

Great (Inflation) Expectations

By Dwija Saraiya

'The fight for central banks to tame rampant inflation has been arduous'

About a year and a half ago, in July 2021, when rate-setters in Europe and America dismissed the risk of entrenched inflation, the Central Bank of Chile got its act together. The country's policymakers lifted interest rates from 0.5% to 0.75%, worrying that inflation would rise drastically. They then raised interest rates again and again, until they reached their current level of 11.25% in October 2022. Perhaps no other central bank has pursued price stability with such dedication.

Has the straight-A student been rewarded? Hardly. In September, prices in Chile rose by 14% year-on-year. Core inflation, which excludes volatile components like energy and food, had soared to 11%. However, Chile's failure to control inflation only speaks of a wider problem. Many financial researchers claim that if the Federal Reserve and the European Central Bank (among others) were ahead of the curve and raised interest rates before inflation hit, the world would not be struggling with high inflation today. All over the world, it is proving extraordinarily difficult to crush price rises.

Researching further, we can spot a trend: Chile finds itself part of a club of eight countries where central banks started a monetary tightening cycle at least a year ago, and did so after having slashed interest rates to all-time lows early in the Covid-19 pandemic. In addition to Chile, the group comprises of Brazil, New Zealand, Hungary, Norway, Peru, Poland and South Korea. Tightening the monetary screw slowed these countries' economies. Mortgage rates rose, house prices fell and short-term GDP growth forecasts were sketchy.

The unlucky gang's struggle to tame inflation could be explained by three possibilities. The first is that it is unrealistic to expect inflation to fall instantly due to the lag between the tightening of monetary policy and resultant decrease in economy-wide consumption (it is also tricky to control inflation when almost every currency is depreciating against the dollar, making imports more expensive). A second possibility could be that the central banks of these eight countries were not aggressive enough in raising interest rates. Finally, the third possibility – and the most worrying one: perhaps this inflation is almost impossible to tame. In pre-pandemic times low-inflation regimes were common in the rich world where, due to its stability, inflation was only a minor factor in short-term and long-term investment planning. However, in periods of high-inflation, such as the 1970s, households and firms start to track price increases more closely which ultimately leads to behavioural alterations that could feed the inflation fire. If the world has shifted from one norm to another, then different tools may be needed to cool prices today.

However, recent estimates outlined by central banks such as the Bank of England (BoE) suggest that aggressive tightening of monetary policy is unnecessary if successful supply side action has been undertaken. Current BoE predictions for the middle of 2023 estimate that inflation will continue to fall in the UK, a country that recently has experienced some of the highest inflation of major economies. Major reasons outlined by the BoE for this predicted fall in inflation are the dwindling growth in energy prices, reduced supply-side difficulties for international business causing import costs to fall in the UK, and a reduced demand for goods

and services within the UK economy (in part a result of successful tightening of monetary policy).

It is ultimately unclear in the current economic climate as to whether aggressive contractionary monetary policy, such as that undertaken by Chile, has been successful in taming inflation – although there are suggestions that global co-operation on higher interest rates would have resulted in lower global interest rates. Only as global inflation begins to plateau and the world co-operates to solve the global energy crisis will we truly see which country's monetary policy has been the most successful.