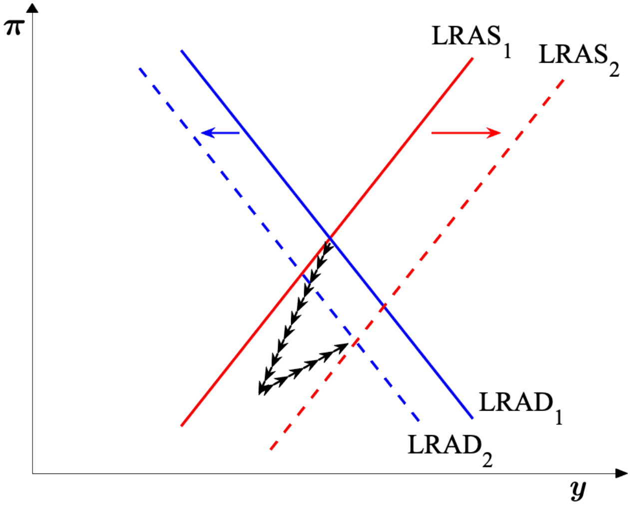
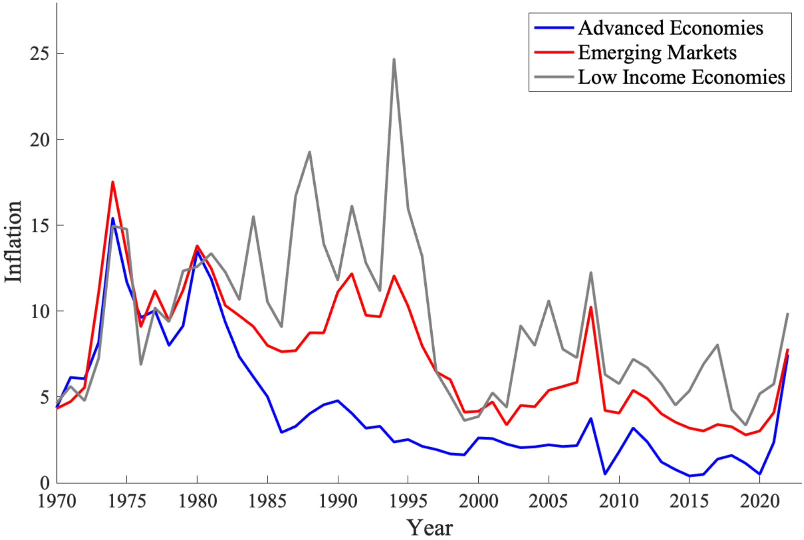


Historical Global Decline in Inflation



Reduction in Endogenous and Exogenous Pressures

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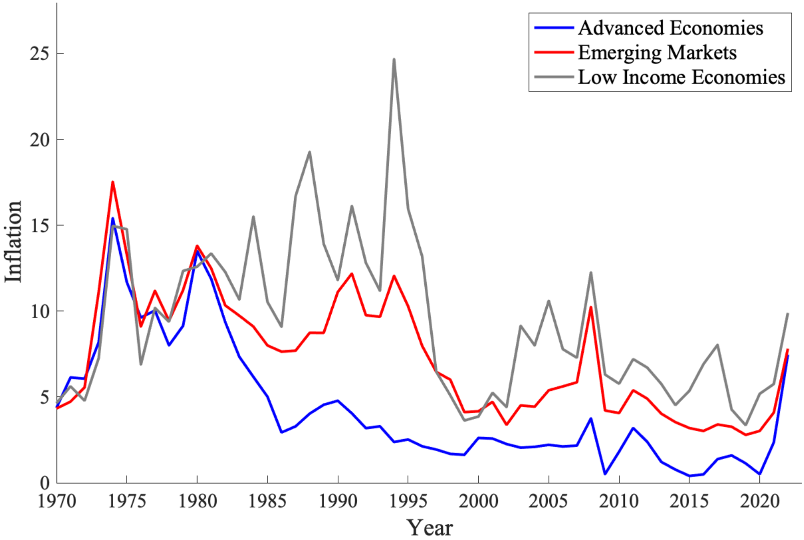
  - Lat Am deterioration of CB independence between 2000s 2010s
  - Inflation decline in economies far away from ZLB
- Cross-sectional evidence
  - Negative correlation between long-run inflation and CB independence
  - Openness, public debt also explains variation (Campillo and Miron, 1997)

Future Path of Inflation?



Increasing Endogenous Central Bank Pressures

- Deglobalization trends
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  - Fragmentation of global capital flows by geopolitics
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  - In fact, current fiscal forecasts potentially too optimistic
    - Given expansion of green spending and industrial policy
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- 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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- 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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- Caveat: Economic forces described might be short-lived
  - Deglobalization could reverse, geopolitical tensions could dissipate
  - ZLB could continue to constrain CBs
- 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

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- Introduce simple LRAD-LRAS framework for long-run inflation
  - Inflation reduces *aggregate* (monopoly) distortions
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- Fresh perspective on factors that helped CBs drive inflation down
- Reasons why delivering low inflation in the future more challenging
  - More successful with strengthening of CB independence, fiscal reforms