Discussion of “Changing Central Bank Pressures and Inflation”

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Summary of the paper

- Studies how economic and political-economy factors exert (dis)inflationary pressures

- Analysis is based on a simple, yet richly intuitive model of demand and supply
  - Departs from Friedman’s long term monetary super-neutrality
  - LRAS upward sloping, LRAD downward sloping
  - Framework captures tension between different relative prices: inflation helps offsets monopoly distortion, but causes inefficient price dispersion

- Looks backwards and forwards
  - Explains how past trends (e.g., globalisation, de-unionisation) have pushed up on growth and down on inflation and what could happen in the near future as they reverse

- Prediction: as trends reverse and political economy pressures intensify, central banks will find it harder to keep low and stable inflation

Comments

- Great paper
- Elegant and intuitive model of long run supply and demand
- Thoughtful and thorough discussion of the past and risks ahead

Features of the model

1. No commitment*

Consistent with reality: CBs optimise over finite policy horizons; “commitment” over e.g., 3-4 years

- Why not more? Cannot commit votes of future board members
- Why not less? Monetary policy lags mean CB cannot offset unexpected shocks immediately

2. Inflation can be non-zero in steady state

Consistent with targets of 2% (or higher in EM, LD countries)

- To be clear: CB’ models don’t necessarily generate zero inflation or inflation at target in steady state. Inflation depends on policy choices.
- Relates to “optimal inflation” literature in richer New Keynesian models (e.g., K. Adams, Gorodnichenko and others). Goes back to Tobin (1972)’ s “grease in the wheels”: with downward nominal rigidity, inflation helps adjust relative prices (see Geneva Report by Guerrieri et al 2023) Foundations for **(positive) inflation targets**

*Commitment in the literature means setting an infinite path for inflation and output gaps for all future times and states of the world)

What is the mandate of the CB?

- In the paper, the CB tries to optimise a social welfare function that considers all (possibly changing) distortions in the economy
- In practice, CBs are delegated much narrower (and simpler) mandates
  - Barro and Gordon (1983) and Rogoff (1985) with an exogenous inflation target are good representations
  - One can rationalise mandates with a social welfare function
  - Why 2%? New Zealand accident (more recent literature not too far)

Can/do CBs aim off their narrow targets to improve social welfare?

- Full-employment/output potential not as precisely defined as inflation target
  But key lesson from CB practice and theory (Barro-Gordon 83, Rogoff 85):
  - need realistic estimates of inflation-target-consistent output potential; if CB aims to go beyond that potential→ inflationary bias. Big effort to estimate output potential in CBs
  - "flexible-price equilibrium level of output" is the best a CB can aim for; flex-price potential level might be below "efficient" level

- Primacy of inflation target, with limited short-term flexibility
  - Monetary policy lags imply inflation cannot be offset immediately – unless you cause a crisis!
- Deviations from target are costly for CB. Performance scrutinised by media, parliaments, academics; body of expertise ready to detect and harshly criticise any slight sign of deviations

BUT, the point of the paper:

- Changing pressures may lead CB to aim for output above potential (in model, high labour share), change in remits or loss of independence

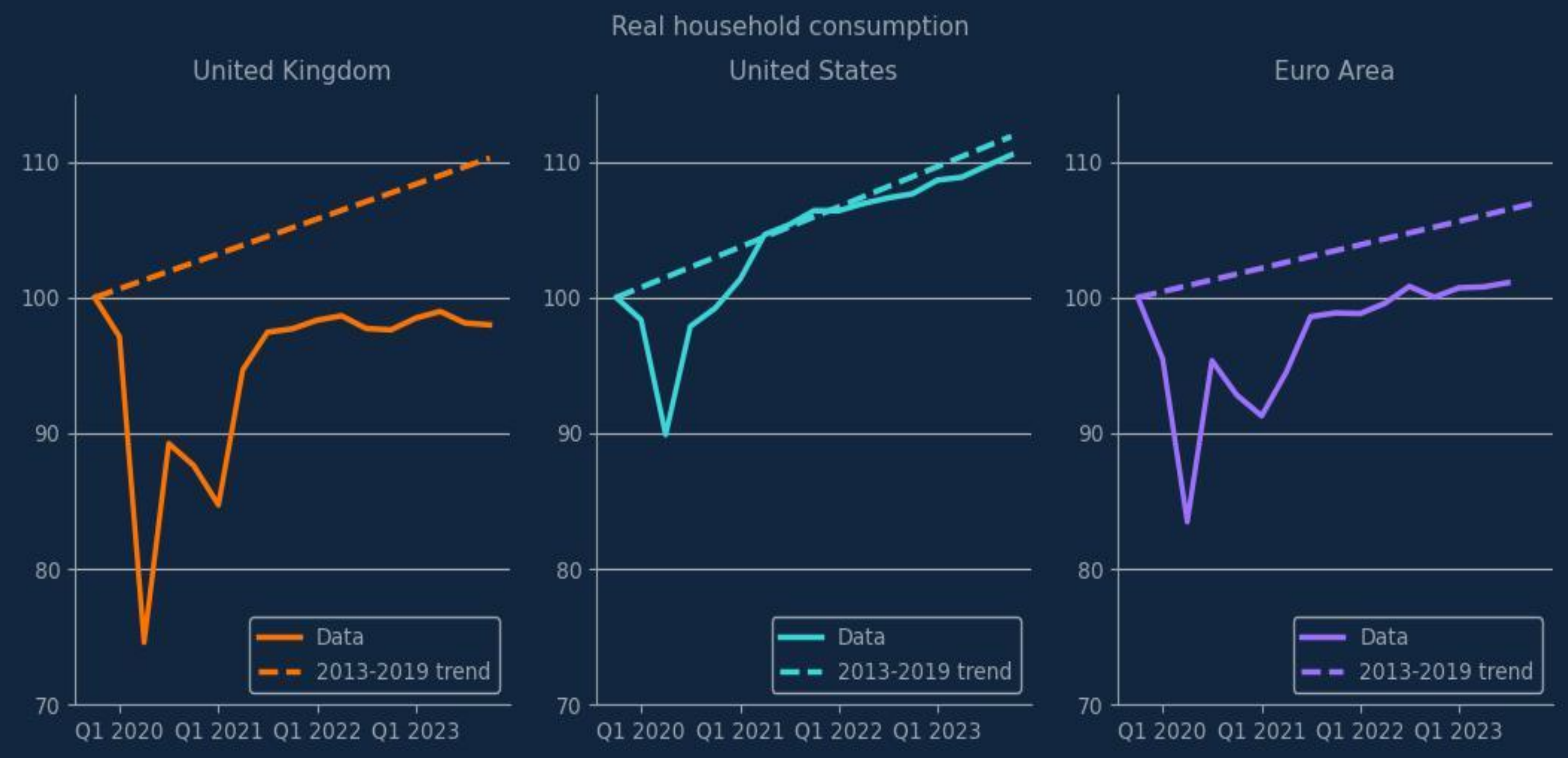
What might change: trends

- Paper: past trends in globalisation and falls in union power eased pressures on CBs. In addition: lower indebtedness (compared to now)

- In the 90s-2010s no big negative supply shock (different from 70s-80s)
  - No major energy crisis, no pandemic; financial crisis had a bigger demand component

- Extraordinary concentration of tail events in 2020-23, particularly in Europe and the UK. Despite this, the UK or EA have not tried to aim off potential

UK consumption today is 2% ***below*** pre-Covid level; EA, just above (US: 11% above)



Updated: UK and US Q4 2023, EA Q3 2023- Source: ONS, FRED, Eurostat

Test on CB: high concentration of extraordinary supply shocks

- Despite the fact that consumption in the UK is lower than pre-covid, BoE has hiked as much as the Fed (consumption gap of 13pp); same for ECB

- No sign of the BoE/ECB trying to push consumption or output higher, or tolerating more inflation--quite the opposite
  - UK/EA inflation going back to 2% target within 3 years of the invasion.

Distinction between

1. **Expected** change in trends (can eventually be foreseen): CBs should change estimate of potential (as they did, post-financial crisis). Paper: will they?

2. **Unexpected** trade-off inducing shocks (e.g., energy shock)
   - Will inevitably cause a transitory deviation from target, given lags. Given **lags**, policy cannot offset the immediate impact, focus on 2^{nd} round effects.
     - (Could offset inflation faster, but at higher risk of financial disruption)

   - If shocks become so frequent or persistent that they change potential/trend, we are back to 1.

Changing trends

- Partial equilibrium effects are intuitive
- What happens in GE?

Globalisation in General Equilibrium

- Globalisation lowered prices of imported goods thus rising real incomes and, in GE, rising private demand, pushing up services inflation
  - Balassa Samuelson effect with nominal frictions; CBs deal with imbalance
- De-globalisation reduces real incomes, and eventually demand, which could lower domestic inflationary pressures **(Ambrosino et al. 2024)**
  - Globalisation peaked in 2008, but no reversal of inflationary pressures; inflation below target pre-2019 ("inflationary in PE," but not in GE)
- Difference in the paper: de-globalisation causes higher markups
  - Distribution issues. If CB keeps labour share constant, that would be inflationary
- De-globalisation itself might not be inflationary - it depends on how aggregate demand reacts to lower real incomes. Inflation might be muted in GE by private demand response. Key is **lower growth** in output and real incomes: will CB be pressed to stimulate the economy (or keep labour share constant)?

The risk highlighted by the paper, given low trend growth:

1. Governments undermine CB independence or force them to aim beyond potential
2. Lead to a change of remit (e.g., given LRAS, higher inflation target)

What to do?

Big role for academic and policy institutions (like Brookings) to play a part in the debate.

On 1. agreement amongst most economists that this would be disastrous

On 2. debate on optimal inflation target not settled (Blanchard, FT Nov 2022); more generally, in flexible inflation targeting regimes, more work is needed on dual or secondary objectives - big differences across CB mandates

Final remarks

- An excellent paper to think about the risks to come as key trends reverse
- Discussants instinctively tend to look for the other side of the argument
- But hard to argue against risk highlighted by the paper, which could jeopardise central bank independence

An important empirical contribution on this: Drechsel, Thomas (2023), “Estimating the Effects of Political Pressure on the Fed: A Narrative Approach with New Data”