Inflation, financial stability, and macroprudential policy

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SUERF panel
These remarks represent my own views, and not necessarily those of IMF staff, IMF Management, or the IMF Executive Board
Inflation Risks and Monetary Policy
Global Inflation Surge

- Large surge in global inflation
- Increasingly broad-based including services
- Causes include:
  - massive fiscal and monetary stimulus
  - Pandemic-related supply disruptions
  - Unexpected given flat Phillips Curve and long history of low inflation

Sources: Haver, OECD, and IMF staff calculations.
Note: Median of year-on-year headline inflation rates across AEs and EMs.
Bringing inflation down

- Inflation expected to remain high next year before declining to target in 2024
- Growth must slow and U rise to bring inflation down
- Substantial rise in real interest rates path likely needed (moving well above neutral)
  - So financial conditions must tighten further
- Substantial upside inflation risks
Macroeconomic and financial stability risks

- Environment of substantial macroeconomic and financial stability risks
- In near-term, key risk is that inflation is more persistent (esp. wages/services)
- Would require potentially **much sharper policy rate adjustment** especially if Phillips Curve relatively flat
- Could induce much more larger output declines and a disruptive tightening of financial conditions

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**Core Inflation**
(YoY, dev. from baseline)

- Percentage points
- Monetary Tightening

**Policy Rate**
(APR, dev. from baseline)

- Percentage points
- Note: average of first 4 quarters.
Interaction with “Legacy” Risks from Lower-for-Longer
Financial stability risks in new environment

➢ Rapid shift from “lower for longer” regime to environment with much higher interest rates likely to generate substantial problems

➢ Balance sheet strains highly leveraged borrowers, especially borrowing short

➢ Escalating borrowing costs for riskier investors

➢ Falls in asset prices, including collateral values of “safe assets” such as long-term government debt, and also housing

➢ Pressures from dollar appreciation: strain for unhedged dollar borrowers, especially EMs
**Property sector a key risk**

- Low interest rates even before COVID fueled large run-ups in house prices
- Accelerated during COVID: low rates, fiscal stimulus, shift to at-home

### House Price Inflation

Source: BIS Residential Property Price database
In many European countries, variable rate mortgages still substantial.

Sources: ECB, Statistical Data Warehouse
Price vs. Financial Stability Tradeoffs under High Inflation
Unwelcome CB Tradeoffs: Price vs. Financial Stability

- Pre-covid “confluence” of objectives: central banks could ease policy rates to ease financial stresses, and this reduces risk that inflation drifts down
- With high inflation: more tensions between objectives
  - Price stability requires interest rates to rise
  - But this causes large increases in risk and term premiums
- Familiar and challenging conflict from historical perspective
  - Gold standard: raise interest rates sharply to defend exchange rate but put huge stress on banks
  - Great Inflation: policy tightenings led to large increases in borrowing spreads
Role of additional ex post tools
Ex post tools to improve tradeoffs

➢ Hence central banks may need additional instruments:

➢ May give more latitude to use policy rate to achieve better macro outcomes while reducing financial stability risks.

➢ Can use model simulations to illustrate potential benefits of ECB’s TPI:

➢ Key risk that policy rate hike causes disproportionate rise in periphery spreads

➢ Ask if asset purchases of periphery debt can improve outcomes for periphery and core?

➢ Explore in two country block model of euro area of Blanchard, Erceg, and Linde (2016) with financial accelerator

➢ Scenario considers effects of policy tightening in response to large inflationary shock with and without periphery AP.
Price Cost-Push Shocks with Strong Demand in Core
Limitations of additional tools

➢ Some key limitations of these additional instruments:
   ➢ Risks of even larger CB balance sheets
   ➢ Possible tension with monetary policy objectives
   ➢ Political economy risks may weaken CB independence
Macroprudential Policy
**Time to rebuild buffers?**

Countries starting to rebuild buffers as recovery from pandemic progresses

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**Net Tightening of Macroprudential Policies**

Sources: IMF Macroprudential Policy Survey database and staff calculations.

Note: Net tightening = total number of tightening measures minus easing measures. Data for 2021 is less than full year. 182 countries
Releasable capital buffers

➢ A positive neutral CCyB would provide additional resilience

➢ Research points to benefits of having releasable capital buffers, e.g., Berrospide et al (2021); Couaillier et al (2022a) and (2022b)

➢ Could this still be introduced in the current environment?

➢ Macro cost of additional capital could be small – monetary policy could ease a bit (BCBS 2010 and 2019)

➢ Banks could absorb some tightening through retained profits

➢ Phase-in could be state-contingent

➢ A more targeted buffer such as for housing could be considered
Borrower based measures

- Borrower based measures are useful in the current environment

**Should these tools be tightened?**

- Worst loans in GFC were made just before crash
- Even so, tightening BB tools could have more adverse effects on housing markets and output than capital based
- Could instead use soft recommendations to filter tail risks