REFLECTIONS ON THE STATE OF THE GLOBAL ORDER

Central Objectives, the Era of Financial Crisis, and the New Order

Readers who have been following our past issues will remember that we are now in the midst of a multi-faceted crisis in the new world order. Consequently, there is hardly a day that goes by without new additions to the chaotic agenda of the global economy, accompanied by fresh challenges. Looking at the recent issues of the day, we can categorize them under three main headings: central banks aiming for a 2% inflation target, attempts to end the hegemony of the U.S. dollar with special reserve currencies, and the global financial system teetering on the edge of a crisis due to failing banks. In this study, we will examine the current state of these three issues, propose solutions to address them, and strive to increase awareness by considering possible positive and negative scenarios.

First, it is necessary to provide a brief overview of the specific topics we will be addressing. To understand the course of the global economy, as we have done periodically, it is beneficial to analyze the monetary policies of influential central banks. Both the U.S. Federal Reserve and the European Central Bank appear resolute in returning inflation to the 2% target. However, while 2% inflation may seem like a safe zone, it is crucial to examine where this will ultimately lead the global economy in the medium term.

Furthermore, the pandemic policies of the United States and a broader response to Russia's war in Ukraine have triggered widespread speculations about the future of the U.S. dollar's global hegemony. Yet should we assume, especially when it comes to reserve currencies, that a more divided world will automatically give way to a more multipolar world? In the subsequent sections of our research, we will delve into this issue. Lastly, the second-largest bank bankruptcy in the history of the United States has raised questions about the stability of all financial systems. While there are clear differences between the current situation and the onset of the global financial crisis 15 years ago, there are also disconcerting similarities. It is by addressing these very similarities that we will issue a cautionary alert.

HOW ACCURATE ARE CENTRAL BANKS' INFLATION TARGETS?

To illustrate the current state of central banks, it's worth recalling a famous quip about democracy made by the former British Prime Minister Winston Churchill. When discussing democracy, Churchill remarked, 'Democracy is the worst form of government, except for all those other forms that have been tried.' The same logic can be applied to the inflation targets of advanced economy central banks. When compared to anything higher or lower (with a non-trivial difference), a 2% inflation target is likely to be the better choice. However, there are some parameters to consider here.

A comprehensive evaluation of the appropriate target raises a few questions. First, how accurate are inflation measurements? Despite significant improvements in measuring inflation, there remains an upward bias, primarily due to incomplete and lagging quality adjustments and adjustments for new products. In other words, when inflation measurements show 2%, the actual inflation is roughly around 1% or less. When they indicate 4%, the actual inflation is around 3%. Hence, raising the measured inflation target from 2% to 4% effectively triples the real inflation target.

Second, we should ask what the optimal inflation rate is. Analyzing this question, leading figures in economics, including Knut Wicksell, Milton Friedman, Robert Mundell, James Tobin, and Edmund S. Phelps, have found different measures of the 'inflation tax' and arrived at different conclusions regarding the optimal relationship with the budget deficit. The concepts of policy and monetary policy emerged as they examined this relationship. At various points in his career, Friedman defended both deflation and inflation based on these concepts.

WE REMEMBER COMPROMISES?

Certainly, the historical narrative related to inflation cannot be confined solely to policies or monetary policies. New models proposed in the fight against inflation also meant an increase in compromises. In particular, the substitutability of bonds and money raised fundamental questions related to conditions (such as whether there is an upper limit to the private sector's willingness to hold bonds) and the relative cost of others. Distorted taxes brought along potential costs of a higher inflation target for the real economy, such as greater variability in relative prices or increasing costs through untaxed and increasing taxation distortion over time.

When examining central banks' inflation targets, it is also prudent to engrave the following question in our minds: Is a stable inflation rate, within at least a modest range, preferred over a significantly varying inflation rate? If so, it's worth asking whether central banks can realistically maintain a relatively stable higher inflation rate. Additionally, it's essential to inquire whether a higher target is compatible with a monetary policy approach based on rules that are under the dual mandate, including maximum employment, as monitored by the Fed. To what extent does this compromise on price stability, and can any spillage be controlled? After abandoning the 2% target, could it be readopted, or would monetary authorities lose too much credibility?

Finally, it is worthwhile to consider whether a higher target will deter elected officials from adhering to fiscal discipline or not, especially when they are already insufficient in this regard. It's worth remembering that when inflation rose to 4%, President Richard Nixon applied wage and price controls to the American economy. All things considered, sticking with 2% appears to be by far the best option.