Opinion

Inflation was temporary, after all

The risk now is that a failure of central banks to cut interest rates in a timely manner will result in higher unemployment and further downward pressure on wage increases.

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Just look at two charts about the US and the euro area. The first one displays the inflation rate, the second the unemployment rate. Inflation starts rising in 2020, peaks in 2022 and then declines almost as fast as it surged. The peak occurs at about the time when the central banks started to raise their interest rates. The last observations put it about one percentage point above 2%, the official target. The second chart shows that Unemployment surges in the US in 2020 and then declines to the pre-pandemic level while, in the euro area it gently keeps moving along a declining trend that started in 2014.

These basic facts suggest three incontrovertible observations.

nothing to do with traditional Phillips curve trade-off. Third, monetary policy has played no role in bringing inflation down. These observations are as basic as the facts. No doubt, they can be developed and nuanced by looking at many details, but they cannot disprove the broader picture in any meaningful way.

This is all embarrassing. The central banks have been castigated for sticking with their initial assertion that the inflation surge would be temporary. (Disclaimer: along many other economists, I have mocked central banks for their assertion, so I am not trying to say «I told you so».) The central banks then promised to make up for time lost and they now claim victory over inflation, but this is a victory for the now-abandoned claim that it would be temporary. Everyone is looking at them for their next steps, but this attention is unjustified. Like the rest of us, the central banks are merely looking at the train that is passing by.

Footprints of central bank actions are nowhere to be seen

Why are these observations incontrovertible? Monetary policy is known to affect inflation with long and variable lags, historically ranging from 18 to 24 months. There is no way that monetary policies started in 2021 and gradually picking up steam can explain the contemporaneous inflation reflux. Monetary policy is also understood to operate through the goods and labor markets, running the economy up and down the Phillips curve. While growth has fluctuated widely over the period, the labor markets have become tighter as disinflation has taken hold.

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high for long, central banks again practice forward guidance when there is not enough clarity to do so.»

The economic slowdown that seems to now occur may be ascribed to monetary policy, and may lead to further disinflation once unemployment starts rising but, so far at least, the footprints of central bank actions are nowhere to be seen. There is no doubt that higher interest rates have impacted the financial markets, but financial conditions are just part of the transmission process of monetary policy. What happens on financial markets should not be confused with macroeconomic fundamentals such as growth, employment and inflation. They may portend subsequent evolutions, though, more on that later.

Of course, the fact that the movements of inflation and unemployment do not correspond to the predictions of the Phillips curve confirm the presence of powerful supply shocks that shifted the curve up and then down, driven by all the well identified suspects: supply chain disruptions that came and went, increased prices of primary commodities and food that have now stabilized or even declined, and changing labor market patterns in the wake of lockdowns that are now ebbing. Monetary policies could have played a role along the shifting Phillips curve, but the timing suggests that its effects have only started to materialize now. Fiscal policies probably played an important role, but they have been, and continue to be, procyclical.

If markets become jittery, it is easy to suspend QT

So much for interpreting the past. Looking forward, the basic observations suggest a number of implications for the future. First, assuming away further supply shocks, monetary policy actions are now having their classic impacts, through the financial markets. Higher interest rates destabilize many financial intermediaries that had grown accustomed to near-zero interest rates. The resulting tighter credit conditions hit housing and investment spending. Lower growth and soon-to-rise unemployment will hurt wages and therefore private spending. This should bring inflation close to, or even below target. As they promise to keep interest rates high for long, central banks again practice forward guidance when there is not enough clarity to do so. Quite soon, they might have to promptly cut the interest rates to avoid becoming caught once more with too low inflation and interest rates at their lower effective levels.

The next implication concerns Quantitative Tightening (QT). The risk is that when the central banks cut interest rates they will stop or slow QT down. Liquidity supply directly affects financial market stability, but it does not impact the macroeconomy and it is not a substitute for interest rates. Central banks like to think otherwise. They have started QT shortly after they began to raise the interest rates, but they proceed at a measured pace for fear of destabilizing the financial markets. That fear subsists, and may be justified, but it does not call for the end or even slowdown of QT. If markets become jittery, it is easy to suspend QT, even to temporarily revert to Quantitative Easing, and then resume QT.

The bloated balance sheets of central banks, which are mirrored in bloated balance sheets of commercial banks, are an anomalous legacy of the period when interest rates were at their minimum effective levels. Before, money was purpose-

fully kept scarce to justify positive interest rates. Nowadays, money supply is excessive and the only way central banks can enforce positive interest rates is by remunerating the deposits of commercial banks. It is not at all clear why central banks should give up their seigniorage income, which is now often negative, to subsidize commercial banks as a reward for holding excess reserves.

Income distribution matters

Finally, in most countries, the purchasing power of wages has declined, sometimes quite significantly, even though unemployment has been declining to historically low levels. Real wage cuts are a hallmark of supply shocks. If there is no further supply shock, nominal wages should catch up with prices. The risk is that a failure to cut interest rates in a timely manner will result in higher unemployment and further downward pressure on wage increases.

From a narrow economic viewpoint, this may not matter much but income distribution is important. Workers have been hurt by the lockdowns and the subsequent loss of their purchasing power, which has been hidden sometimes by various subsidies during the pandemic and the subsequent recovery. Higher public debts and the multiplication of demands for expanded government spending (to deal with climate change, to support the digital transition and to beef up defense) will force the end of these subsidies where they are still in place. It is important to avoid social unrest at a time when many countries face increased political polarization.

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