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The Anatomy of the Global Inflation Spike

Oct 4, 2023 | **RICHARD CLARIDA**

The post-pandemic surge of inflation must be analyzed in its global context, with insights drawn from the notable correlations between countries - and especially between advanced economies. Only then can one properly judge major central banks' performance in managing the situation and pursuing their mandates.

NEW YORK – Persistent surges in core price inflation (which excludes food and energy), and the resulting overshoot of central-bank inflation targets, have been a distinctive and distressing feature of the post-pandemic global economic landscape (Chart 1). When confronted with such an economically significant phenomenon, those of us who pay attention to the relevant international evidence will look for common factors to account for the observed correlation between countries. I can think of at least three.

First, there is ample evidence to suggest that the initial surge of inflation across countries in 2021 and 2022 was triggered in part by an adverse shock to aggregate supply (here and Chart 2). Second, there was substantial (and, in the case of the United States, unprecedented) fiscal and monetary policy support, delivered first in 2020-2021, to cushion the blow to economic activity and employment, and then again in 2022 (especially in Europe), to offset the higher energy and food process caused by Russia's invasion of Ukraine (Chart 3).

Across the advanced economies, central banks responded to the COVID-19 shock by deploying various combinations of interest-rate cuts (or keeping rates at the effective lower bound), offering forward guidance, and expanding their balance sheets via large-scale quantitative-easing (QE) programs (here , here , and Chart 4). Interestingly, between 2020 and 2022, there was more cross-country variation in the scale of fiscal policies than in the scale of monetary policies. While correlation is not causation, it bears mentioning that there was much more of a correlation – at least in 2020-2022 – between the cross-country fiscal response to the pandemic and

cross-country inflation than there was between cross-country growth in the monetary base and inflation (here and Chart 5).

A third common factor contributing to the post-pandemic inflation surge was a large and persistent change in sectoral-relative prices, especially the relative prices of goods versus services (Chart 6 and). Making this argument does not require one to take a stand on how much the initial increase in the relative price of goods versus services reflected demand versus supply. If the equilibrium price of goods goes up for whatever reason, the overall price level will go up unless the central bank wants to engineer a decline in the price of services.

If there is some nominal price rigidity in the service sector, the central bank has a choice. It can allow the relative price increase to pass through and accept a one-time increase in the price level (which in isolation would produce "transitory" inflation). Or, it can hike rates and throw people out of work to reduce the price of services sufficiently to keep the increase in the price index equal to the inflation target. In the event, central banks opted, at least initially, to accommodate the price pressures by not trying to offset the increase in the relative price of goods relative to services.

When considering the monetary-policy response to the 2021-2022 global surge of inflation, it is noteworthy that no advanced-economy central bank in this decade began to hike rates until headline inflation had already exceeded its target rate. Equally, nearly all advanced-economy central banks (save Switzerland and Norway) delayed rate hikes until core inflation, too, had already exceeded their respective targets (Chart 8).

The question that many have asked is why monetary policies across most advanced economies "fell behind the curve" in this way (here). Critics of the US Federal Reserve (where I served as vice chair from September 2018 to January 2022) suggest that a persistent inflation overshoot, and a delay in lifting rates until inflation was already above target, must stem from a failure of the underlying monetary-policy framework. According to this reasoning, the post-pandemic record summarized in Chart 7 indicates a breakdown of both inflation targeting and its "first cousin," flexible average inflation targeting, which the Fed adopted in August 2020.

I beg to differ. As I argue in a recent paper (here), the post-pandemic record is better understood as resulting from ex-post errors of tactics and execution, not from the monetary-policy frameworks. Remember, the Fed committed in September 2020 to delay liftoff (rate hikes) until "labor market conditions … reached levels consistent with … maximum employment and inflation ha[d] risen to 2 percent." It then followed up in December 2020 with guidance that it would begin to taper the pace of QE asset purchases only after "considerable progress" had been made toward its maximum-employment and price-stability goals. But while these commitments were certainly consistent with the Fed's new framework, they were not required by it.

Moreover, the employment and inflation conditions for liftoff that the Fed had committed to in September 2020 were met in December 2021, just months after the liftoff date that the standard Taylor Rule framework would have set (here) . And now, underlying inflation across advanced economies appears to have peaked. With the unwinding of the adverse supply disruptions that

contributed to the initial inflation surge, it looks to be on a downward trajectory – heading back toward official inflation targets.

Having hiked rates aggressively, central bankers appear to be close to the end of the global post-pandemic tightening cycle. Their judgment is that they have moved rates into sufficiently restrictive territory and that if current policies are sustained for some time, inflation will eventually return to target. I suspect that the mantra of "lower for longer," which prevailed among central banks for most of the previous decade, will soon be replaced by "higher for as long as it takes."

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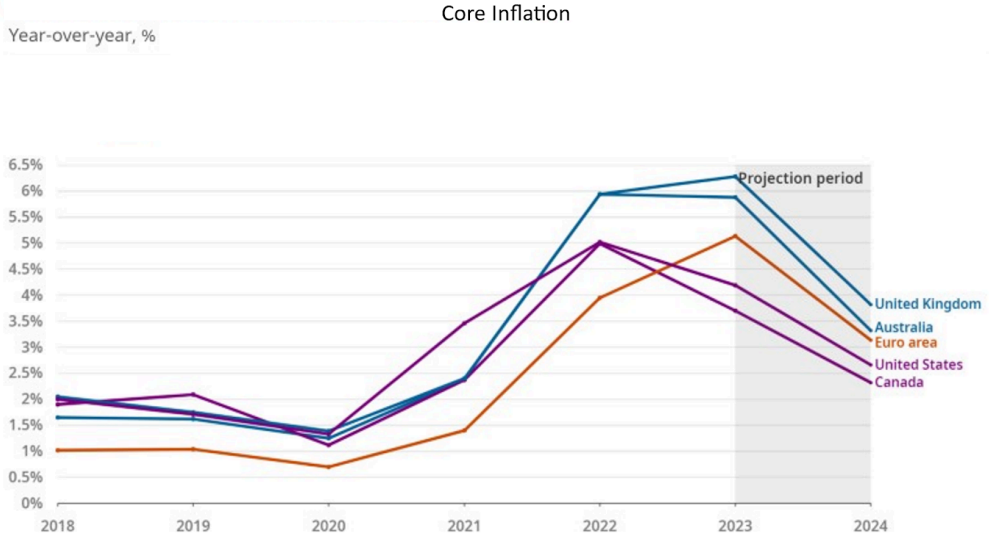
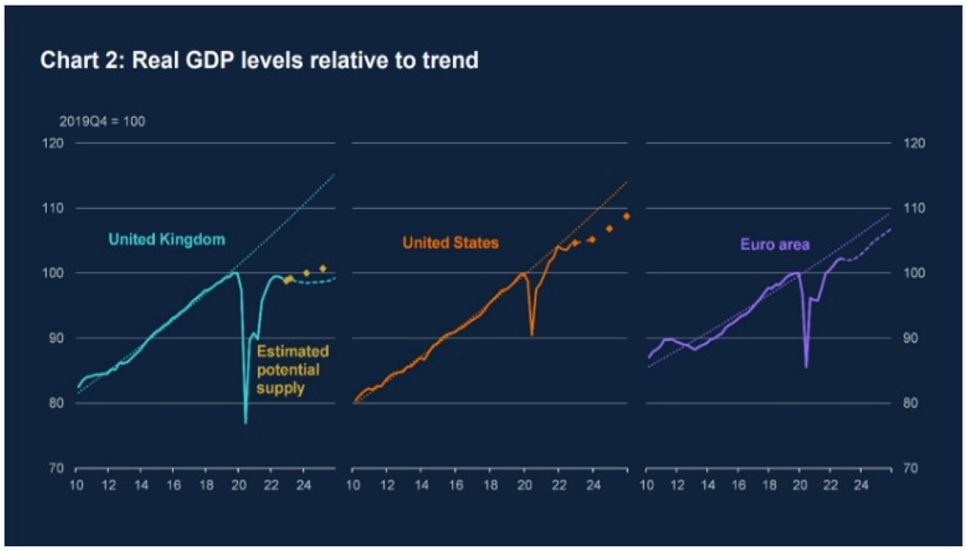
Chart 1

Core Inflation



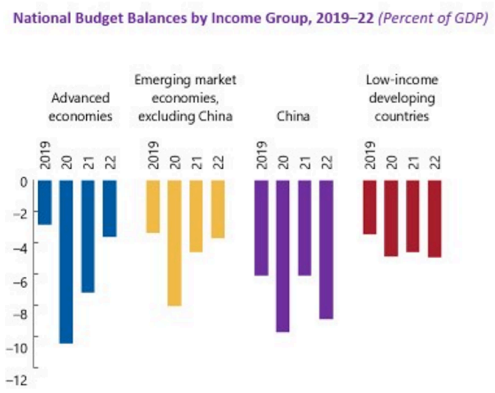
Source: OECD

Chart 2



Source: Bank of England

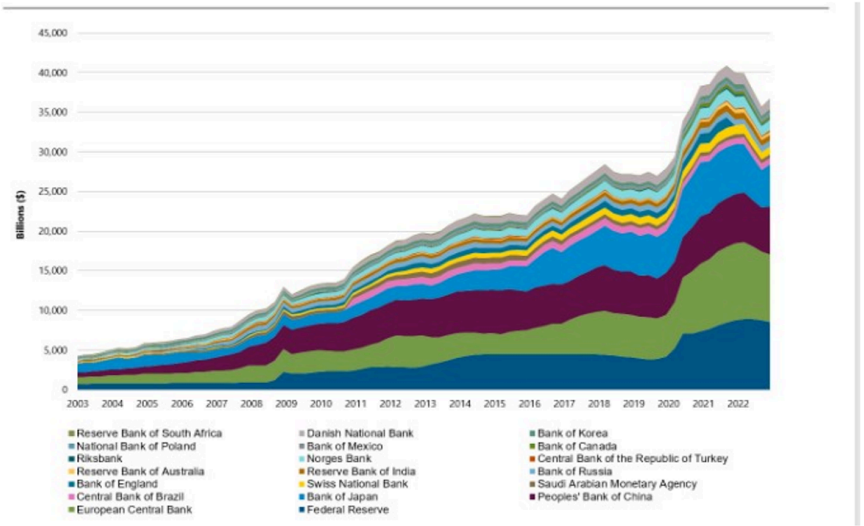
Chart 3



Source: IMF, World Economic Outlook.

Chart 4

Global Central Bank Balance Sheets



Source: Haver

Chart 5

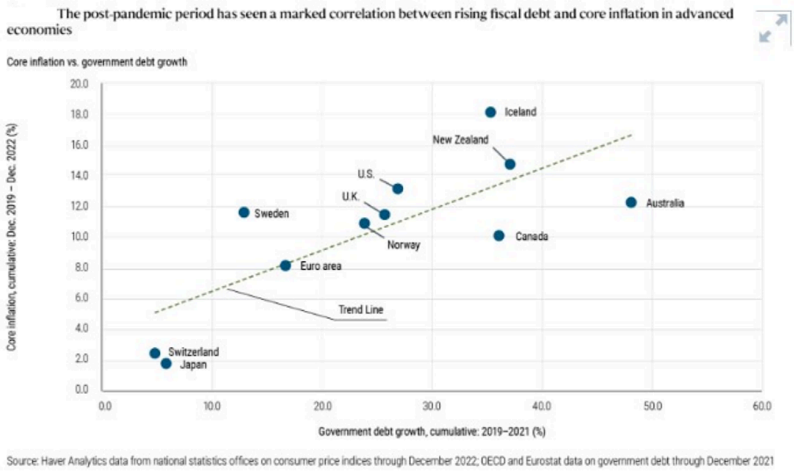
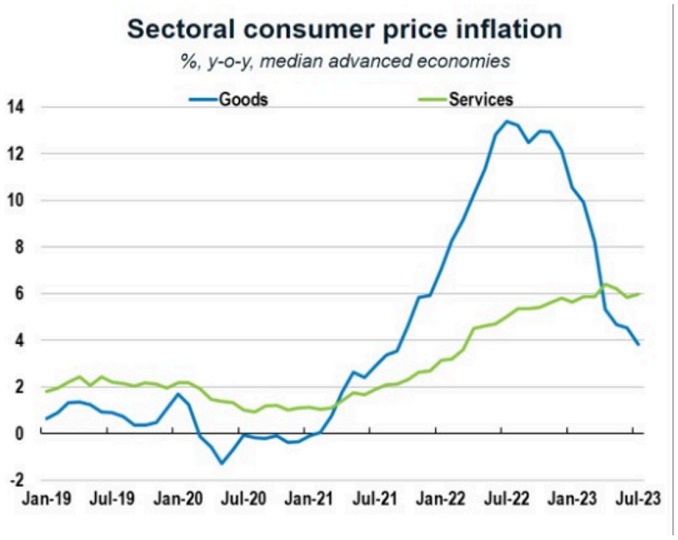


Chart 6



Source: OECD

Chart 7

Lift off in Advanced Economies

Country	Core CPI measure name	Reference rate name	Date of first rate hike post pandemic	Core inflation before first rate hike, %	First month core inflation above 2% + stayed	Headline inflation before first rate hike, %	Most recent core inflation (as of 9/25/2023), %	Most recent headline inflation (as of 9/25/2023), %
USD	US Personal Consumption Expenditure Core Price Index YoY SA	Federal Funds Target Rate - Upper Bound	3/16/2022	5.42	3/31/2021	7.9	4.24	3.7
CAD	Bank of Canada Core Inflation Index Trimmed Mean YoY	Bank of Canada Overnight Lending Rate	3/3/2022	4.40	3/31/2021	5.7	3.90	4.0
NZD	RBNZ New Zealand CPI Sectoral Factor Model Tradable Core YoY%	Reserve Bank of New Zealand Official Cash Rate	10/8/2021	2.50	9/30/2021	4.9	4.80	6.0
NOK	Norway CPI Underlying (CPI-ATE) YoY%	Norway Deposit Rate Norges Bank Announcement Rate	9/23/2021	1.00	2/28/2022	3.4	6.30	4.8
EUR	Eurostat Eurozone Core MUICP YoY NSA	ECB Main Refinancing Operations Announcement Rate	7/21/2022	3.70	10/31/2021	8.6	5.30	5.2
CHF	Switzerland Core CPI YoY	Switzerland National Bank Policy Rate	6/16/2022	1.70	1/31/2023	2.9	1.50	1.6
AUD	Australia CPI Measures Trimmed Mean YoY SA	Australia RBA Cash Rate Target	5/3/2022	3.80	9/30/2021	5.1	5.90	6.0
GBP	UK CPI Ex Energy Food Alcohol & Tobacco YoY	UK Bank of England Official Bank Rate	12/16/2021	4.00	8/31/2021	5.1	6.20	6.7
SEK	Sweden Underlying Inflation Rate CPIF excluding Energy YoY%	Sweden Repo Rate (Decision Rate)	4/28/2022	4.10	1/31/2022	6.0	7.20	7.5

Source: Bloomberg