THE HINDU

Rising U.S. dollar reflects more robust economic fundamentals in U.S. than in other major economies: Cornell University Prof. Eswar Prasad

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Eswar Prasad also elaborates on how Western central banks lost control over inflation, the economic costs of inflation, the future of central bank independence, and more

A strong U.S. dollar and high inflation have been the defining global macroeconomic trends of the year. In an interview with *The Hindu*, Eswar Prasad, a professor at Cornell University and the author of "The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance", argues that the rising U.S. dollar is a reflection of more robust economic fundamentals in the U.S. than in other major economies. He also elaborates on how Western central banks lost control over inflation, the economic costs of inflation, the future of central bank independence, and more.

How did the U.S. Federal Reserve and other central banks in the developed world lose control over inflation that was relatively benign in the last few decades?

The world has been hit by a series of supply disruptions that have turned out to be quite persistent. This includes COVID-related disruptions to global supply chains (including the effects of China's zero-COVID policy), the Russian invasion of Ukraine, and a number of natural disasters. Economic theory is clear that monetary policy is generally the wrong tool to counteract price increases due to supply disruptions.

However, one element that some central bankers seem to have misread is how consumer demand has remained strong and added to inflationary pressures, particularly in economies such as the United States. The enormous amounts of central bank money creation and government spending in the years since the global financial crisis of 2008-2009, both of which were ramped up further to deal with the COVID-related recession, also created latent inflationary pressures. These pressures remained dormant until the combination of strong demand and weak supply eventually triggered the recent surge in inflation.

The risk for central bankers is that they lose control of the inflation narrative if expectations about future inflation become entrenched. Rising inflation expectations can become a selffulfilling prophecy as workers demand higher wages and firms increase prices in tandem, making it very difficult to then rein in inflation.

Why should rising prices bother us if incomes are also going to rise in tandem with prices? What exactly are the economic costs of high inflation that are forcing central banks to raise interest rates?

High inflation is often accompanied by rising wages as workers try to protect the purchasing power of their incomes. The effects of high inflation usually fall hardest on the poor, who might not have steady incomes or formal sector employment that allows them to make wage gains to match inflation. Spending on food and energy constitutes a large share of the consumption baskets of poorer households, so high inflation in food and energy is particularly hard on them. Moreover, they would not benefit from the increase in the nominal value of financial assets simply because they tend to have few such assets to begin with.

High inflation also tends to be more volatile; in turn, this volatility and uncertainty can dampen investment by firms, which has adverse effects on employment and output growth. High inflation also corrodes confidence in the government and the central bank, which can create a dynamic of rising inflation that can spin out of control and cause further economic disruption.

Why has the U.S. dollar strengthened over the last decade and a half despite the easy monetary policy adopted by the U.S. Federal Reserve since the financial crisis of 2008? Is this a sign that other central banks adopted monetary policies that were far worse?

The dollar's strength is symptomatic of and also a contributing factor to economic and financial distress around the world. The dollar's continued rise reflects a combination of more robust economic fundamentals and stronger inflationary pressures in the U.S. than in most other major economies, which together presage further interest rate hikes by the Fed.

A stronger dollar will help to slightly moderate inflationary pressures in the U.S., although it is far from sufficient to overcome the supply-side constraints and robust demand that are driving those pressures. On the other side, a strong dollar makes a bad situation worse in the rest of the world. The Fed's rate hikes and the strong dollar have together tightened financing conditions in global markets and increased debt servicing burdens for developing countries whose governments and corporations have borrowed heavily in dollars.

Many currencies that have depreciated against the dollar have in fact not changed much in value against other currencies on a trade-weighted basis. [The Indian rupee is an example—down by about 10-12 percent relative to the dollar over this year but the trade-weighted nominal exchange rate of the rupee is down only by about 2-3 percent]. Nevertheless, depreciation relative to the dollar does add to inflationary pressures in many economies since much of their imports are denominated in dollars.

A strong dollar worsens the already difficult circumstances that many countries find themselves in and could spell even further trouble down the road for countries that have little room left for macroeconomic policy maneuver to deal with rising inflation and falling growth.

For a long time, the inflation rate in developing countries like India was higher than the inflation rate in developed economies like the U.S. But today inflation rates in developed countries are as high as those in the developing world. Do you see this as a temporary or a more permanent (secular) shift in global inflation trends?

The risk is that high inflation becomes entrenched in advanced economies, which could influence the behavior of workers and firms, and in turn could make it harder to corral inflation and bring it back to reasonable levels.

Many advanced economies are now facing the combination of steep currency depreciations (relative to the U.S. dollar), rising government bond yields, strained public finances, and tightening policy constraints that have long characterized periods of economic and financial stress in emerging market economies.

My sense is that the major advanced economy central banks are all committed to bringing inflation down to moderate levels in line with their respective inflation targets. To this end, they appear willing to tolerate lower GDP growth, higher unemployment, and possibly even recessions. All of these are painful consequences of tighter monetary policy but the consensus appears to be that any delay in reining in inflation could cause even greater economic pain and turmoil down the road.

Are central banks today being used increasingly more often to finance government spending? If yes, what are the implications of the compromise in central bank independence?

The great recession of 2008-2009, which mainly hit advanced economies but whose aftershocks were felt around the world, was met with a suitably aggressive response from national governments in the form of massive increases indebt-financed government spending to fend off economic collapse. This pattern was repeated amidst the COVID-related worldwide recession, even though it was a short-lived one.

During the protracted period of near-zero policy interest rates in advanced economies, central banks took to printing money and buying a lot of these government debt securities. They did this in order to try and stimulate consumption and investment by keeping long-term interest rates low.

Pressures on central banks to finance government deficits has been a long-standing problem for central banks in emerging market economies but, with their actions over the past few years, central banks in advanced economies have also set a similar unfortunate precedent. This poses a threat to the autonomy of central banks, although it is likely that their institutional independence will allow advanced economy central banks to fend off any political pressures to continue financing government debt accumulation.

Is there a way out?

Governments and central banks no longer have the luxury of unfettered fiscal and monetary stimulus to stabilize growth and offset adverse shocks. At a minimum, governments must avoid unhelpful populist policies (especially poorly targeted fiscal measures), do what they can to overcome supply bottlenecks, and support central banks as they strive to bring inflation under control.

Faced with limited room for maneuver, monetary, fiscal, and other economic policies must act in concert in alleviating short-term inflationary pressures and focusing on measures that can improve long-term growth. Mitigating constraints on labor supply and trade, for instance, in addition to incentives for investments in green technology and various forms of infrastructure, could be helpful. Such measures in turn are essential to underpin both private sector demand and confidence in the short run while helping re-anchor inflation expectations. ENDS