Three Uncomfortable Truths

For Monetary Policy

Remarks by Gita Gopinath

International Monetary Fund

Prepared for the ECB Forum on Central Banking

June 26, 2023

I. Introduction

Good evening and thank you President Lagarde for that kind introduction. And thanks to the European Central Bank for inviting me to participate in this year's forum, coming at a critical time for central banking.

The battle against inflation is very much ongoing, both in the euro area and around much of the world. Headline inflation has declined, but the stickier components remain persistently high. Central banks must continue to fight high inflation *now*, while also determining if—and how—monetary policy strategy may need to change in the *future*.

This is, of course, no easy task. This evening, I will focus on how to contend with high inflation by confronting what I will call *three uncomfortable truths for monetary policy*.

- The first uncomfortable truth is that **inflation is taking too long to get back to target.** This means that central banks, including the ECB, must remain committed to fighting inflation despite risks of weaker economic growth.
- The second uncomfortable truth is that **financial stresses could generate tensions between central banks' price and financial stability objectives**. Achieving "separation" through additional tools is possible, but not a fait accompli.
- The third uncomfortable truth is that going forward, **central banks are likely to experience more upside inflation risks than before the pandemic.** Monetary policy strategies and the use of tools like forward guidance and quantitative easing must accordingly be refined.

Let's begin by exploring the first uncomfortable truth: inflation is taking too long to get back to target.

II. Uncomfortable Truth #1: Inflation is taking too long to get back to target.

Inflation forecasters have been optimistic that inflation will revert quickly to target ever since it spiked two years ago. As you can see, (slide 4) this includes the ECB and the IMF, whose forecasts are nearly indistinguishable. What we see in these charts is that inflation sits well above previous forecasts. This reminds me of Samuel Beckett's famous play, *Waiting for Godot*. In the play, both the cast and audience await a mysterious character named Godot who never appears. Similarly, we are still waiting for low inflation to reappear. We hope, of course, that real life will have a different ending than the play. But as of now, the audience is still waiting.

Despite repeated forecast errors, markets remain particularly optimistic that inflation in the euro area and most advanced economies will recede to near-target levels relatively

quickly (slide 5, left panel). These disinflation hopes—likely fueled by the sharp drop in energy prices—underpin expectations that policy rates will decline soon, despite central bank guidance to the contrary (right panel). Surveys of market analysts paint a similar picture and suggest that inflation is likely to come down without much of a hit to growth. It is useful to bear in mind that there is not much historical precedent for such an outcome.

Setting aside forecasts, the fact is that inflation is too high and remains broad-based in the euro area, as in many other countries (slide 6). While headline inflation has eased significantly, inflation in services has stayed high, and the date by when it is expected to return to target could slip further.

II.A Why inflation has proved persistent

While ongoing research will shed light on why inflation has proved so sticky, several factors are probably at play, and continue to pose upside inflation risks.

First, while the ECB has raised interest rates during the past year by 400 basis points—the most in its history—activity has only slowed modestly. The unemployment rate is at historic lows. Wage growth has been solid and is picking up, though not by enough to begin reversing sharp declines in real wages over the past two years.

The combination of tight labor markets with a still solid stock of household savings and residual pent-up demand may be behind the resilience in activity we have seen so far.

Second, despite the large increase in the nominal policy rate, financial conditions may not be tight enough which impedes monetary policy transmission (slide 8). As seen in the right chart, real rates using market-based measures of inflation expectations are still quite low, and near-term real rates using household measures are likely negative.

Lastly, the pandemic has likely lowered potential output and productivity, which would also help explain some of the upward pressure on inflation.

What is worrisome is that sustained high inflation could change inflation dynamics and make the task of bringing inflation down more difficult. Given the massive decline in real wages since the pandemic, some wage catchup is to be expected. All else equal, if inflation is to fall quickly, firms must allow their profit margins—which have shot up during the past two years—to decline and absorb some of the expected rise in labor costs. But firms may resist this, especially if the economy remains resilient, while workers may demand payback for their real wage losses. Such dynamics would slow inflation reduction and likely feed into expectations and increase susceptibility to further upside cost or resource pressures.

II.B. Fiscal policy can help, but…

Some side effects of fighting inflation with monetary policy could be reduced by giving fiscal policy a bigger role. Indeed, economic conditions call for fiscal tightening. It could help cool demand and reduce the need for rising interest rates, especially if done in concert by a broad group of countries.

At a minimum, it is critical for euro area governments to resist any temptation to dilute the deficit reduction projected under current policies. Where support is needed, they must shift from providing broad-based to well-targeted support, and revenue windfalls from high inflation should be saved.

II.C. Appropriate policy strategy

Ultimately, it is up to central banks to deliver price stability irrespective of fiscal stance. With underlying inflation high and upside inflation risks substantial, risk management considerations in the euro area suggest that monetary policy should continue to tighten and then remain in restrictive territory until core inflation is on a clear downward path. The ECB—and other central banks in a similar situation—should be prepared to react forcefully to further upside inflation pressures, or to evidence that inflation is more persistent, even if it means much more labor market cooling. The costs of fighting inflation will be significantly larger if a protracted period of high inflation boosts inflation expectations and changes inflation dynamics.

There are also some downside risks to inflation that could arise, for instance, from the recent unwinding of supply chain disruptions and fall in energy prices. The effect of the recent tightening in monetary policy is still working through the system. While central banks must be vigilant about not easing prematurely, they should be prepared to adjust course if a chorus of indicators suggest that these downside inflation risks are materializing.

III. Uncomfortable Truth #2: Financial stresses could generate tensions between central banks' price and financial stability objectives.

If inflation persists and central banks need to tighten much more than markets expect, today's modestly tight financial conditions could give way to a rapid repricing of assets and a sharp rise in credit spreads. We've seen during the past year how, under some circumstances, policy tightening can come with significant financial stresses, including in Korea, the UK, and more recently in the US.

For the euro area, tighter monetary policy may also have diverse regional effects, with spreads rising more in some high-debt economies. Higher rates can also amplify other vulnerabilities arising from household indebtedness and a large share of variable rate mortgages in some countries.

This brings me to the second uncomfortable truth:, Financial stresses could generate tensions between central banks' price and financial stability objectives. This is because, while central banks can extend broad-based liquidity support to solvent banks, they are not equipped to deal with the problems of insolvent borrowers. Let me explain.

III.A. Policy response to modest financial stress

If financial stresses remain modest, central banks shouldn't face too much of a challenge in achieving both price and financial stability objectives. If households and firms face a rise in borrowing costs, central banks can lower policy rates to keep output and inflation on roughly the same path. Other relatively standard central bank tools—such as discount window lending and other forms of liquidity support—can also help.

Of course, lowering policy rates—even if to keep broad financial conditions unchanged—may be misinterpreted as waning resolve to fight inflation, so effective communication is important.

III.B. When stress threatens to morph into systemic crisis

The situation becomes much more difficult if financial stresses threaten to morph into a systemic crisis. Critically, forestalling a crisis may go beyond what central banks can do alone. While they can extend broad-based liquidity support to solvent banks, they cannot support insolvent banks, firms, or households. These must be addressed by governments and may require sizeable fiscal resources. And central banks may be considerably limited in alleviating nonbank stresses given difficulties in assessing solvency and the political economy risks of picking winners and losers.

Forceful and timely interventions that are backed with the requisite fiscal support could allow monetary policy to focus on price stability, as was the case during the recent stress episodes. This separation is clearly the most desirable outcome. But when governments lack fiscal space or political support to respond to the problem, central banks may need to adjust their monetary policy reaction function to account for financial stress. While central banks must never lose sight of their commitment to price stability, they could tolerate a somewhat slower return to the inflation target to avert systemic stress. Even so, the bar

should be high to doing so. Such a shift in the reaction function could leave the central bank behind the curve in fighting inflation – as, for instance, happened when the Federal Reserve decided to ease policy in the mid-1960s on fears of a credit crunch, even as inflation pressures were building.

Put simply, while separation is achievable in principle, it is challenging in practice, and must not be taken for granted.

III.C. Steps to strengthen the EU framework

The ECB has taken forceful steps to help achieve both price and financial stability goals. This includes the Transmission Protection Instrument, which helps guard against the risk of a sharp divergence in borrowing costs across countries and should reduce the risk of an adverse feedback loop developing between sovereigns and banks.

So, what other steps can the ECB and European Union (EU) take (slide 14)? These would build upon several measures these institutions have already taken to deepen financial resilience. The EU, for example, applies Basel III capital and liquidity requirements to all banks, not just the largest ones, and the capital and liquidity ratios of the banking system as a whole are solid.

In the near-term, continuing enhanced risk assessments and bank stress-testing (as envisaged in the ongoing EBA-ECB bank stress tests) will help ensure EU banks remain resilient to rate hikes and rapid deposit outflows.

In addition, ensuring prudent public debt paths to safeguard fiscal sustainability—including by finalizing the reform of the EU economic and fiscal governance framework—is essential and critically needed. So is strengthening pan-European institutions such as the European Stability Mechanism that can provide rapid financial support to sovereigns and to the Single Resolution Fund. As part of its journey toward completing a Banking Union, the EU should make meaningful progress toward a European deposit insurance scheme to increase risk sharing across borders. Making the EU crisis management and bank resolution framework more flexible, possibly by including a systemic risk exception, would also help raise resilience. Moreover, further progress with capital markets union will help deepen capital markets and reduce fragmentation risk within the EU.

On the macroprudential policy side, it would be helpful to strengthen capital buffers even further. Banks should save some of their current high profits as capital. The macroprudential toolkit should be expanded for nonbank financial intermediaries (IMF 2023c).

IV. Uncomfortable Truth #3: Central banks are likely to experience more upside inflation risks than before the pandemic.

This brings me to the third uncomfortable truth: **central banks are likely to experience more upside inflation risks than before the pandemic**. Monetary policy strategies and the use of tools like forward guidance and quantitative easing must accordingly be refined.

The monetary policy strategies implemented in the post-GFC period by the ECB and other major central banks focused heavily on supporting activity and boosting too-low inflation when the effective lower bound (ELB) seemed a pervasive constraint. There was little sense that inflation could rise persistently above target given the perceived flatness of the Phillips Curve, or that central banks would face significant tradeoffs in addressing supply shocks. Risk management considerations tilted heavily toward downside risks to activity and inflation.

IV.A. More upside inflation risk

Looking forward, central banks are likely to experience more upside inflation risks than before the pandemic for two sets of reasons (slide 16). Some of the upside risk reflects structural changes affecting aggregate supply—heightened by the pandemic and the war in Ukraine—and that may result in larger and more persistent shocks. In addition, we have also learned the lesson that the Phillips Curve is not reliably flat.

Turning first to structural changes, there is a substantial risk that the more volatile supply shocks of the pandemic era will persist. Despite a considerable easing of pandemic-related supply pressures, the restructuring of global supply chains that was intensified by the pandemic and war, coupled with geo-economic fragmentation, may cause ongoing disruptions to global supply. Many countries are turning to inward-looking policies, which raise production costs, and, ironically, make countries less resilient and more susceptible to supply-side shocks (WEO, April 2022). As seen in the left chart, the number of new restrictions on trade and foreign direct investment (FDI) imposed on EU countries ratcheted up markedly during the pandemic. EU countries have also increased their own restrictions on in-bound trade and FDI.

The increasing physical and transition risks from climate change are also likely to amplify short-term fluctuations in inflation and output. Delays in achieving Paris Agreement goals increase the risk of a disorderly transition and serious disruptions to energy supply, which could boost inflation sharply and create more difficult tradeoffs for central banks.

The pandemic has also taught us more about the Phillips Curve (slide 17). Evidence increasingly shows that nonlinearities may become pronounced at high levels of resource utilization, so that inflation is more sensitive to resource pressures. Difficulties in measuring economic slack may also make it harder for policymakers to gauge the point at which inflationary pressures will escalate.

IV.B. Implications for policy strategy

These takeaways suggest that when it comes to policy strategy, it will be important to be more cautious about "looking through" supply shocks (slide 18). Central banks may need to react more aggressively if the supply shocks are broad-based and affect key sectors of the economy, or if inflation has already been running above target, so that expectations are more likely to be dislodged. They may also need to react more aggressively in a strong economy in which producers can pass on cost hikes more easily and workers are less willing to accept real wage declines. And they should be confident that the shocks are mainly supply-driven, rather than fueled by strong demand.

While the focus now is on high inflation, what we've learned about the Phillips Curve also has important implications for the monetary policy response to future periods of below-target inflation. Some refinement may be needed to the "lower-for-longer" strategies—used widely after the Global Financial crisis—that typically involved maintaining policy rates at the effective lower bound until inflation reaches or overshoots its target. Lower-for-longer strategies may still be desirable under some conditions, particularly for an economy in deep recession and facing chronically low inflation.

But the pandemic experience suggests that policymakers should be more cautious about calibrating policy to generate a persistent fall of unemployment below the natural rate U* when inflation is running only modestly below target—say between 1.5 percent and 2 percent. And there could well be a case for preemptive tightening under these conditions if resource pressures appear tight and there is a material risk that new shocks—such as fiscal expansion—could push the economy to overheat. By allowing for a more gradual pace of tightening, a preemptive approach would also reduce the financial stability risks likely to accompany a rapid exit from low rates (the second uncomfortable truth).

IV.C. Refining the use of tools

Refining monetary policy strategies also calls for adjusting the use of tools (slide 19). Forward guidance is a helpful tool, and conditional promises can enhance its impact. But

such promises should be tempered by escape clauses if developments unfold much differently than expected. The forward guidance provided by central banks during the pandemic may have been too much of a straitjacket and prevented a faster reaction to inflation surprises.

The costs and benefits of quantitative easing (QE) should also be reconsidered. QE will likely remain a critical tool should central banks face circumstances like the post-GFC period in which unemployment runs high and inflation low even though policy rates have hit their floor. But there should be more wariness of using QE—and accompanying it with forward guidance promising low policy rates—when employment has largely recovered, and inflation remains only modestly below target. Maintaining QE in such circumstances increases the risk that the economy will overheat and that policy will be forced into a sharp U-turn.

So, when we consider the monetary policy of tomorrow, it is important to recall today's lessons: First, take a closer look at supply shocks before deciding to simply "look through" them. Second, be careful about running the economy hot, and be ready to act preemptively if it does—even if inflation isn't yet burning brightly. Third, make sure that forward guidance is coupled with escape clauses; and fourth, be more cautious about deploying QE outside of a recession.

V. Conclusion

To conclude, now is the time to face the three uncomfortable truths that I've outlined. Inflation remains sticky; financial stresses could make price and financial stability a difficult balancing act; and more upside inflation risks will likely come our way. I am heartened by the actions that the ECB—and many other central banks—have taken to tackle inflation. But the battle won't be easy—financial stresses may intensify, and growth may have to slow more. Even so, we know that we can't have sustained economic growth without a return to price stability. The good news is that while low inflation may seem elusive, it is certainly no stranger, and central bank actions can deliver it. Unlike the characters in *Godot*, we are not waiting for a potential stranger to arrive; we are inviting an old friend to return.

References

Adrian, Tobias, and Vitor Gaspar. 2022. “How Fiscal Constraint Can Help Fight Inflation.” IMF Blog, International Monetary Fund, Washington D.C..

Adrian, Tobias, Gita Gopinath, and Pierre-Olivier Gourinchas. 2023. “Central Banks Can Fend Off Financial Turmoil and Still Fight Inflation”. IMF Blog, International Monetary Fund, Washington D.C.

Ball, Lawrence. 1994. “What Determines the Sacrifice Ratio?” in N. Gregory Mankiw (ed.) *Monetary Policy*, Chicago, IL: University of Chicago Press, pp. 155-193.

Bernanke, Ben and Olivier Blanchard 2023. “What caused the U.S. Pandemic-Era Inflation?” Paper presented at the conference “The Fed: Lessons learned from the past three years” organized by the Brookings Institution, May 2023.

Chari, Anusha and Henry, Peter Blair. 2023. “Disinflation and the Stock Market: Third World Lessons for First World Monetary Policy”. NBER Working Paper No. 31129, April 2023.

Eggertsson, Gauti B. & Michael Woodford, 2003. "The Zero Bound on Interest Rates and Optimal Monetary Policy," Brookings Papers on Economic Activity, Economic Studies Program, The Brookings Institution, vol. 34(1), pages 139-235.

Hansen, Niels-Jakob, Frederick Toscani, and Jing Zhou. forthcoming. “Euro Area Inflation after the Pandemic and Energy Shock: Import Prices, Profits, and Wages.” IMF Working paper, Washington, D.C.

International Monetary Fund (IMF). 2022. “Near-Term Macroeconomic Impact of Decarbonization Policies”, *World Economic Outlook,* Chapter 3, Washington D.C., October.

International Monetary Fund (IMF). 2023a. “Inflation and Disinflation: What Role for Fiscal Policy?”*, Fiscal Monitor*, Chapter 2, Washington D.C., April.

International Monetary Fund (IMF). 2023b. “Safeguarding Financial Stability Amidst High Inflation and Geopolitical Risks”, *Global Financial Stability Report,* Washington D.C., April.

International Monetary Fund (IMF). 2023c. “Nonbank Financial Intermediaries: Vulnerabilities and Tighter Financial Conditions”, *Global Financial Stability Report*, Chapter 2, Washington D.C., April.

Lorenzoni, Guido and Iván Werning, 2023. “Inflation is Conflict”. NBER Working Paper No. 31099.

Schnabel, Isabel. 2021. “Climate Change and Monetary Policy”, *Finance and Development*, September 2021

Gudmundsson, Tryggvi, Chris Jackson, and Rafael Portillo. forthcoming. “The Shifting and Steepening of Phillips Curves: International Evidence and Some Theory.” IMF Working Paper, International Monetary Fund, Washington, DC.