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Crunch time for central banks

The combination of highly expansionary fiscal policies and scarring effects could well lead to inflation rates not seen for decades. A column by Charles Wyplosz.

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«After all, a key function of financial markets is to deal with uncertainty.»

The debate about inflation is just one part of the growing debate about monetary policy. Having missed their inflation target, for years despite a flurry of new tools, central banks now face the opposite challenge. They may have to fight inflation above target and give up their new tools. So far, they have responded with great prudence and some degree of ambiguity. Will they have to come out of the wood faster than they wish?

About the author

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Where will inflation rates be in one year? The pundits disagree and the markets are nervously modifying their views. Meanwhile, central banks display a sense of serenity meant to quiet rising anxiety down. As usual, we wonder whether they know something that we don't and, as usual, this is not the case. The simple truth is that we are coming out of an unprecedented shock, a worldwide pandemic met with unprecedented responses, so that past patterns are a poor, possibly misleading guide to what is coming up next.

Over the last year or so, private savings have increased by large amounts as households were hunkering down to protect themselves from the coronavirus while their income were generally protected thanks to a variety of fiscal supports and subsidies. We knew all along that they would spend much of their accumulated savings once the pandemic threat recedes, which would produce a sharp rebound in economic activity. We also expected the supply side to restart more slowly, leading to temporary excess demand, likely to ignite price increases. This is indeed happening now. Much less is known about what will happen once the stock of excess saving is exhausted.

Sluggish recovery along with rising inflation

Growth will slow down, for sure, but how much? Many people worry about the scarring effects of the pandemic, which would imply a sluggish recovery following the initial surge. Even then, the outlook for inflation is murky. Most expected scarring effects concern the supply side, which would lead to inflation. These effects include a lasting reduction in labor force participation, and the continuing existence of zombie or just inefficient firms, made possible by public support that governments find hard to stop. On the other hand, demand could be subdued because households remain worried if, as is likely, Covid is not eliminated and new virus mutants keep popping up.

Then there is the question of what governments will do. Many will opt for expansionary fiscal policies, if only to strengthen a possibly hesitant recovery. The US shows how this concern may play out. The Biden administration considers that the need to strongly raise public spending goes beyond the aim of strengthening the recovery. It wants to reduce inequalities, to fight against climate change or to develop industrial policies designed to meet the Chinese challenge in high technologies. The combination of highly expansionary fiscal policies and scarring effects could well lead to inflation rates not seen for decades.

None of these developments are certain, except for the expansion of public spending in the US, which might, or might not, be financed by higher taxes. To make things even less clear, the sluggish recovery scenario may come along with rising inflation if supply is slow to respond, while the red-hot scenario of a demand boom may not be strongly inflationary if firms use their own accumulated savings to invest in productivity-enhancing means of production.

The challenge of time inconsistency

The challenge for central banks is immense. In comparison, the Global Financial Crisis was simple. Central banks had to support demand by slashing interest rates and help stabilize the financial markets by injecting massive amounts of liquidity. To be sure, reversing these measures was delicate, but the problem was standard, with well-known precedents. This time around, forecasts are completely unreliable and there is no precedent. So far, central banks seem to follow the celebrated Brainard principle: faced with high uncertainty, central banks should move slowly. This is a reason why they keep promising their interest rates low-for-long and continuing QE. Yet, their prudence may be explained otherwise.

They face another celebrated challenge: time inconsistency, which means that current promises, which make sense today, will not be upheld by future actions, because the situation will have changed, and they know it. For the next couple of years or so, their two key policy objectives are to ensure, at any rate not to harm, the nascent recovery and to avoid financial turmoil. Both objectives call for keeping interest rates low, including far along the yield curve, and for maintaining excess liquidity. This is what they do, but the unpleasant question is whether this stance will have to reversed, and if so when. Their promises of keeping the current stance unchanged assume that inflation will return to target after the current initial surge. The prevailing massive uncertainty, however, means that this assumption is fragile. The Brainard principle also calls for looking at various plausible inflation outcomes, not at a particular possible occurrence, a return to low inflation. If it is plausible that inflation will become entrenched at too high a level in, say, a year or two, the current stance is no longer adequate because it takes time for monetary policy to bring inflation down.

Until very recently, the Fed seemed to have considered that its new average inflation targeting strategy provides the flexibility to navigate through uncertain times. Under the new strategy, the Fed no longer needs to act pre-emptively. It can tolerate a temporary surge in inflation. Even if inflation were to durably overshoot the 2% target, given the past undershooting, the Fed could wait comfortably before changing its stance. Its recent signal, that it could raise its interest rate in 2003 rather than in 2024 as previously suggested, seems to accept that it may have underestimated how far inflation will rise. There is nothing wrong with changing the forecasts, but it illustrates how fragile they are.

Significant risk of making the wrong policy call

This high degree of uncertainty is rattling the financial markets. They need to look further into the future to price asset prices and long-term interest rate. The possible time-inconsistency of the current stance is now coming to the fore. The Fed and the other central banks are asked to change their tunes, or at least to be more precise about their beliefs even though they do not know themselves if and when they may have to make a move.

They may choose to ignore the calls from the financial markets. After all, a key function of financial markets is to deal with uncertainty. Their calls for central banks to reduce policy uncertainty are self-serving. In effect they ask the central banks to absorb the risks from the prevailing high uncertainty. But rising risk premia stand to dent the recovery, which is the current priority of monetary policies, not to mention the possibility of renewed financial turmoil, which is the bane of central banks.

Over recent decades, central banks have acquired hero status as they safely steered the world through momentous challenges. In retrospect, these were easy challenges, at least in comparison with the post-pandemic situation. They do not want to announce when and how they will raise interest rates and stop QE because they don't know, but failing to do so could make matters worse. The risk of making the wrong policy call is quite significant. It really is crunch time for central banks.