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Surging inflation and lessons for central bankers

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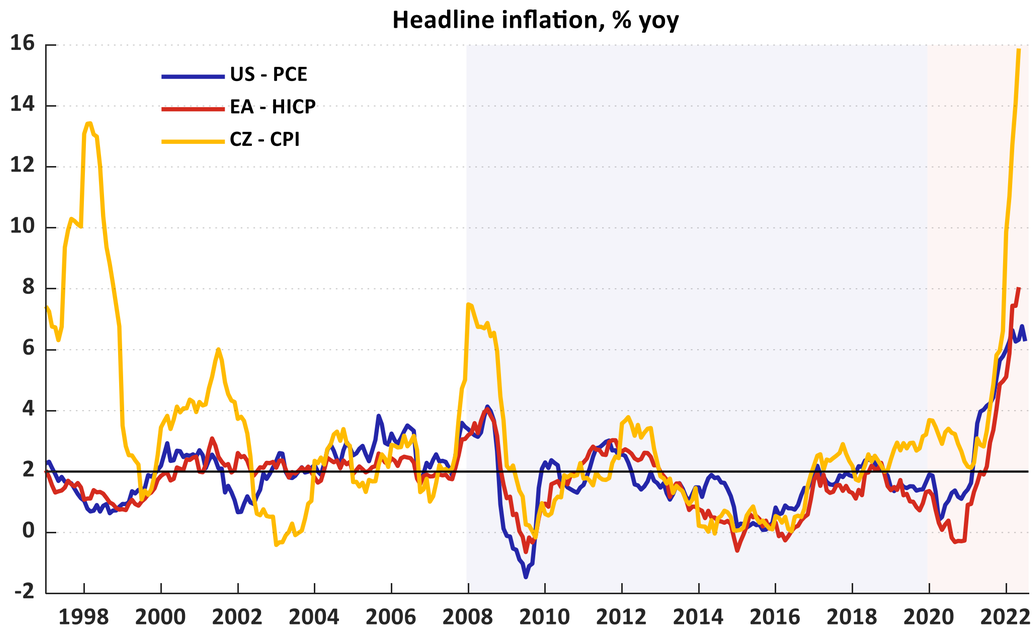
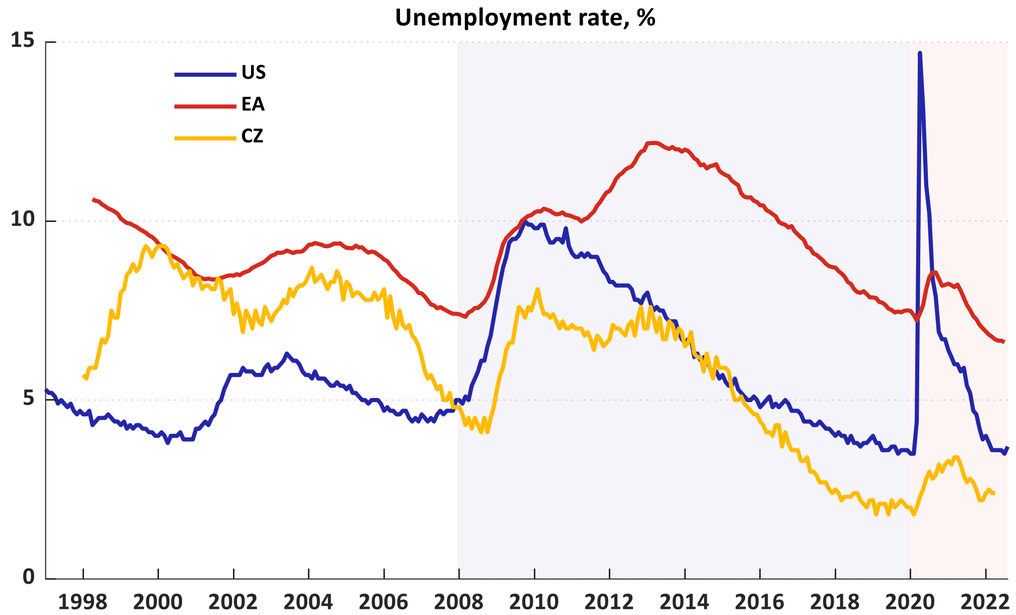
Motivation





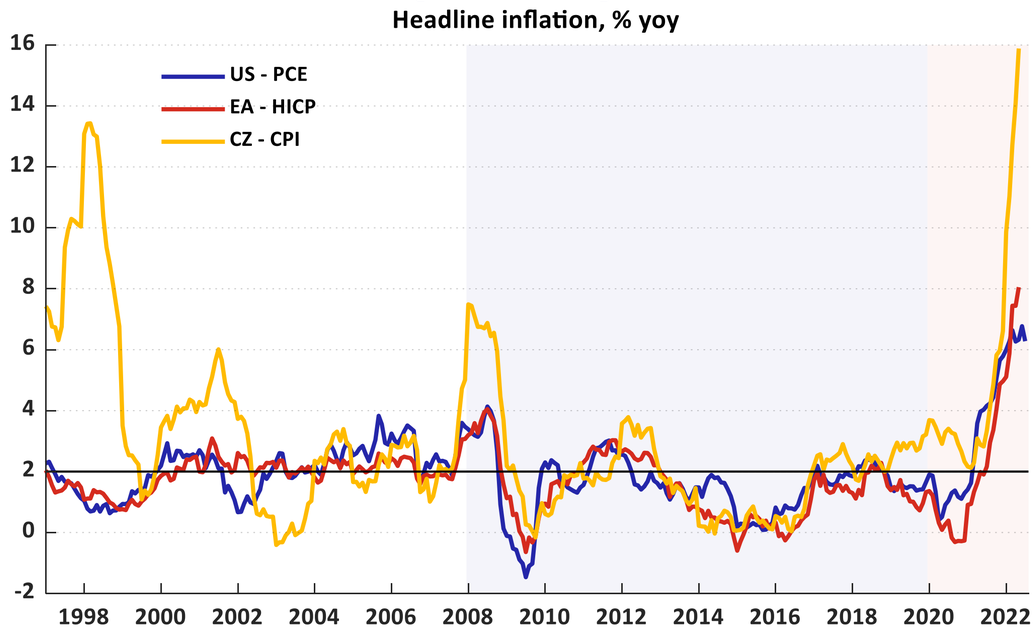
Source: Central banks and Statistical Offices

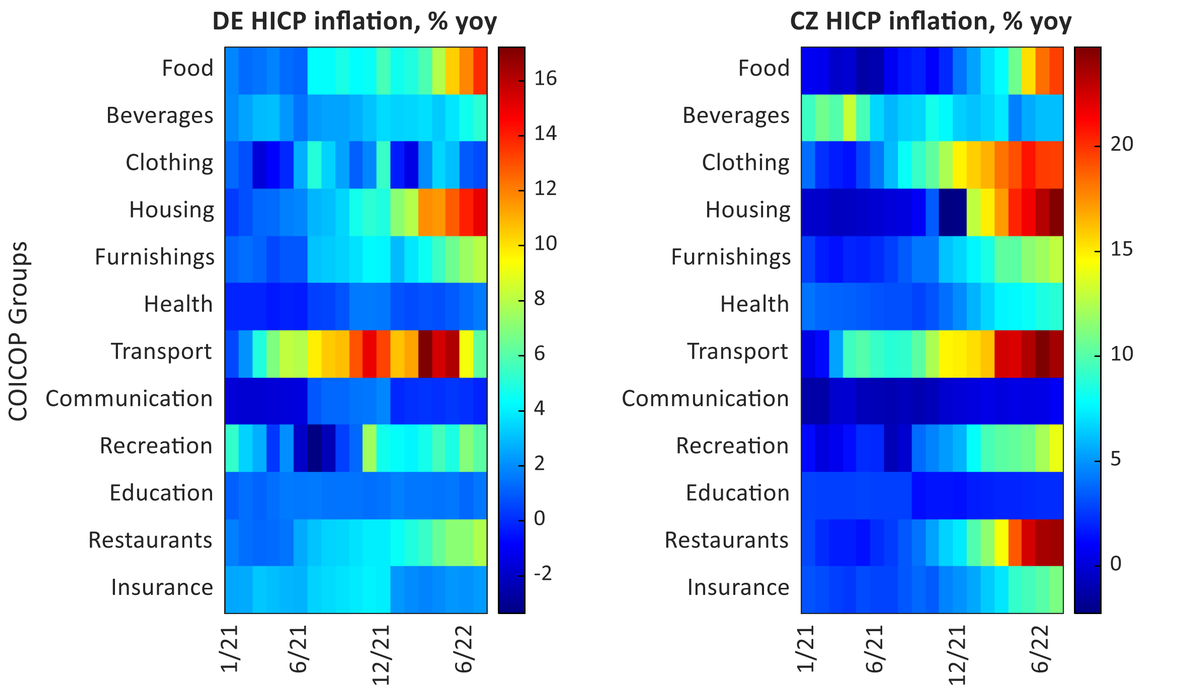
In the wake of the GFC **inflation remained subdued** despite **real recovery** and **unemployment rates** declining to historically lowest levels.

AC's central banks resorted to **unconventional measures** after reaching the effective lower bound of policy interest rates.

"Keep it hot" strategy did not bring inflation => studies on **flattening of Phillips curves,** risks of **deflation,** and fear of **re-introduction of unconventional measures.**

Motivation (cont.)





Source: Central banks and Statistical Offices

After the covid shock **real growth** and **unemployment rates** have returned to pre-covid heights but **inflation has risen** to levels not seen for decades.

Inflation has been driven by **supply** (supply disruptions and bottlenecks) and **demand factors** (strong recovery of demand after lockdowns and shifts of demand from services to goods) along with a **commodity price** increase due to rising global uncertainty.

Inflation surge is widespread across countries as well as across HICP subcomponents.

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Questions

What is behind the change of inflation dynamics and the recent inflation surge beside commonly articulated factors?

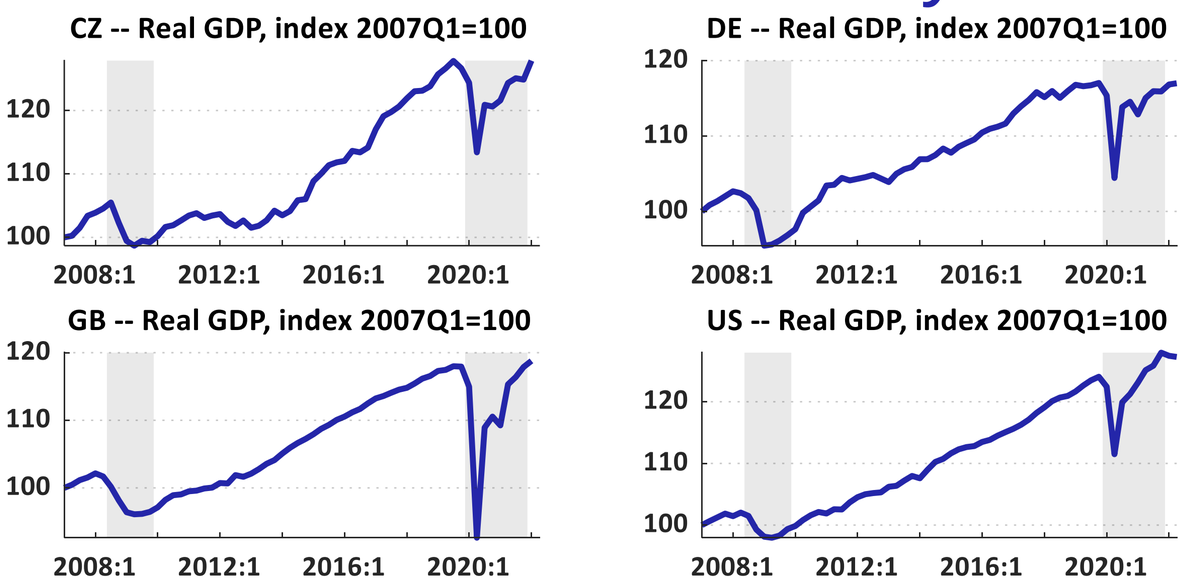
i) **Too much stimulus** – monetary and fiscal policy synergy

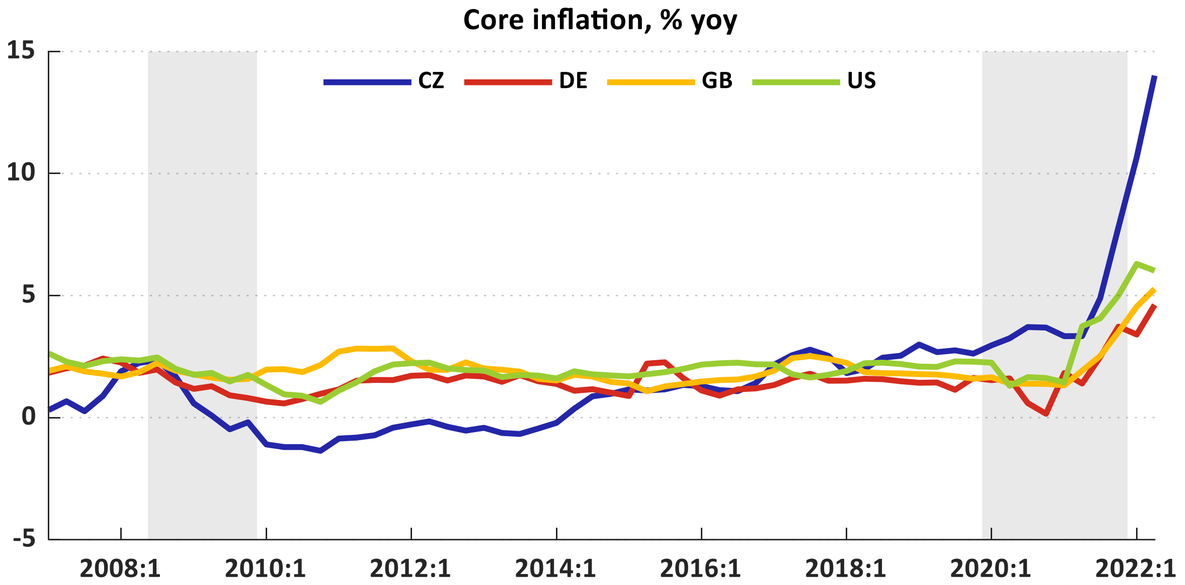
ii) **False belief in PCs flattening**

iii) **Loss of central bank focus on price stability**

What lessons can be drawn for central bankers?

Too much stimulus – stylized facts





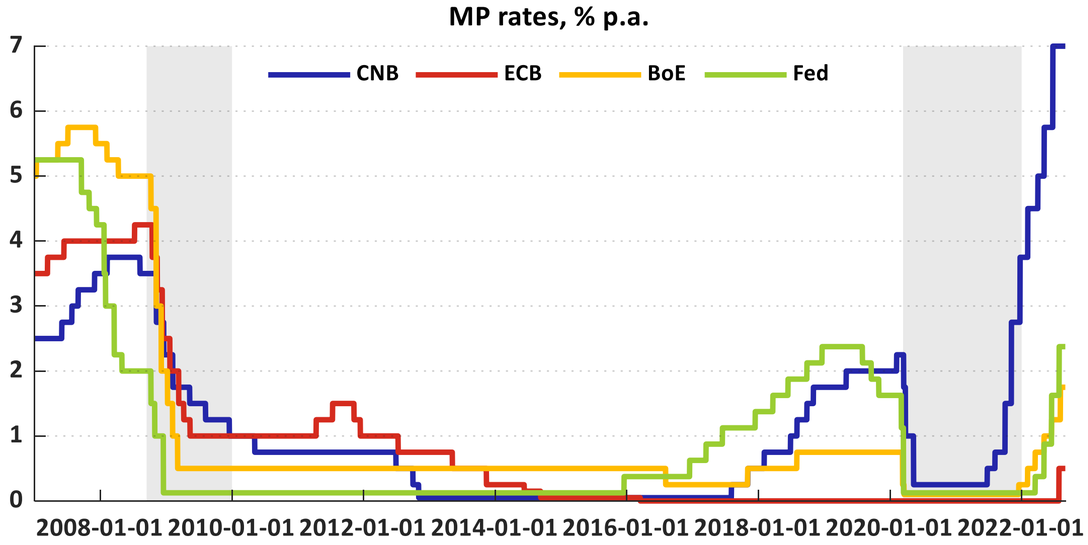
Source: Central banks and Statistical Offices

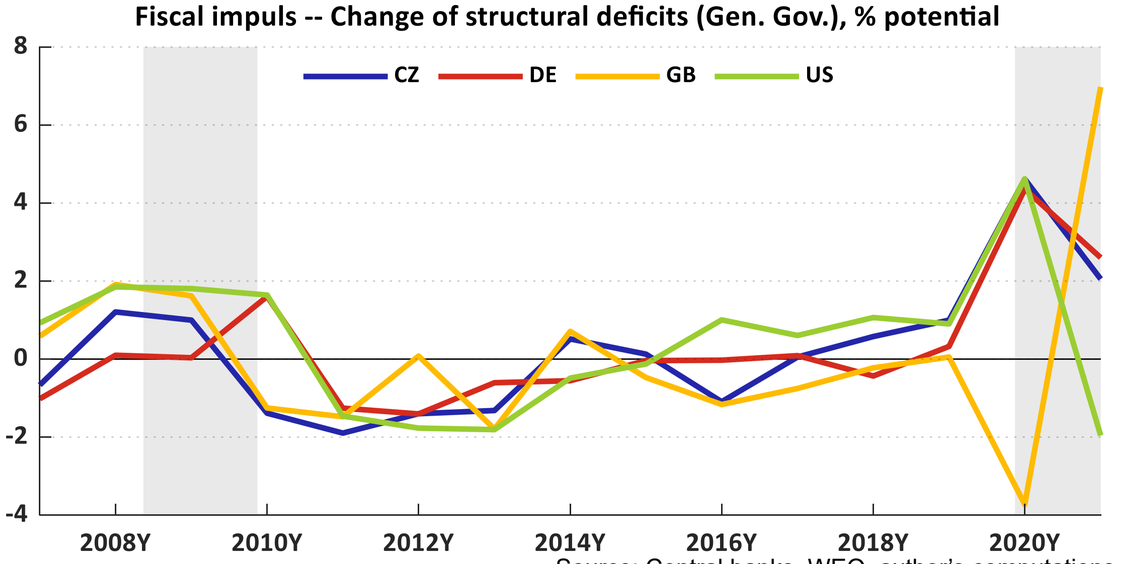
The GFC led to an **L-shaped recession**, while the covid shock was characterized by a **V-shaped recession** with a rapid return of real GDP to the pre-pandemic levels.

Real economic activity shaped dynamics of core inflation on top of other factors – **inflation fell** in response to **the GFC** but **has risen** after **the covid shock.**

The different dynamics of GDP and inflation reflect also a **quick and simultaneous easing of monetary and fiscal policy** (too much of a good thing).

Too much stimulus – policy synergy





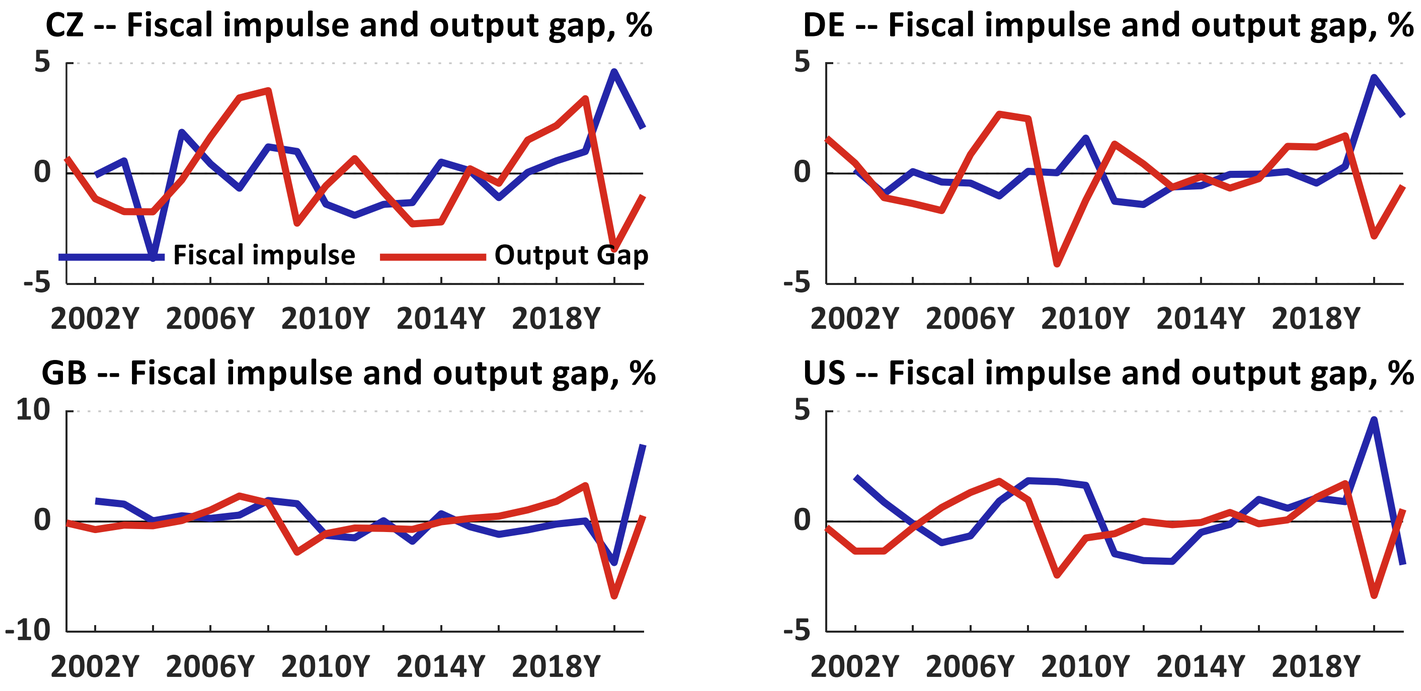
Source: Central banks, WEO, author's computations

Monetary policy – almost immediate return to zero rate levels in response to covid

Fiscal policy – more prompt and stronger fiscal response compared to GFC

The Covid shock shows that both policies have learned lessons from the GFC and demonstrates the **power of synergy between monetary and fiscal policies.**

Too much stimulus – lessons



Source: Central banks, WEO, author's computations
Note: Fiscal impulse approximate by changes in structural deficits. Output gaps estimated using HP filter.

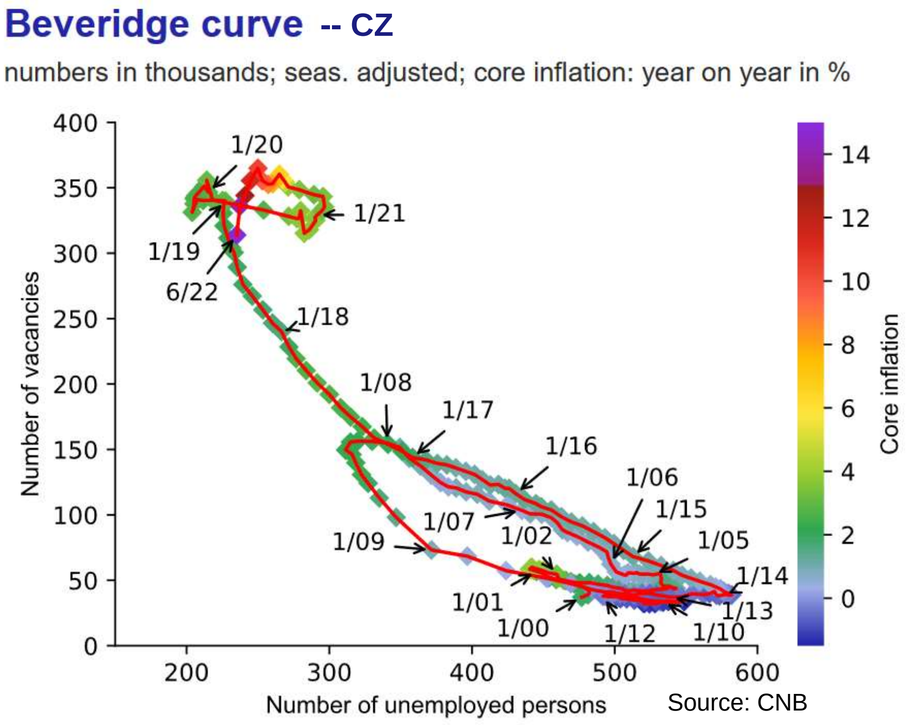
Strong synergy of monetary and fiscal coordination

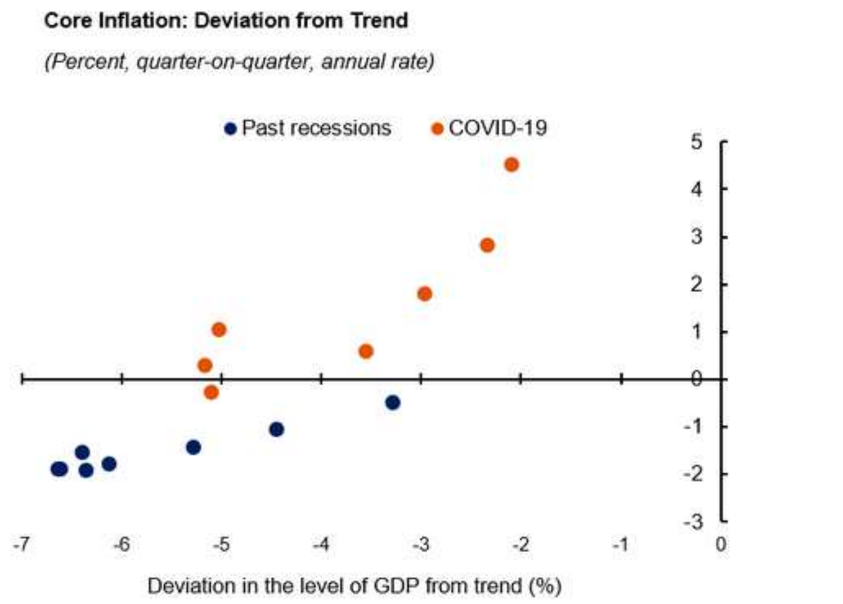
Significant negative shocks to real economic activity lead to the alignment of monetary and fiscal policy and the use of synergies – **"natural" coordination**

Coherence of policies during a standard business cycle and in periods of policy normalization as shocks subside – **is fiscal policy always countercyclical?**

The primary goal of **monetary policy** should be **ensuring price stability**

False belief in PCs flattening



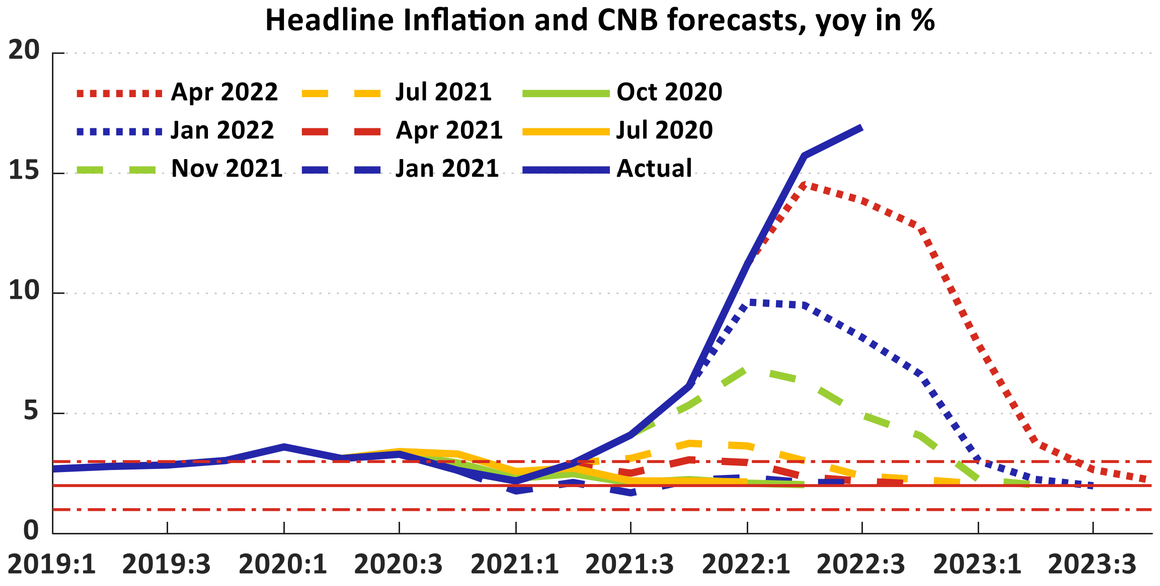


Sources: Gudmundsson and others (forthcoming), Haver Analytics, IMF staff estimates.
Note: Average response of core inflation and level of GDP to past recessions between 1990 and 2022Q1 estimated using local projections on a panel of 30 advanced economies. The chart shows the average estimated responses in the first seven quarters after the start of past recessions. For COVID-19, it shows the estimated responses from 2020Q3 to 2022Q1.

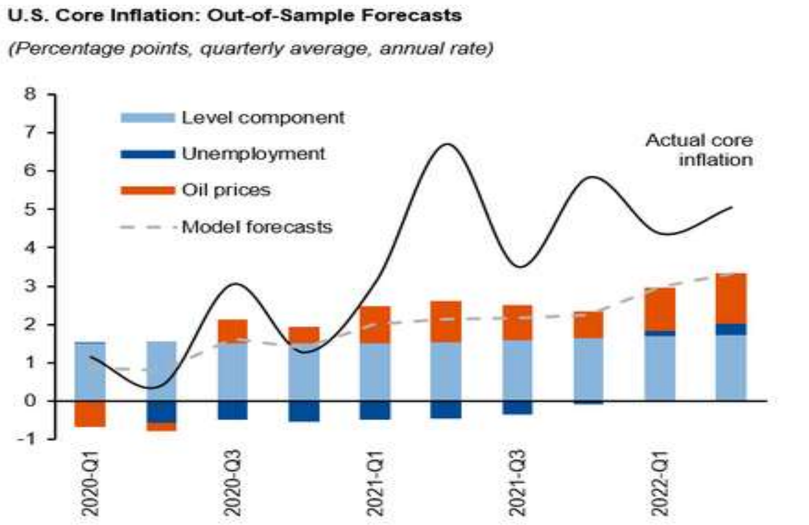
Inflation surge has been **surprising** given the past experience – the same north-west position of the labour market **Beveridge curve** but with high inflation nowadays.

False belief that Phillips curves are extremely flat based on experience after the GFC and supported by some empirical findings – **flat PCs do not explain recent inflation surge**.

False belief in PCs flattening (cont.)



Source: CNB



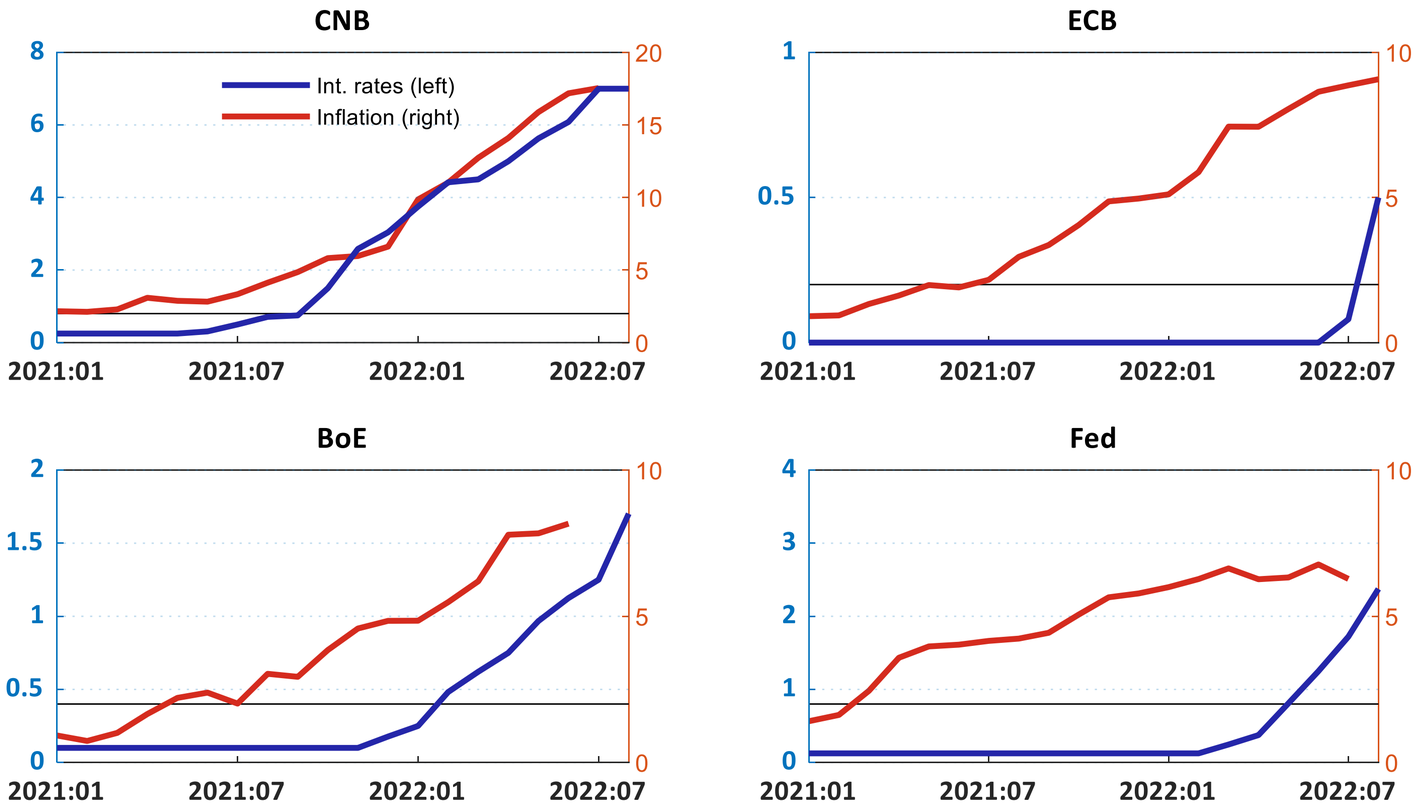
Source: IMF staff estimates based on model of Hooper, Mishkin, and Sufi (2020).
Note: Forecast based on 1960-2019 estimates. The 'Level component' includes the effects of lagged inflation, long-run expectations, and deterministic model components on the forecast.

Flat PCs led to **lower inflation forecasts** compared to the actual data with implications for monetary policy actions.

Too low inflation forecasts can be explained only partly by bias in external assumptions and by rising expectations, ex-post evaluation suggests that **nonlinearities** might have been omitted along with the **false assumption about PCs flattening.**

BIS Annual Report 2022 – "… *in high inflation environments, price changes tend to exert a bigger and more persistent effect on overall inflation than they do when inflation is low* …"

Loss of central bank focus on price stability



Source: Central banks and Statistical offices

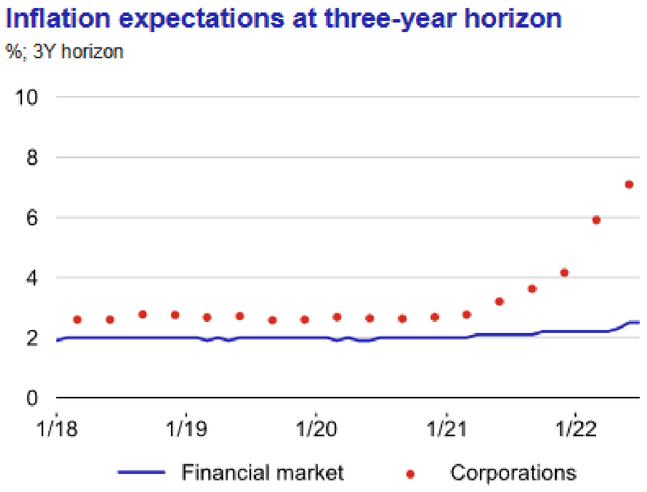
Initially, **supply shocks were** considered as **short lived**, raising inflation only temporarily.

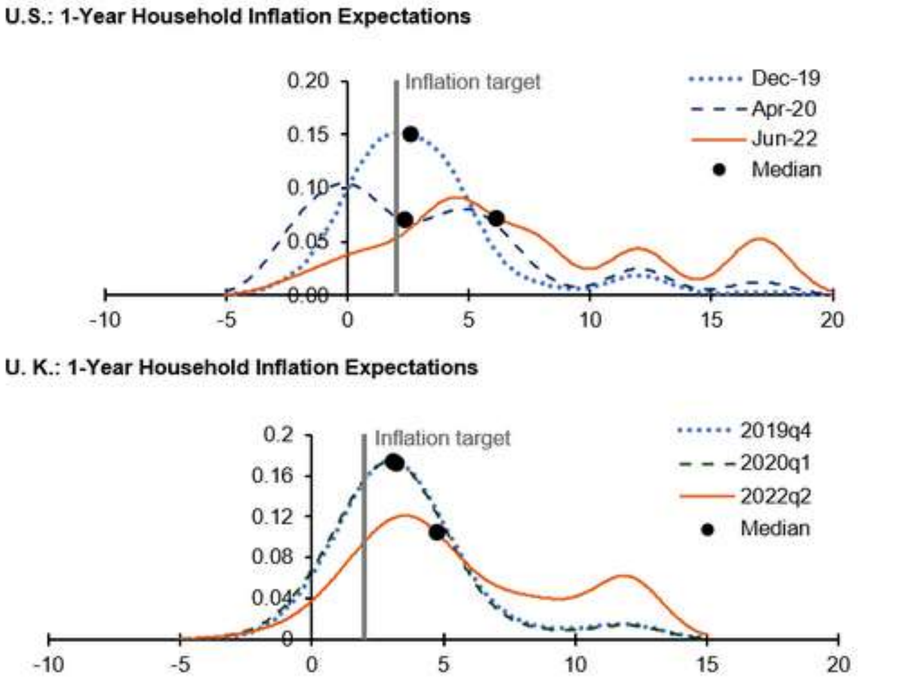
"Running the economy hot", "looking through" shocks, or arguing that shocks are **"out of MP scope"** was considered as **desirable and benign** with respect to inflation based on the past experience.

No more "**what ever it takes**" statements as in 1990s during the Great Moderation.

Using ex-post view, **central banks fell behind the curve**, allowing a further decline of real interest rates.

Loss of central bank focus on price stability (cont.)





Source: Gelos and others (forthcoming).
Note: The charts fit kernel densities to households' inflation forecasts, using methodology similar to Reis (2021).

Most central banks in ACs admit that **inflation will be back** – or at least close to – their targets not next year, but in 2024.

Prolonging policy **horizon** at which inflation will be back to the target might **undermine the credibility** of central banks, raising risks of inflation expectations de-anchoring and consequently costly disinflation.

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Lessons for central bankers

Although the covid shock and the war are sort of tail events, they have **tested our monetary policy frameworks**.

The strategy of **“running the economy hot” should be revisited** based on the current experience of large and long lasting deviations from targets as **costs might be higher than benefits**.

Disinflation is costly and costs are rising with de-anchoring of inflation expectations.

Back to basics and past experience – successful disinflation during the great moderation period

High uncertainty about future developments calls for **prudential approach** to monetary policy (but prudential does not always mean less decisive actions; sometimes it is quite on the contrary).

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Thank you for your attention

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