

[How do central banks control inflation? A guide for the perplexed](#)

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How do central banks keep inflation on target? How do they prevent episodes of hyperinflation and their tragic consequences for welfare? Can a central bank control inflation if the economy goes through secular stagnation, a liquidity trap, or a fiscal crisis? Why was inflation so high in 2021-24 and will it persist? These are crucial questions that have answers in current economic theory.

The goal of this article is to provide a unified treatment of the theory of how central banks control inflation. The hope is that researchers will have an accessible entry point to this literature, so they can make sense of monetary policies and inflation outcomes. Our approach has three distinctive features.

The first is that we highlight the common features of different viewpoints by using a single model of prices. We present alternative theories not as opposing views, but rather as actively relying on some economic mechanisms while passively allowing other economic mechanisms to accommodate.

The second feature is that we put the central bank at the center of all of them. It is the central bank whose liabilities define the price level and that has a mandate to target a value for inflation. The central bank's policies are always the key determinant of inflation, whether they can be described as monetary, fiscal or, more accurately, as a mix of both.

The third feature is that we provide one interpretation of the history of inflation as a result of different strategies followed at different times. Our goal is not to defend it as either the only or the right explanation for inflation's movements, but rather to let the reader see the different theoretical concepts at work and their relative strengths.

We conclude that by setting the interest rate on banks' deposits at the central bank (reserves) in an aggressive and transparent way, while having a monetary pillar to anchor expectations, and fiscal support to prevent runs on its liabilities, the central bank can effectively control inflation. We discuss the circumstances when this is not possible, and how central banks can regain control of inflation by picking from a menu of unconventional policies.