THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

CAN THE WORLD DEFEAT INFLATION WITHOUT AN INTERNATIONAL ACCORD?

INTERIM REPORT

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INTRODUCTION

In February 2023, the Commission held its seventh evidentiary session on the future of global economic governance. In this round, the panel – comprising speakers Dr Ricardo Reis, A.W. Phillips Professor of Economics at the London School of Economics, and Dr Brad W. Setser, Whitney Shepardson senior fellow at the Council on Foreign Relations (CFR), and chaired by Baroness Minouche Shafik, President and Vice Chancellor of the LSE – focused on the timely and pressing issue of managing rising inflation since 2020, resulting from the global economic shocks of the COVID-19 pandemic and Russia's invasion of Ukraine. As nations around the world continue to reel from these effects, key indicators of production and consumption point to a likely global recession in 2023. Further, due to monetary tightening implemented to curb inflation, global output has declined as a result of dampened economic activity. Given the continued centrality of the US dollar (USD) in global commerce, its rapid strengthening, until recently, has added further inflationary pressures by raising the cost of imports for various economies. In light of these events, the panel examined the need for greater coordination in the form of an international accord, to manage the spill overs of monetary policy across national economies. This Interim Report relays the panel's collective thoughts on this pertinent issue.

A RESOUNDING "NO" TO AN INTERNATIONAL ACCORD…

From the outset, there was a strong consensus between both panellists that the primacy of the US dollar greatly diminishes the need for an international accord. Given its widespread use as a currency for commerce and foreign reserves globally, Dr Setser argued that addressing domestic inflation within the US, as the US Federal Reserve (Fed) did in early 2023, would ultimately stabilise the global financial system as a by-product. Further, Dr Reis emphasised that an international accord was not necessary to address inflation at the global level or the national level, given that the key actors in curbing inflation – independent national central banks – have strong inherent incentives and mandates to reduce inflation rates. That said, Dr Reis also added that it is presently challenging for small states to fight the effects of inflation on their own, thus efforts to reduce global inflation hinge upon the leadership of the US Fed and the European Central Bank (ECB). Given their inherent incentives to keep inflation low, an international accord would thus not be required.

NONETHELESS, GREATER COORDINATION IS STILL REQUIRED TO…

Manage global monetary tightening policy

Although both panellists agreed that the US-led global monetary system can operate independently to mitigate rising inflation rates, they nonetheless agreed that there needs to be greater coordination between states as they manage their respective interest rates independently. Dr Reis argued that because national central banks retained the independent capacity to manage interest rates, the rate and process by which inflation is lowered will largely occur in piecemeal fashion. If shifts occur in such an uncoordinated manner, it introduces significant exchange rate and capital flow volatility into the global monetary system which could ultimately lead to economic crashes. Similarly, Dr Setser noted that in response to the US Fed tightening its monetary policy, there was a corresponding tightening of the USD globally. While in theory adopting floating exchange rates would allow countries to manage inflation on their own, this did not in fact occur due to a concurrent supply crunch. Furthermore, given the independence states have in managing their own monetary policy and the additional policy tools available to different states, countries can choose not to follow global trends of monetary tightening. For instance, Japan and China did not go along with current trends in global monetary tightening. The lack of coordinated efforts geared towards monetary tightening ultimately generates greater pressure on exchange rates.

Manage public debt

The panel also raised the need for greater coordination to manage public debt levels globally.

On one hand, Dr Reis emphasised the need to review existing methods of coordination to maintain the commitment of the international community towards achieving a two percent inflation rate globally. Citing public debt management as a key factor, Dr Reis made the case that states are likely to face strong pressures to renege on their commitments. Specifically, officials and policymakers are likely to be pushed to manage public debt in light of expected future rises in interest rates. Thus, central banks are likely to be compelled to keep interest rates low, facilitating debt management at the expense of inflation rate management. This is likely to affect countries asymmetrically, as the level of public debt differs greatly between states. Countries with higher levels of public debt are thus likely to face stronger pressures to renege on interest rate commitments. There is also concern regarding the composition of foreign debt; in the case of Sri Lanka, significant proportions of its public debt are owed to lenders such as China and India, who are untested in their willingness to cooperate in the face of a potential debt crisis. As a result, international organisations that are globally involved in public debt issues – the International Monetary Fund (IMF), the Paris Club (PC), and the World Bank (WB) – are at risk of falling victim to, or becoming perpetrators, of inflation.

On the other hand, Dr Setser highlighted the need for greater coordination in managing the spill over effects on public debt from US Fed efforts to regulate interest rates in response to domestic inflation. Aside from the high cost of borrowing from the US, China, as an alternative lender, denominates its policy lending using the US Dollar; this lending is linked to short-term interest rates, which sharply increases borrowing costs. Nonetheless, the effects of US Fed interest rate adjustments are not felt equally across different countries, with stronger impacts on those with weaker economies. Further, US monetary tightening measures also tend to squeeze marginal borrowers out of the market. As a result, the international community is faced with two significant public debt issues: legacy debts, where borrower countries have lent money in previous cycles

but are unable to service this debt, and a concurrent drying up of funds for developing countries to tap in the current cycle. Dr Setser advocated the need for greater and more urgent international coordination to effectively address these public debt challenges, particularly as existing measures to manage debt reduction have failed while several developing countries have been stymied in their efforts to access funds from international organisations such as the IMF.

Respond to Energy Shocks

Finally, Dr Setser also raised the need for greater coordination regarding the financial effects of recent energy shocks. Although there was initially strong coordination by the G7 to limit sanctions on Russia to sectors other than energy, there was still a significant shock to the energy market. Since then, there has been further cooperation between the US, EU, and Japan to add greater friction to the oil market such that Russia is forced to sell its oil at a discounted rate rather than to its natural markets. As a result of a coordinated response, the parties were able to keep Russian oil supplies flowing while continuing to apply financial pressure through sanctions.

Nonetheless, these efforts at coordinating a coherent sanctions response were juxtaposed against an uncoordinated response in buttressing global energy supplies. While the US generated positive spill over effects by tapping its petroleum reserves, buffering some of the initial pressures arising from sanctions on Russian energy resources, the EU's necessary decision to accelerate the filling of its natural gas reserves created greater pressures on the energy market; this caused a spike in energy prices, with detrimental effects on smaller, developing economies. As such, Dr Setser raised concerns about the current architecture of the global energy market, particularly regarding the dearth of a global oil and natural gas reserve matching the scale of the US petroleum reserve to mitigate potential headwinds in an increasingly volatile geopolitical situation.

RESILIENCE OF THE US-LED FINANCIAL SYSTEM

Although both panellists disagreed on the potential for losses to generate significant costs for investors in US government bonds, they both agreed that the existing US-led financial system is likely to remain robust. Dr Reis flagged a potential challenge to US primacy in the form of government bond debts. Specifically, he highlighted that foreign governments that purchased large amounts of US Government bonds suffered the greatest losses as a result of rising inflation and he expected that this would lead to a reassessment of the risk of purchasing government bonds, as well as a potential shift in attitudes leading to further cracks in the existing US-led financial system. Nonetheless, Dr Setser believed the negative impact on government bond investors is manageable, as they possess more foreign currency that can be used as a buffer against debt. Both panellists agreed that dollar primacy will remain an integral part of the existing financial architecture, thereby reducing the need for an international accord to manage inflation globally. ■

PARTICIPANTS

Brad Setser	Whitney Shepardson Senior Fellow, Council on Foreign Relations
Ricardo Reis	A.W. Phillips Professor of Economics, London School of Economics
Minouche Shafik	President and Vice Chancellor, London School of Economics

LSE Ideas

LSE Global Economic Governance Commission

The LSE Global Economic Governance Commission is a forum for debating and redesigning global economic governance.

COVID-19 has presented the world with a new Bretton Woods moment. It has exposed the fragilities of the global monetary order and the dislocations in the global trading system. With economic damages rising and tax revenues falling, it has presented a new crisis for global development and demonstrated the overdue need for global tax coordination. As states have struggled to band together to overcome their shared challenges, it has made clear the difficult road ahead for the global climate agenda.

To steer the much-needed transformation of the rules, practices, and institutions of the global economy, The London School of Economics and Political Science and LSE IDEAS have convened the LSE Global Economic Governance Commission. The Commission brings together leading academics and policymakers around five core domains of global economic governance: monetary policy, trade policy, development policy, tax policy, and climate policy. The Commission hosts public and closed-door panels, lectures, and workshops on all matters relating to global economic governance. Event details are announced online by LSE and LSE IDEAS.