Crossing a line: Is current inflation a threat to central bank independence?

More likely central banks will interpret their mandates more flexibly and argue that they have the tools to rein in inflation if necessary

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A new kid on the block – inflation

Following the news, it is easy to conclude that consumer price inflation, that is the general increase in prices for products and services consumed by households, is rearing its ugly head again.[2] In April US consumer price inflation increased to 4.2% on the year-earlier period, the highest increase since September 2008 just before the Great Financial Crisis. In the UK consumer prices were 1.5% higher in April than in April 2020 when the world economy had just gone into lockdown in response to the Covid-19 outbreak, a doubling from the previous month. The increase would have been higher if not for the government's temporary reduction in VAT rates on hospitality services, which will expire later this year. Are these the first signs of a period of high inflation? And do we need to be worried?

It all feels very different to just a few years ago when policymakers identified deflation – a fall in consumer prices – as one of the biggest threats to the global economy.

These news have stimulated a lively debate in the economics community and have put central banks - the guardians of low inflation - once again in the limelight. Will they clamp down on higher inflation by raising interest rates or will they tolerate some inflation?

This matters for the economy: raising rates, if misjudged, could undermine the recovery post Covid-19, while a build up of inflationary pressures might require more drastic policy action later to avoid any longer-term negative on the economy. It also matters for the capital markets. Inflation and what central banks might do about it has already led to turbulence as investors have started

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[2] Producer price inflation is a related concept and captures the increase in prices at which producers sell their products and services either to final consumers or to other businesses as part of the production process. An increase in producer prices is often judged to indicate that consumer prices might increase soon afterwards as well.

worrying about future prospects and are unsure how to invest in these uncertain times. And as we learnt during the Great Financial Crisis more than a decade ago, what happens in the capital markets could well have implications for the economy more generally.

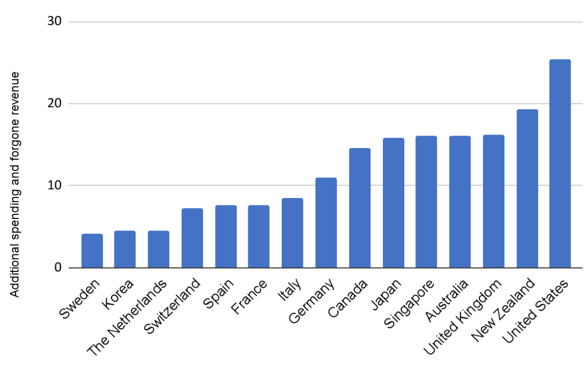
What explains current inflation?

Much of the recent jump in inflation is the mechanical result of what is called the base effect. With the world going into lockdown in response to the Covid-19 outbreak and global demand collapsing, oil and other raw commodity prices plunged (in the case of oil even turning briefly negative as storage facilities reached capacity). With global demand picking up again and prices returning to pre-crisis levels, a comparison with last year's prices would mechanically show a substantial increase. Over time we would expect this base effect to dissipate. Central bankers are right to "see through" this type of mechanical inflation.

There are other drivers at play though, among them a global shortage in semiconductors hitting the production of cars, computers, televisions among many other things, driving up their prices. The increase in April inflation in the US was, for example, partly due to a sharp rise in second-hand car prices, in turn the result of a lack of new vehicles.

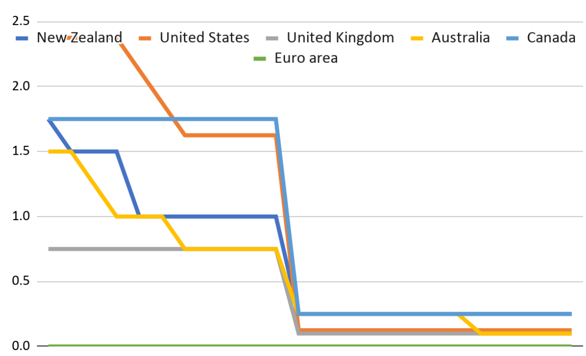
As countries emerge from the crisis, policymakers will need to ask themselves increasingly whether their own policies could contribute to inflation. Governments offered unprecedented levels of fiscal support in the form of additional spending or foregone revenue during the crisis (see Chart 1), while central banks lowered their policy rates as much as they could (see Chart 2) and accelerated their asset purchase programmes.

Chart 1: Discretionary fiscal measures (% of GDP, 2020)



Source: IMF Fiscal Measures Response Database.

Chart 2: Central bank policy rates (%)



Source: BIS Policy Rates.

What next though? Should policymakers continue to offer the same level of support or should they start withdrawing as the recovery gathers pace? The appropriate level of support will depend on the speed and strength of the recovery – how quickly can we roll out the vaccines, will there be new mutations of the virus requiring further lockdowns, what will households do with the savings they accumulated during the pandemic when shops and restaurants were closed, and foreign holidays not an option?

Some historical perspective on inflation rates

Only those who have experienced the 1970s or 1980s or recently returned from an emerging country such as Turkey or Argentina will have any first-hand experience of serious levels of inflation. Back in the 1970s and early 1980s consumer price inflation in the UK regularly exceeded

10%, peaking at nearly 25% in 1975 after the first oil price shock and then at 20% in the early 1980s.[3] Inflation reached nearly 10% one more time in the early 1990s but has since then been around 2.5% (with two more spikes close to 5%) for much of the time. In other words, anyone in their 30s or even early 40s will not have experienced any serious levels of inflation in the UK.[4]

A short history of central bank independence and inflation targeting

It is these experiences – shared across the advanced world at that time – that encouraged governments to make their central banks institutionally and operationally independent. Starting with New Zealand in the late 1980s, governments around the world granted their central banks independence. No more government meddling in monetary policy for political purposes.[5] Long gone are the days when the Chancellor of the Exchequer called the Governor of the Bank of England (BoE) and told them what to do with interest rates.[6] And if inflation is the key concern, what can be better than directly targeting whatever you might consider to be an acceptable inflation rate? The result was inflation targeting, which replaced targeting the money supply – the amount of cash and cash-like assets such as bank deposits in circulation in the economy - as the key policy objective for central banks.

While most central banks have gained their independence, it generally remains for governments or parliaments to decide what policy objectives to pursue. The UK government, for example, has mandated the Bank of England to target 2% inflation (with a symmetric tolerance band), while supporting employment and the economy.[7] The US Congress gave the Federal Reserve a mandate in 1977 to "promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates". Meanwhile European governments set out their mandate for the European Central Bank (ECB) in the Maastricht Treaty. In most cases central banks were then given substantial freedoms to decide how they would meet their mandates.

Is central bank independence threatened?

Former US-President Donald Trump challenged the Fed using social media but even he did not revoke formal independence and it is difficult to see any government contemplating such a move. The reputational damage would be too great, with credit rating agencies probably forced to downgrade the creditworthiness of the sovereign and funding cost rising.

Governments do not need to revoke independence to gain greater control over monetary policy though. A change in a central bank's mandate could go a long way for example. An inflation target of, say, 2% is not set in stone. Often specific policy targets only exist because they seemed appropriate at the time they were established.[8] Path dependency then starts to matter. Central banks can also be encouraged to review their monetary policy strategies and re-interpret their mandates given changing circumstances.

For example, what does "price stability" mean exactly for the ECB? Since 2003 the ECB has interpreted this mandate as aiming for inflation "*below, but close to, 2% over the medium term*" but

[3] As a result of compounding, prices double within eight years with annual inflation of 10%. This reduces to six years once annual inflation is 15%.
[4] What those born after the 1980s will have experienced though is asset price inflation, with residential house prices doubling in the short period between 2000 and 2006 alone. Asset price inflation, and how to treat it in inflation indicators, is a major point of controversy among economists, statisticians, and policymakers.
[5] Not all countries have made their central banks immune from political interventions, see recent developments in Turkey.
[6] See The Mark and George Show for insights on how monetary policy was conducted before Gordon Brown, then Chancellor of the Exchequer, made the BoE independent in 1997.
[7] In the March 2021 Budget, Chancellor Rishi Sunak also mandated the Bank of England to consider environmental sustainability and the transition to a net-zero economy in its policy setting, see Budget 2021.
[8] The European Union's Maastricht debt to GDP rule of 60% comes to mind.

other interpretations must exist. The ECB is currently conducting a strategic review of its monetary policy framework. One outcome of the review could be for the ECB to move to an inflation target with an explicit symmetric target range, which would give it some breathing space if inflation exceeded the target for a while. After a decade of low inflation rates pre Covid-19, the ECB might judge that it could temporarily tolerate a bit more inflation than it did in the past without losing credibility. The Federal Reserve came to that conclusion for itself after its own strategic review last year. Rather than targeting an inflation rate of 2%, it is now targeting 2% inflation *on average*, in other words it will tolerate some overshooting as long as it is temporary.[9]

What are central banks going to do now?

Finance ministries and central banks coordinated their policy responses during the Covid-19 crisis and can be expected to continue to do so now in the recovery phase. With government debt to GDP ratios at historical highs, many governments will be keen to withdraw their fiscal support as quickly as possible, which would leave limited scope for central banks to rein in their own support in the short to medium term. It also seems unlikely that central banks would tighten aggressively to offset any major fiscal loosening. The Federal Reserve, for example, can sit tight for a while, knowing that its response to the US administration's fiscal package is in line with its new monetary policy framework.

Last but not least, central banks might be caught by what is called fiscal dominance: with governments relying heavily on low borrowing costs to fund their high debt levels, central banks might be reluctant to raise interest rates or reduce their asset purchase programmes and risk a sovereign debt crisis.

What is most likely is that central banks will maintain their supportive policy stance for the foreseeable future, even if inflation rises above targets. Just to remind markets what tools are available to them, central banks might raise policy rates slightly. So long as inflation remains "reasonable" – say 4-5% - central banks can then be expected to try to persuade the markets that they are monitoring the situation carefully (for example labour market and wage trends) and have the necessary tools to stop inflationary pressures from becoming permanent.[10] This could happen if wage settlements far exceeded any productivity gains in the economy, economists call this phenomenon "de-anchoring of inflation expectations". And with policy rates close to the lower bound in most countries, central banks are in a strong position to make these claims credibly. There is after all no upper bound to interest rates.

That would be quite a turnaround from just a few years ago, when central banks struggled to convince markets that they could still stimulate the economy after a decade of sluggish growth and record low interest rates. It could also mark the beginning of a new chapter for central banks: after a decade of taking the lead on macroeconomic policy in the wake of the Great Financial Crisis, perhaps it is time for fiscal policy to take centre stage again.

[9] As part of the review, the Fed also made changes to its employment objective.

[10] In its May 2021 Monthly Report, the German Bundesbank suggests that consumer price inflation could reach 4% by end of the year, see The current economic situation in Germany May 2021.