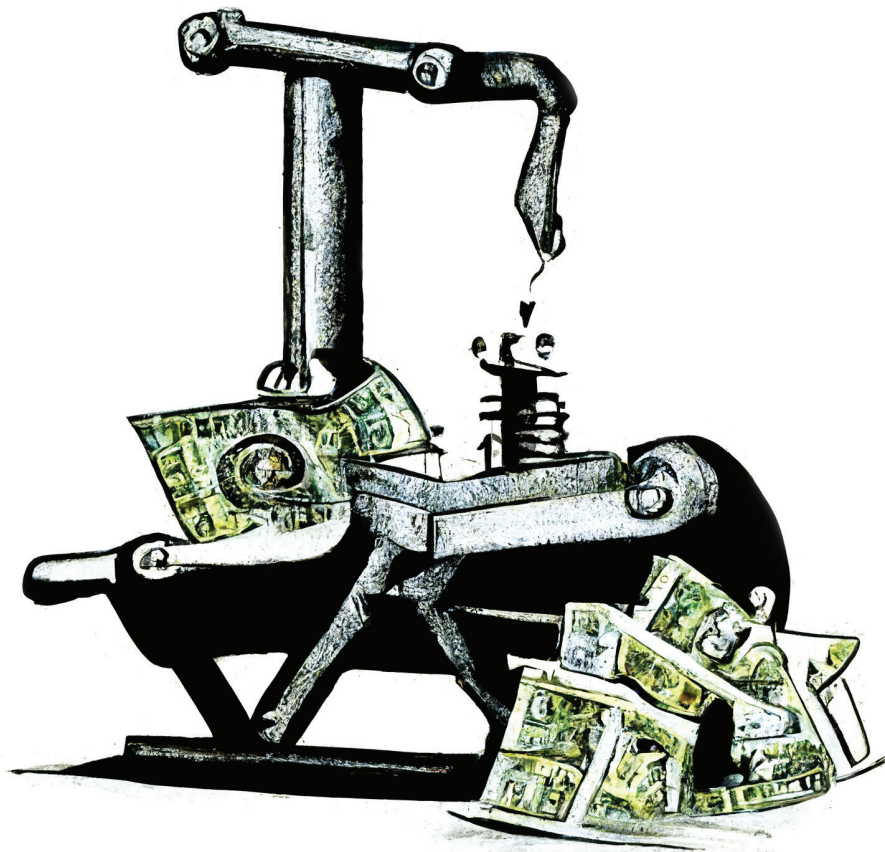


HOW CENTRAL BANK MISTAKES AFTER 2019 LED TO INFLATION

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FOREWORD BY WILLIAM WHITE



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About the New Zealand Initiative

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Foreword

Too much hubris, not enough humility

In this short essay, the authors make a convincing case that stimulative monetary policy during the global covid pandemic contributed materially to the inflation surge that followed and which persists today. Equally important, they focus intensively on the various reasons that might have contributed to this tragic policy error. A persistent theme is that of central bank hubris; a trust in policy frameworks, models, assumptions and their own professional competence that would eventually prove to be unwarranted. The authors conclude that central banks can restore their lost credibility, as guardians of price stability, only by admitting their errors and specifying clearly how they intend to improve their performance in the future.

As I read this insightful essay, I became ever more convinced that the root of the central banking problem is what a philosopher would call an ontological error. Central bankers have fundamentally misread the nature of the system they are trying to control. They wrongly assume that the economy is simple and static, and therefore as understandable and controllable as a machine. In contrast, it is as complex and adaptive as a forest, a system where policy can have different effects over different time horizons, many unintended consequences and where there is no “equilibrium”. Humility rather than hubris should have conditioned monetary policy right from the start.

A primary example of the practical policy errors arising from this fundamental ontological error relates to the importance of supply side shocks in the global economy. Central banks have systematically ignored the importance of such shocks. First, during the period of “The Great Moderation”, leading up to the Great Financial Crisis that started around 2008, central banks attributed low and stable inflation (and high and stable growth) to their own wise policies of demand management. In reality, the underlying cause was a series of positive supply side shocks that included both globalisation and positive demographic trends. The Great Financial Crisis then was triggered, and caused to persist, largely by the unwinding of excesses in the real and financial sectors that were directly due to the stance of monetary policy prior to the crisis. Second, as Wheeler and Wilkinson stress, during the initial phase of the covid pandemic, central banks failed to appreciate how much supply potential had been reduced by illness and lockdowns. As a result, they failed to see how easily inflation might be triggered by still more monetary expansion, particularly as an adjunct to unprecedented fiscal expansion. More technically, the authors note that the central banks assumed Philips’ curves were flat and that inflationary expectations were well anchored. Both assumptions have been proven “wildly incorrect”. Third and subsequently, central banks asserted that the original negative, supply side shocks would prove “transitory” - another error. And fourth, central banks today also seem largely unaware of the further negative supply shocks that are fast approaching. In effect, the favourable supply side shocks we saw prior to the Great Moderation are now going into reverse, and in addition, we now also have climate change and massive resource misallocations to contend with. Wheeler and Wilkinson rightly imply that this “stagflationary environment” will pose huge challenges for central banks going forward.

Given past and prospective cuts to real wages, there is now a real danger of a wage-price spiral in many countries, and this must be avoided. Some tightening of aggregate demand would seem inevitable, perhaps even requiring a recession. Wheeler and Wilkinson accept this reluctantly as the lesser of evils. But how should that tightening be done? Given all the pressures for more fiscal expenditure – to support dealing with climate change, equality issues, public health and national security – cutting fiscal deficits would likely require significant tax increases, particularly on the wealthy. This might be desirable, but it might also be politically impossible. If so, the burden will likely shift to still tighter monetary policy than seems currently envisaged. However, this possibility raises in turn potentially dangerous effects on economies that are generally even more indebted and unbalanced than prior to the Great Financial Crisis. Since, as Wheeler and Wilkinson note, it is low-income individuals and countries that are most exposed, the political ramifications for democracy could also be dangerous.

If an over-indebted world now faces a medium-term future of chronic supply side shortages, three policy conclusions emerge. First, we must think harder about using non-monetary means to cut aggregate demand to the level of reduced supply. Rereading Keynes' "How to Pay for the War" might be a useful starting point. Second, we must tighten monetary policy firmly, but with careful attention to non-linear outcomes. The effects of "quantitative tightening" on market liquidity require special attention. Third, we must review carefully our judicial and administrative procedures to ensure that necessary debt restructuring, and there will be a lot of it, is orderly rather than disorderly. Wheeler and Wilkinson are surely right in concluding that "Central banks could acknowledge what they believe they got wrong and what steps they are taking to rebuild public confidence". That lesson needs to be learned by other arms of government as well.

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Introduction

When President Bush hosted a meeting of Finance Ministers from G20 countries at a White House reception in 2008, he apologized for the economic, financial, and social damage that the Global Financial Crisis was inflicting on their countries. The US accepted responsibility for that crisis.

Today, the global economy faces another economic crisis. Annual consumer price inflation in many advanced economies is at a 40-year high, and measures of core inflation (headline inflation excluding food and energy) and inflation expectations are elevated above the ranges their governments set for headline inflation. Dangerously high global debt ratios compound the difficulties.

Even fully anticipated inflation misallocates resources because of the difficulties of inflation-indexing the tax system. Unanticipated high inflation is a stealth tax that imposes many costs. It redistributes income and wealth undesirably, disguises the relative prices needed to guide investment decisions, and thereby erodes competitiveness.

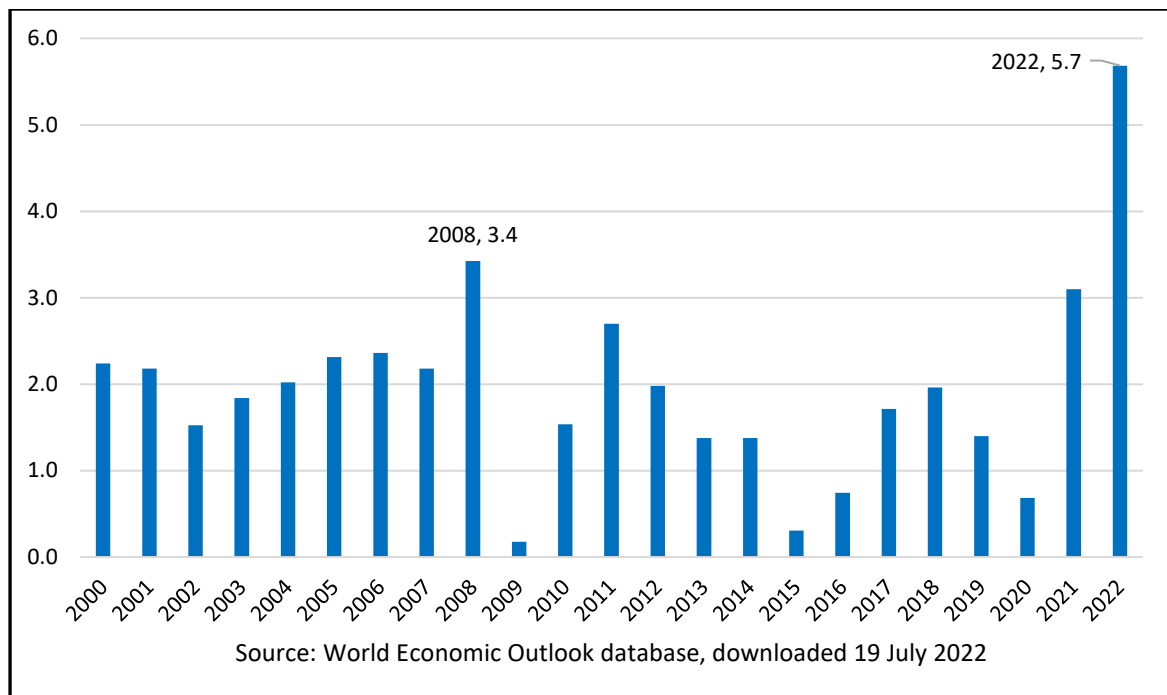
Furthermore, the substantial tightening in monetary policy needed to re-establish price stability raises debt servicing costs and bankruptcies and likely sharply reduces real incomes, employment, and asset prices. These challenges are even greater for the many developing countries and corporates heavily exposed to US dollar debt due to their limited incomes, the strong US dollar exchange rate, and the prospect of sharply higher interest rates.

Central bank policies are the main cause of high inflation

Some central bankers suggested that global forces are the main cause of rapid inflation and pointed to commodity price increases flowing from damaged supply lines due to Covid restrictions (e.g., for microprocessors) and Russia's invasion of Ukraine (and its impact on energy prices, wheat, and fertilizer). But these are not the main drivers of inflation. Several countries have annual inflation rates in the 2%-4% range including China, Japan, Switzerland, Saudi Arabia, and many Asian countries. Between May 2020 and May 2022 core inflation in the US was 10 percent and accounted for 70% of the headline inflation of 14 percent. Core inflation was 8 percent in the U.K. and accounted for 70% of the 11.5 percent of headline inflation. Core inflation accounted for 60% of headline inflation in France and 50% in Germany during this period.

The main cause of inflationary pressures lies in the errors of judgment made by central banks in conducting monetary policy during the Covid pandemic. While Russia's invasion of Ukraine accentuated the rise in inflationary pressures, commodity prices were already high because of the rapid global expansion in liquidity and debt.

Figure 1: Annual Average Consumer Price Inflation in Advanced Economies 2000-2022

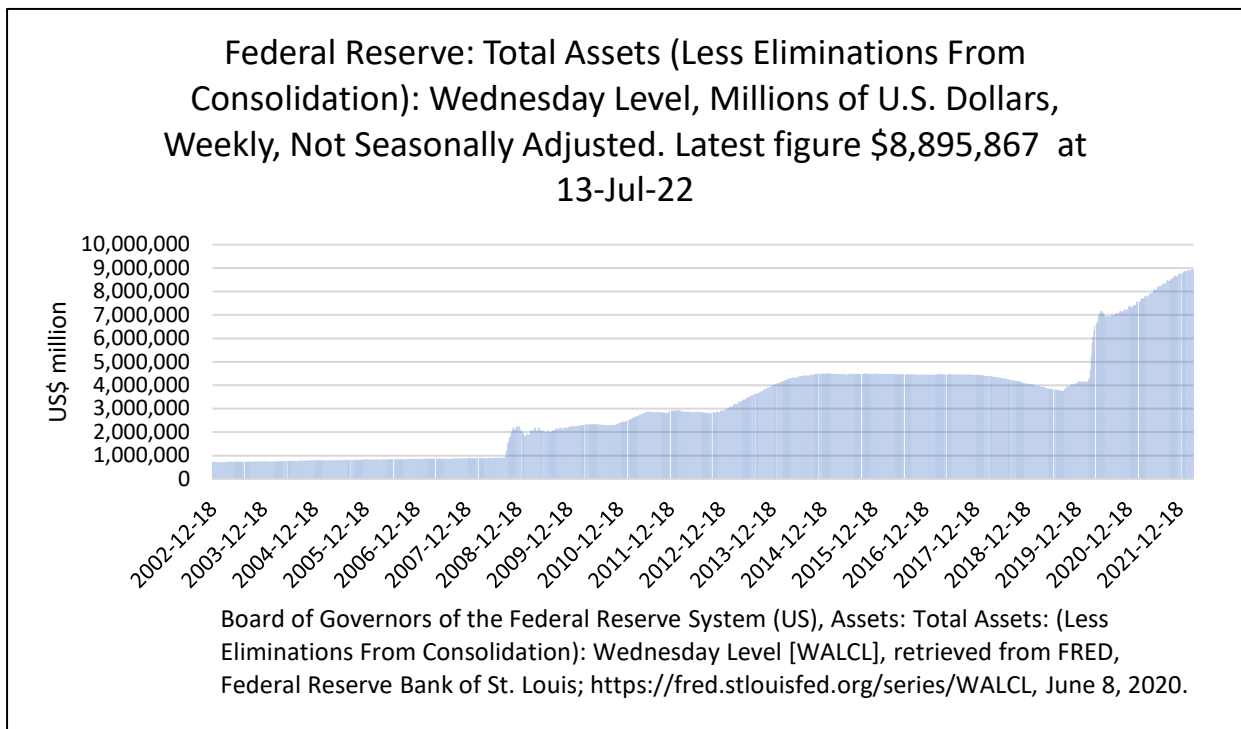


Restricting the assembly and movement of citizens and implementing lockdowns during Covid created major economic challenges for governments. Faced with a large negative output shock and the prospect that without offsetting policy stimulus economies would move into recession, governments responded with large programs of deficit spending based around wage and employment subsidies and other income transfers. In the 7 major wealthy advanced economies general government debt increased by 20 percent of GDP over 2020 and 2021.

At the same time, central banks responded by lowering their policy rates close to zero (and negative in the case of the European Central Bank and the central banks of Japan, Switzerland, Sweden, and Denmark). They also experimented with different types of state-contingent and time-contingent forward guidance on policy actions and unveiled plans to introduce various funding for lending schemes and large programs of quantitative easing. Quantitative easing involved purchasing government securities, such as long-term bonds and other assets, from banks and other investors in the secondary market with the goal of lowering long-term interest rates and stimulating private spending.

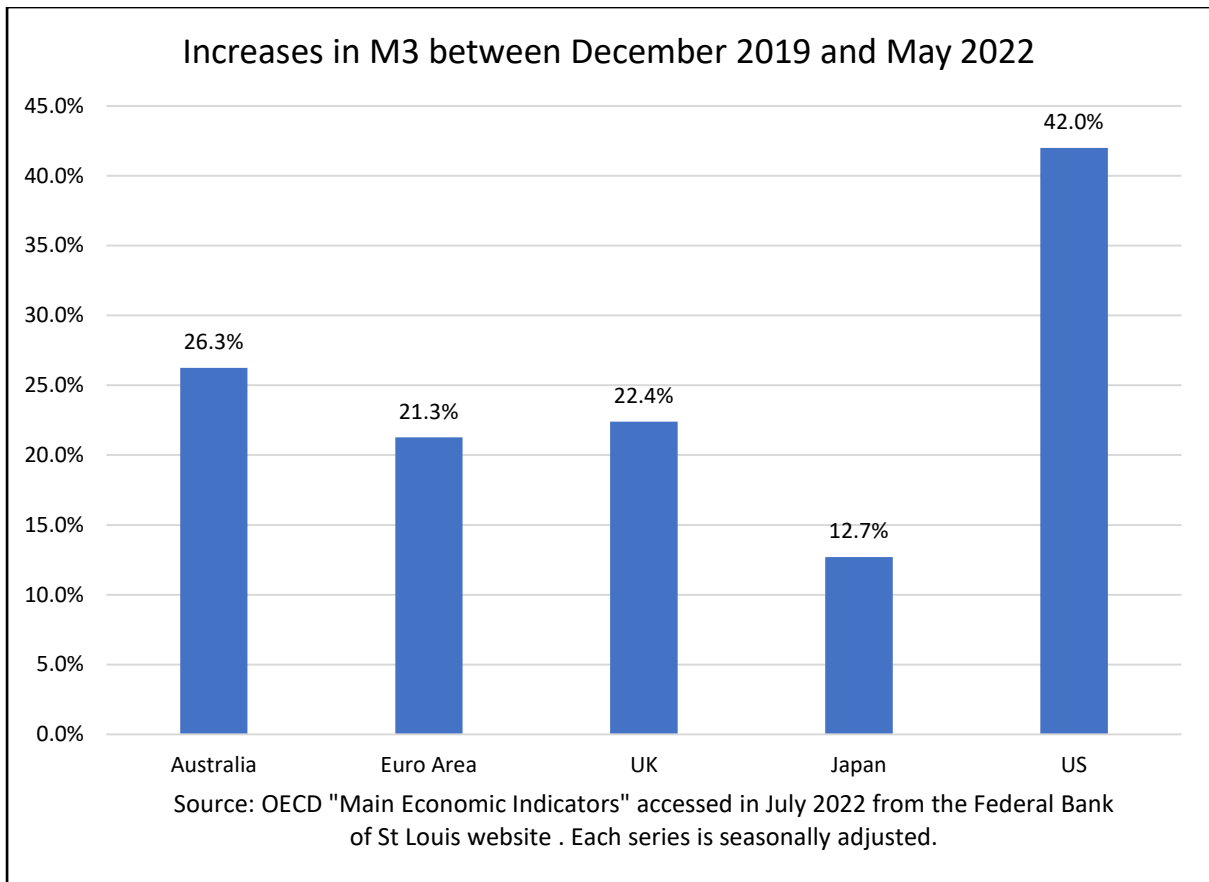
The scale of these programs was enormous. In the US, the size of the Federal Reserve's asset portfolio increased from USD \$4 trillion in early 2020 to almost USD \$9 trillion in early 2022-equivalent to around 23% of pre-Covid GDP. (In three rounds of quantitative easing in the six years following the global financial crisis the Federal Reserve's asset portfolio increased by USD \$3 trillion). New Zealand also had a large program of quantitative easing with \$53.5 billion of asset purchases - equivalent to 17 % of pre-covid GDP.

Figure 2: Total Assets US Federal Reserve System 2002-2022



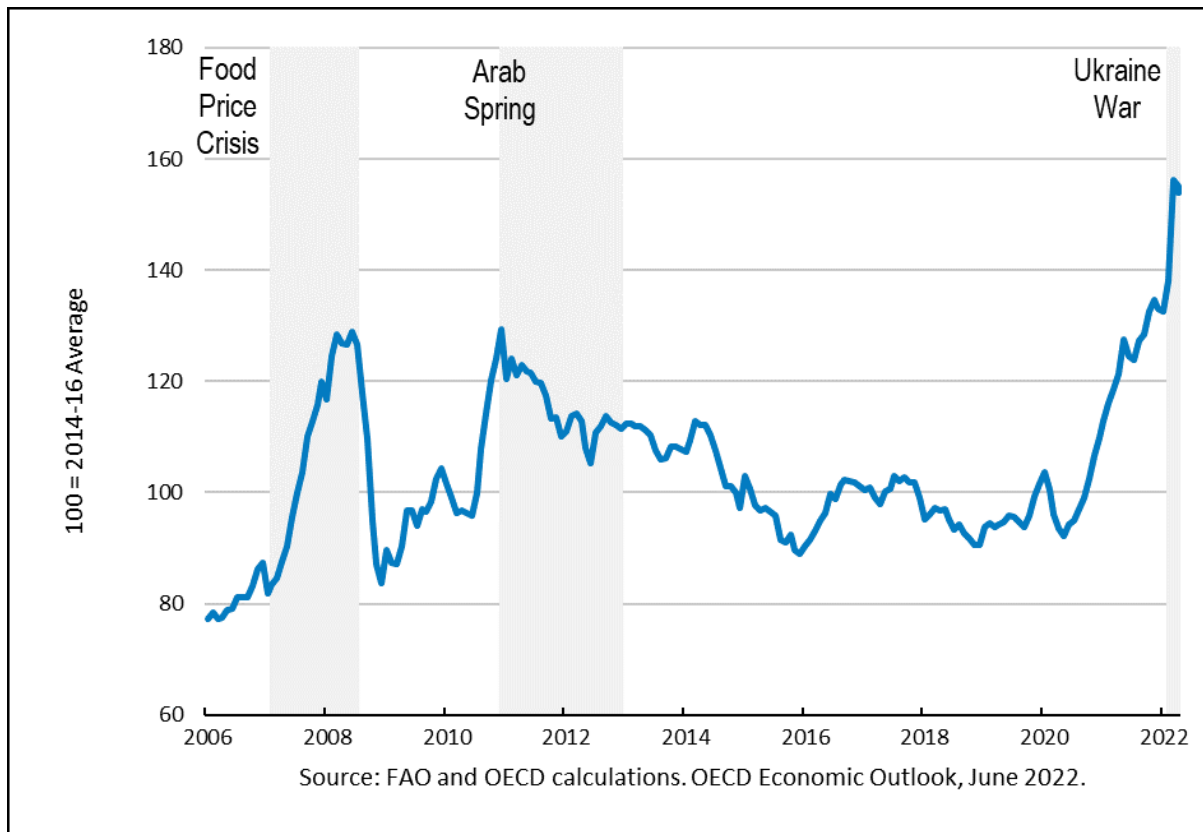
These purchases were intended to increase the money supply in each country and in the Euro area. And they did, depending in good part on the scale of the injections in each case. “M3” is a widely cited broad measure of the money supply. Figure 3 shows the increases in M3 between December 2019 (i.e., pre-Covid) and May 2022 for four major countries and the Euro area. The cross-country differences are marked, the outliers being the US and Japan.

Figure 3: Diverse cross-country increases in M3 from 2019



The surge in global inflation since early 2021 primarily results from the extraordinary degree of monetary and fiscal stimulus that central banks and governments undertook following the outbreak of the Covid pandemic. Excessive monetary stimulus pushed up commodity and equity prices, narrowed risk premia and led to rapid inflation in housing markets. These effects were predictable. Buoyant commodity prices are often linked to rapid increases in global liquidity, and the FAO Food Price Index increased by around 50% during the surge in quantitative easing and before the Russian invasion of Ukraine. Similarly, three weeks before Russia's invasion of Ukraine, the price of Brent crude oil was at its highest level since 2015.

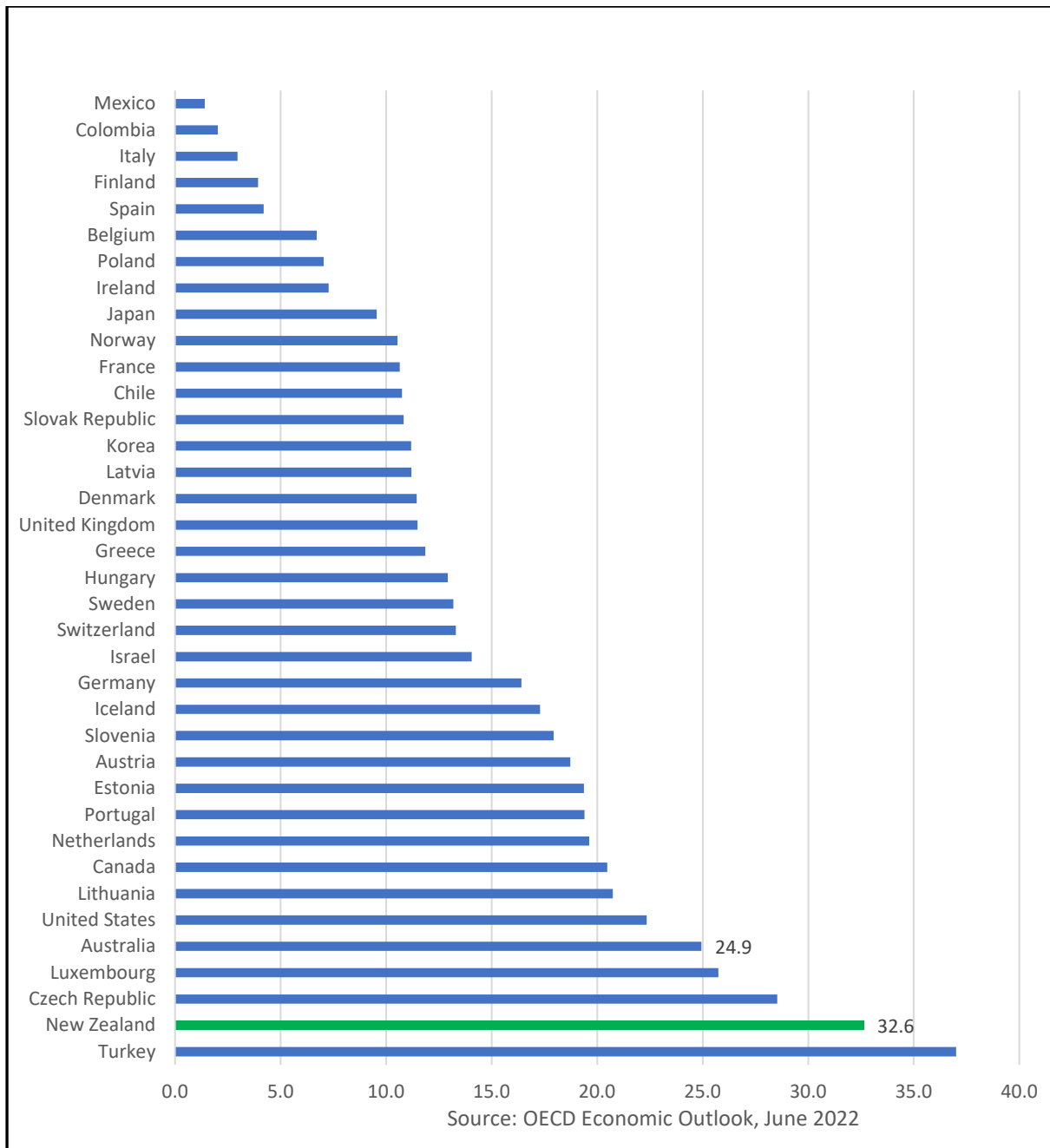
Figure 4: FAO Real Food (Commodity) Price Index 2006-2022



Central banks overdid interest rate cuts and the scale of their quantitative easing, and many continued large asset purchase programs when it was clear from the tightness of the labour market and rise in bond yields from late 2020 that their economies were stronger than forecast and that inflation pressures were starting to build.

It was inevitable that the combination of extremely low and often unprecedented interest rates, readily available liquidity, and central bank pressuring of commercial banks to rapidly expand their lending would fuel house price inflation, especially as the size of the housing stock changes very slowly. Between the December quarter 2019 and December quarter 2021 real house prices in the OECD median country increased by 13% - in New Zealand they rose by 33%, second only to Turkey.

Figure 5: Real house price growth (2019Q4 - 2021Q4)



Central banks were slow to curtail their quantitative easing and begin raising interest rates. Now that they are raising policy rates and long-term rates are rising, they are incurring huge mark-to-market losses on the long-maturity bonds they purchased (or the government is incurring the loss if it guaranteed the central bank against losses due to rising interest rates). The RBNZ's balance sheet puts the claim in June 2022 at \$8.8 billion, over \$4,000 per household. At the same time, the higher policy rates see central banks paying commercial banks much more interest on the massive excess reserves the latter have at the central bank. Banking system settlement balances at the RBNZ are currently \$45 billion. Each 2% rise in the RBNZ's overnight cash rate adds \$900 million a year to the cost to taxpayers.

Some central bankers have said that there was no alternative and have no regrets at the outcome in terms of explosive house prices and rapidly rising consumer price inflation. They are wrong on the first point and should have major regrets on the second.

How did central banks make these policy mistakes?

Central banks need to ask themselves and publicly explain why their models and judgments were so inaccurate. There are several areas for review.

(i) Central banks became over-confident in their inflation targeting frameworks

When inflation targeting became popular among many leading central banks in the 1990s, it was thought to solve many problems. Earlier attempts to look for nominal anchors that could maintain a stable relationship to the rate of inflation based on growth rates of the money supply proved unreliable when deregulation of financial markets and the financial product innovation that accompanied it led to rapid growth in monetary and credit aggregates. Subsequent moves to base policy on a broader toolbox of monetary indicators failed as markets struggled to understand which elements in the toolbox were assigned greater weight in any monetary policy decision. Inflation targeting was thought to solve the problems; a public commitment to an inflation objective would provide a strong nominal anchor for stabilising inflation expectations and enable central banks to maintain underlying and headline inflation within target ranges.

Central banks became complacent about their ability to maintain low inflation. They seemed to downplay the role played by positive supply shocks associated with globalisation, the global oversupply of manufactured goods, falling prices for information technology and capital goods, and the growing international competition for services such as education and health care in contributing to low inflation over the past two decades. They believed that when Covid restrictions were eased inflation expectations would remain anchored and that the growth in productivity would help restrain inflationary pressures.

They also believed that they could 'game' inflation expectations by having policy interest rates close to zero (or negative) while also operating massive programs of quantitative easing. They believed that the credibility they had built through years of maintaining low and stable inflation would ensure that levels of core inflation and inflation expectations would remain well-anchored at levels consistent with price stability. This assumption proved to be wildly incorrect.

(ii) Central banks were over-confident in the models they use to base monetary policy decisions

Many central banks use output gap models to assess the size of an economy's output gap (i.e., the degree to which there are capacity pressures within an economy and the inflationary pressures that accompany them). Technically they try to assess the difference between the actual level of GDP and the level of potential GDP (i.e., the level of GDP consistent with price stability and full employment). Central banks then attempt to project the path of policy interest rates needed to close the output gap (or return the level of GDP to the level of potential GDP) and return inflation to the target range. They also compare the actual policy rate at any time with their estimated neutral interest rate – the policy rate of interest which is neither expansionary nor contractionary for the economy. The difference between the actual policy rate and the estimated neutral interest rate indicates the extent to which current interest rate settings are stimulatory or contractionary.

There are many challenges with such models. They are inevitably simplified representations of a set of economic relationships that can provide useful insights into the impact of economic shocks and policy prescriptions. The parameters used in their operation - concepts such as potential GDP, output gaps, and the neutral interest rate - are all model based and not observable. No one knows the true values. Different estimation methods can lead to substantially different values. To simplify matters, the models build in a (Phillips Curve) relationship that assumes that wage inflation will remain low as the labour market tightens, and the models have an equilibrating or mean-reversion mechanism that returns economic variables, including inflation, to their normal or target ranges within a specified time interval. There are wide error bands around the central assessment of the output gap and considerable uncertainty about the actual level for the real neutral interest rate in integrated global capital markets.

The models are not intended to be accurate descriptions of the economy. They do not incorporate a banking sector, nor can they capture the wide range of shocks and disturbances that affect an economy. The interest rate profile that emerges is entirely dependent on the assumptions fed into the model. The models did not perform well in forecasting inflation pressures. Output gaps started to close quicker than anticipated mainly because of the scale of the monetary and fiscal stimulus, and central banks mistakenly thought the resulting inflationary pressures would be temporary.

(iii) Central banks were excessively optimistic that they could successfully 'fine tune' economic activity.

The last two years have shown how difficult it is for central banks to use monetary policy interventions to smooth economic activity while maintaining price stability. This should not have been a surprise. It is well-known that monetary policy is a blunt instrument of economic management, and it is often difficult to know what growth path an economy is on at any point in time. Also, the time lags between a monetary policy intervention and its impact on economic activity can be long, and the central bank can never be sure which of

the many possible transmission mechanisms through which monetary policy operates may be dominant.

At a time when governments were already committing massive increases in budgetary support in response to Covid and Covid restrictions, it is unclear why central banks felt the need to inject an enormous amount of liquidity into the global economy. Covid primarily disrupted production and governments used fiscal policy to provide extensive financial support to households and businesses. More money was chasing fewer goods and pushing up asset prices. Household incomes were being held up artificially by government deficit spending. Pent up demand led to increased spending as covid restrictions eased. When the aggregate supply curve for an economy is steeply sloped as in the case of covid lockdowns, and households and firms are receiving extensive income support, adopting excessively easy monetary policy, and rapidly expanding the volume of broad money runs a major risk of fuelling price inflation in asset and product markets.

Some writers claim that central banks were so activist because they have seen themselves as the first line of defence (some suggest the only act in town) from the onset of the global financial crisis almost 15 years ago. They responded to multiple economic and financial shocks then and since by rolling out new programs of quantitative easing, adopting historically low interest rates, and experimenting with different types of forward commitments and ways of signalling policy intentions. They saw themselves as indispensable and having the tools and judgment to play the leading role in economic management.

(iv) Central banks took their eye off their core responsibilities and focused on issues that were much less central to their roles.

Confident in their ability to maintain low inflation, central banks in recent years began diverting resources to other topics such as climate change and inequality (and in the case of the RBNZ also embracing New Zealand's indigenous history and culture and adopting a Māori world view in the operations of the central bank).

Such issues bear little if any relationship to the reasons why central banks exist -- ensuring price stability and financial stability. Current monetary excesses and fiscal imbalances are undoubtedly much more pressing risks. While there are longer -term risks to the overall financial system from climate change that should be researched, climate risks to date have not posed material risks to banks. It is a question of balance of priorities while also recognising that the specialist skills and policies needed to address climate change and inequality lie outside central banks.

In undertaking quantitative easing some central banks began to operate like fiscal agencies and fund managers in making decisions about which sovereign bonds to buy or which corporate bonds and exchange traded equity funds to purchase. The European Central Bank's decision to selectively purchase different member country sovereign bonds (e.g., those of Italy, Spain and Greece) in an attempt to narrow sovereign spreads within the Euro area has been very divisive among member governments.

There is a risk that central banks may feel encouraged to use climate change considerations as a criterion in bond purchasing programs when undertaking quantitative easing. Central banks should resist such a role and not be directly involved in credit allocation decisions; these decisions need to rest with the government.

(v) Dual mandates for monetary policy create conflicts

Central to the objectives assigned by governments to central banks in conducting monetary policy is responsibility for price stability or preserving the purchasing power of the domestic currency. But sometimes other objectives are also added, such as: “supporting the Government’s economic policies including its objectives on growth and employment” (Bank of England); “keeping in mind the objectives of growth” (Reserve Bank of Australia); “sustained growth and high employment” (Riksbank); and “growth, employment and narrowing social gaps” (Bank of Israel).

Where goals in addition to price stability are assigned, governments in advanced economies have nearly always given primacy to price stability as the overriding objective. Two exceptions are the US and New Zealand. In addition to price stability, the Federal Reserve is required to “promote maximum employment and moderate long term interest rates”. In addition, House Democrats recently introduced a House bill that would require the Federal Reserve to “exercise all duties and functions in a manner that fosters the elimination of disparities across racial and ethnic groups with respect to employment, income, wealth and access to affordable credit”. In New Zealand, the RBNZ is tasked with “maintaining a stable general level of prices over the medium term and supporting maximum sustainable employment”.

The assignment of clear policy goals for central banks is extremely important. Multiple policy goals such as achieving price stability and maximizing employment can come into serious conflict when inflation is higher than desirable and employment is falling or growing only slowly. In such situations the central bank needs to decide whether to raise interest rates to lower inflationary pressures, or lower interest rates to stimulate employment growth. This issue becomes increasingly problematic when an economy experiences stagflation—a situation now facing many countries.

(vi) Did some central banks try too hard to support government political objectives in making judgements about monetary policy?

Inflation targeting central banks highly value the operational independence granted by governments in implementing monetary policy. Important government-imposed pre-conditions for this delegated authority include a specific inflation goal or target and strong transparency and accountability disciplines.

The relationship between central banks and the government is not always at arm’s length. It is not unusual to see governments threaten or dismiss governors, board members and members of monetary policy committees, and appoint new ones. Central banks are conscious that operational independence in monetary policy depends on the consent of the government and can easily be withdrawn. Most central banks also depend on the

government for their annual or multi-year budget funding, or agreement as to how much seigniorage they can retain for operational expenses.

Governments vary on whether they will exert pressure on central banks by privately or publicly expressing views about monetary policy or the level of interest rates. At the same time, central banks in most countries are careful not to be publicly critical of government fiscal and other policies.

Whether such considerations affected the types of decisions that central banks made in conducting monetary policy over the past two years is difficult to say, but it should not be ruled out as a possibility in some instances.

The European Central Bank is a special case in that it seeks to sustain the Euro exchange rate system without a unified fiscal authority. Its activities thereby embroil it in issues that divide its member governments. In some member countries, extraordinarily high levels of government indebtedness exacerbate the tensions between their interest rate policies and public debt interest rate burdens. The more in debt is a government, the more pressure it is likely to put on its central bank to keep interest rates low.

The outlook for inflation and growth

Unless a recession is underway, multilateral financial institutions like the IMF and World Bank never forecast recessions when presenting or revising forecasts of global growth or growth in the advanced group of economies. But they sometimes lower projections and are currently doing so. Over coming months there are likely to be further downward revisions.

Countries vary greatly as to the magnitude of their inflation problem. For those with higher inflation like the UK, several European countries, the US and New Zealand, inflation is likely to remain an ongoing problem over the next two years even though some agricultural and industrial commodity prices-including oil- have eased recently, the rise in manufacturing producer prices in China is slowing, and supply chains (outside of the Russia/Ukraine region) are operating more efficiently.

Most central banks are still in the early stages of tightening, especially the Bank of England and the European Central Bank. Policy rates remain below the estimated neutral interest rate and need to be above it for a period to exert downward pressure on headline and core inflation. In the U.S for example, the Federal Open Market Committee's estimate of the neutral rate is around 2.5%, albeit with considerable uncertainty. The Fed Funds rate is now 1.5%-1.75% and may be above 3.5% by the end of the year.

How stubborn inflation will be and how high policy rates need to rise will depend on how much inflation expectations have increased, the level of wage inflation, movements in commodity prices and the extent to which the slowdown in economic activity reduces inflationary pressures. The degree to which employees, unions and other groups seek to negotiate wage, salary, and benefit increases to offset the substantial declines in spending power, and the extent to which businesses seek to maintain profit margins, are particularly important. In the UK, for example, several major unions are demanding double digit wage

increases and engaging in or threatening industrial stoppages. This increases the risk of economic recession accompanied by entrenched ongoing inflation.

At the same time, central banks need to begin or continue unwinding the massive asset portfolios they acquired during quantitative easing. Many have sensibly decided to announce a monthly program of asset sales and taken steps to separate these measures from the signalling of policy rates. This also involves challenges as bond sales will place upward pressure on long-term bond yields. The central bank will need to coordinate its sales with the government's debt managers who are also selling bonds into the market and may have specific duration objectives.

Central banks will try to avoid triggering an economic recession and seek to balance the rate increases required to bring inflation expectations closer into line with the objectives for price stability, while recognising that the softening in the economy will also reduce inflation pressures. This balance is very difficult to engineer given the challenges associated with economic forecasting and when headline rates of inflation are far from target levels. It is likely that some advanced economies, including the US and UK economies and the Euro area will move into recession in 2023 if not before.

Global economic growth is likely to be well below trend over the next two years as the effects of inflation and higher interest rates affect household and business spending across much of the world. Bankruptcies will rise, especially among the large numbers of zombie firms that have survived due to access to ample cheap finance in recent years. Unemployment rates will increase with poorer sectors of society bearing the brunt.

Developing countries that lack the financial buffers and safety nets of western economies will feel the greatest impact-especially those whose governments and corporate sectors are heavily exposed to US dollar borrowings. Rating agencies have markedly downgraded the credit ratings for the debt of emerging market and developing countries during the past year. They have done so because of deteriorating government fiscal positions and external deficits due to higher import costs, extensive subsidies on food and energy, and spiralling debt servicing costs. Many suffered serious capital outflows. Growing demands for debt relief and debt write-offs lie ahead.

Concluding comment

Until 15 months ago, citizens in advanced economies had experienced low inflation over the past 25 years, and wage rate negotiations could operate under a framework of price stability. Now, high headline and rising core inflation have lifted inflation expectations. Central banks transitioned to a high inflation environment and materially damaged their reputations as trusted guardians of price stability. It is a painful process to restore price stability to a level where people stop talking about inflation as a factor in their household and business decisions.

The economic and financial consequences of mismanaging monetary policy during the past two years and the corrective actions needed to address them will be felt in all economies around the world, especially by the poorest and most vulnerable groups over the next two

years. The World Bank estimates that 60% of all low-income countries need to restructure their debts or are at risk of needing to do so. Inflation and the costs associated with measures to restore price stability are already key factors in shaping election outcomes in many countries. In the 18 months following the height of the global financial crisis in 2008 a large number of governments failed to win re-election, especially in the European Union.

Central bankers need to reflect deeply on the management of monetary policy over the past two years and review their models and the assumptions and judgments they made. They must ensure that they have first rate financial market expertise on their monetary policy committees and Boards. Trite responses about “having no regrets”, “would not do anything differently”, and “there is no alternative” are irresponsible and further damage a central bank’s credibility. Central bankers need to learn from their misjudgements because the social, economic, and political consequences of major mistakes run deep and the trust and confidence that the public have in them can be readily depleted.

Just as President Bush acknowledged US responsibility for the global financial crisis, central banks could acknowledge what they believe they got wrong and what steps they are taking to rebuild public confidence.

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