Inflation, financial stability, and macroprudential policy

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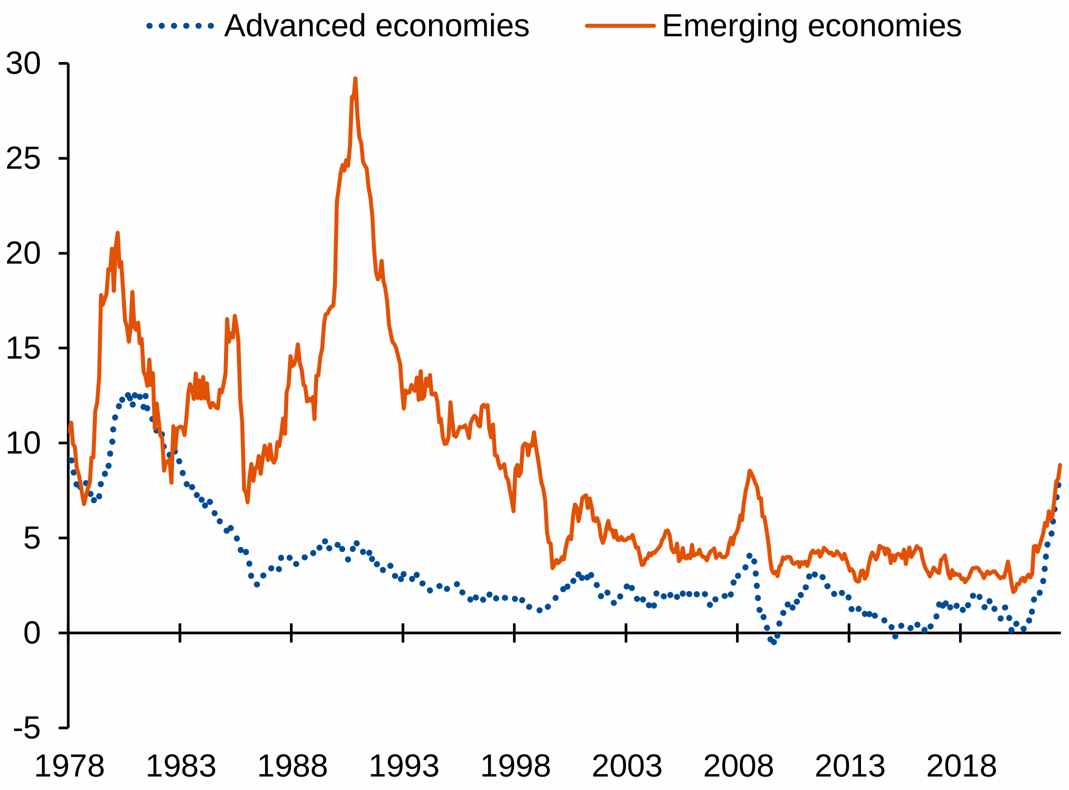
October 5, 2022
SUERF panel
These remarks represent my own views, and not necessarily those of IMF staff, IMF Management, or the IMF Executive Board

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

Inflation in Advanced and EM Economies



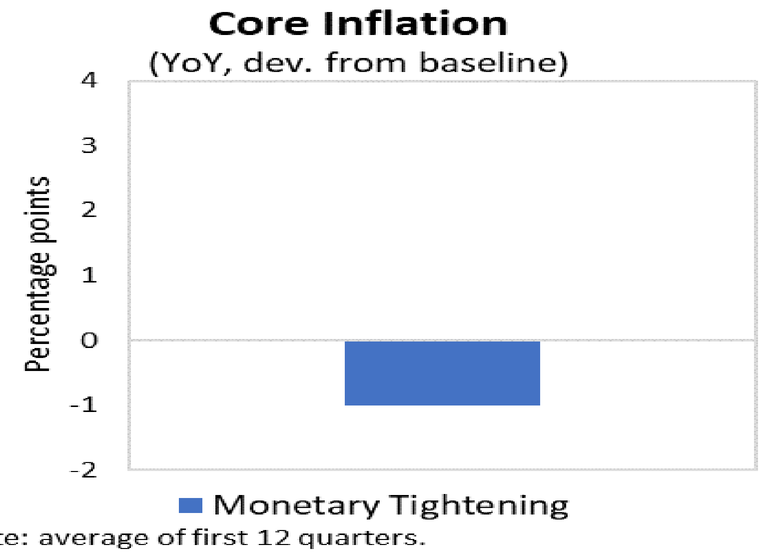
Sources: Haver, OECD, and IMF staff calculations.
Note: Median of year-on-year headline inflation rates across AEs and EMs.

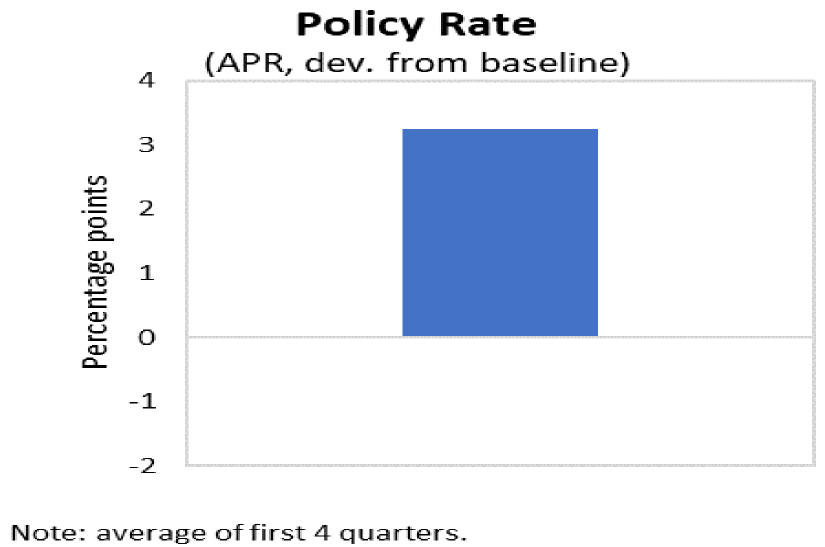
Bringing inflation down

- 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





Interaction with “Legacy” Risks from Lower-for-Longer

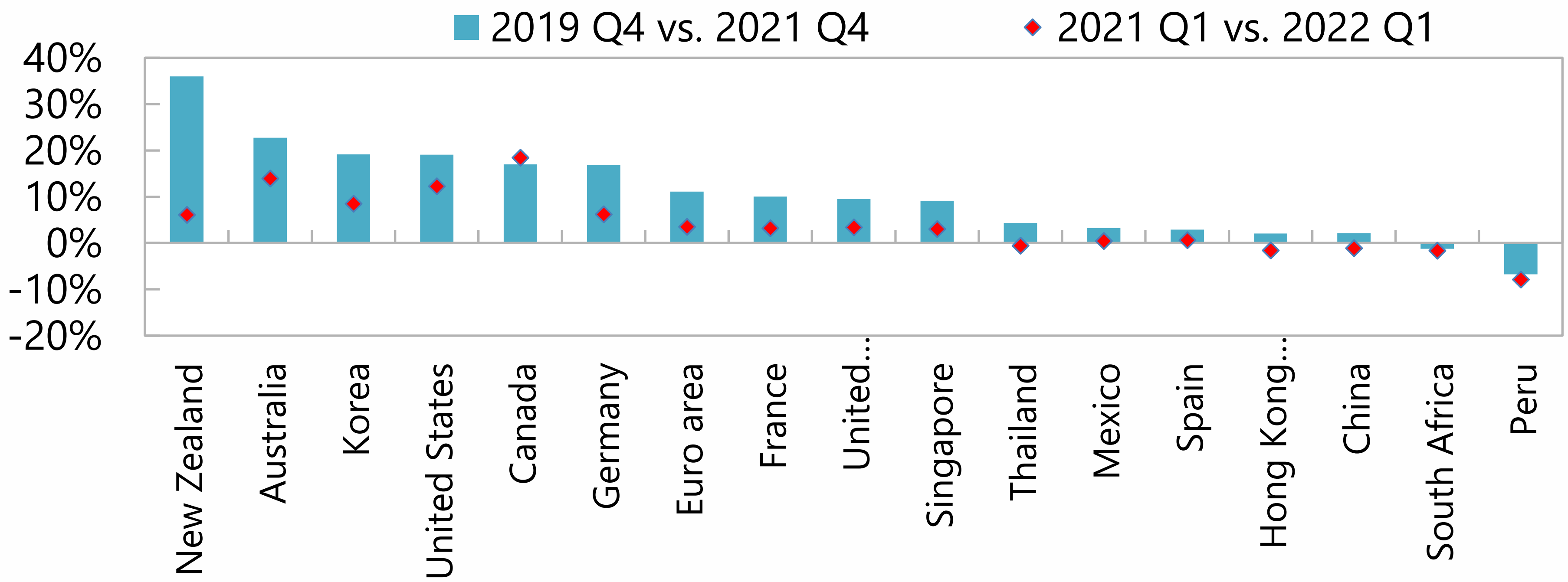
Financial stability risks in new environment

- 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

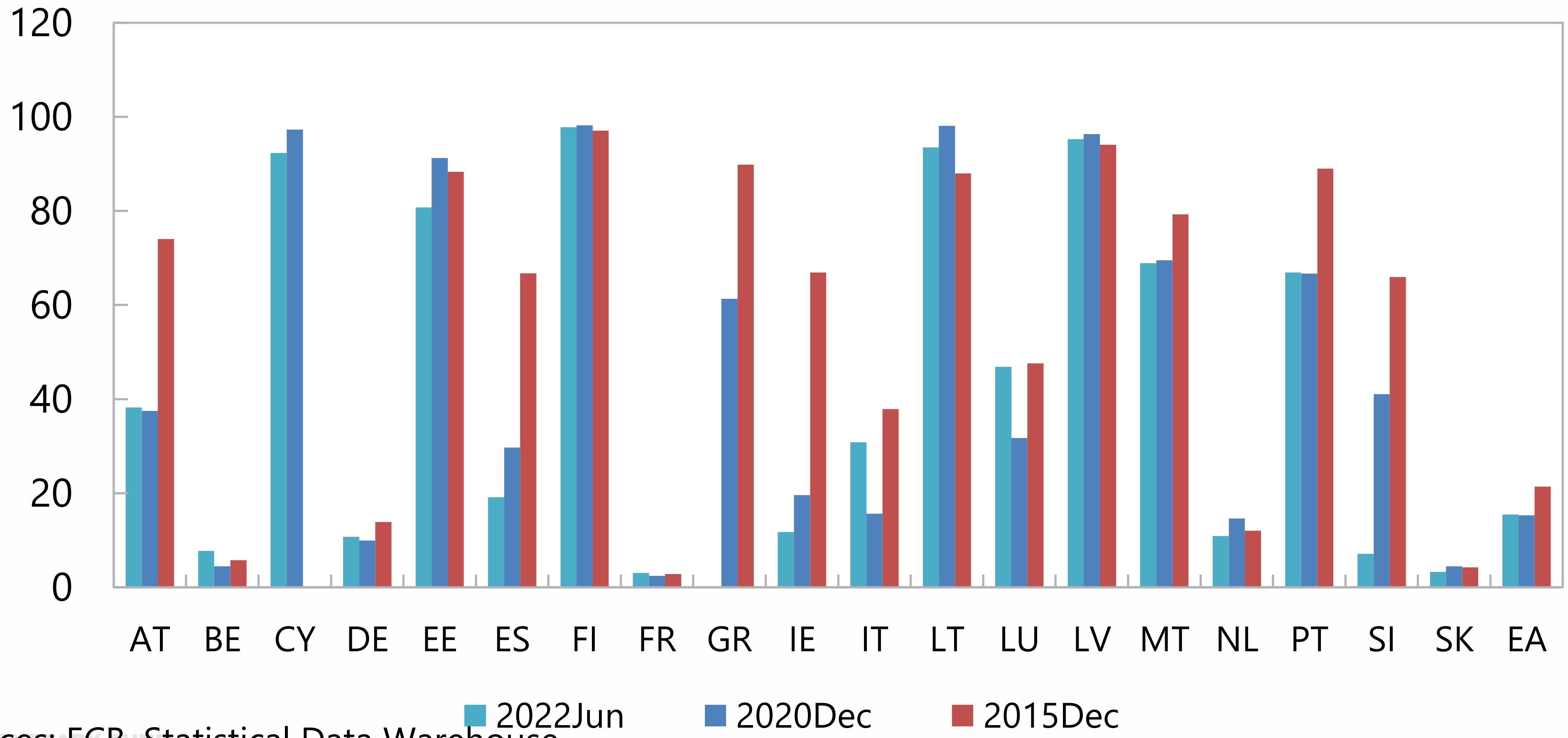
House Price Inflation



Source: BIS Residential Property Price database

Country-specific vulnerabilities

- 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

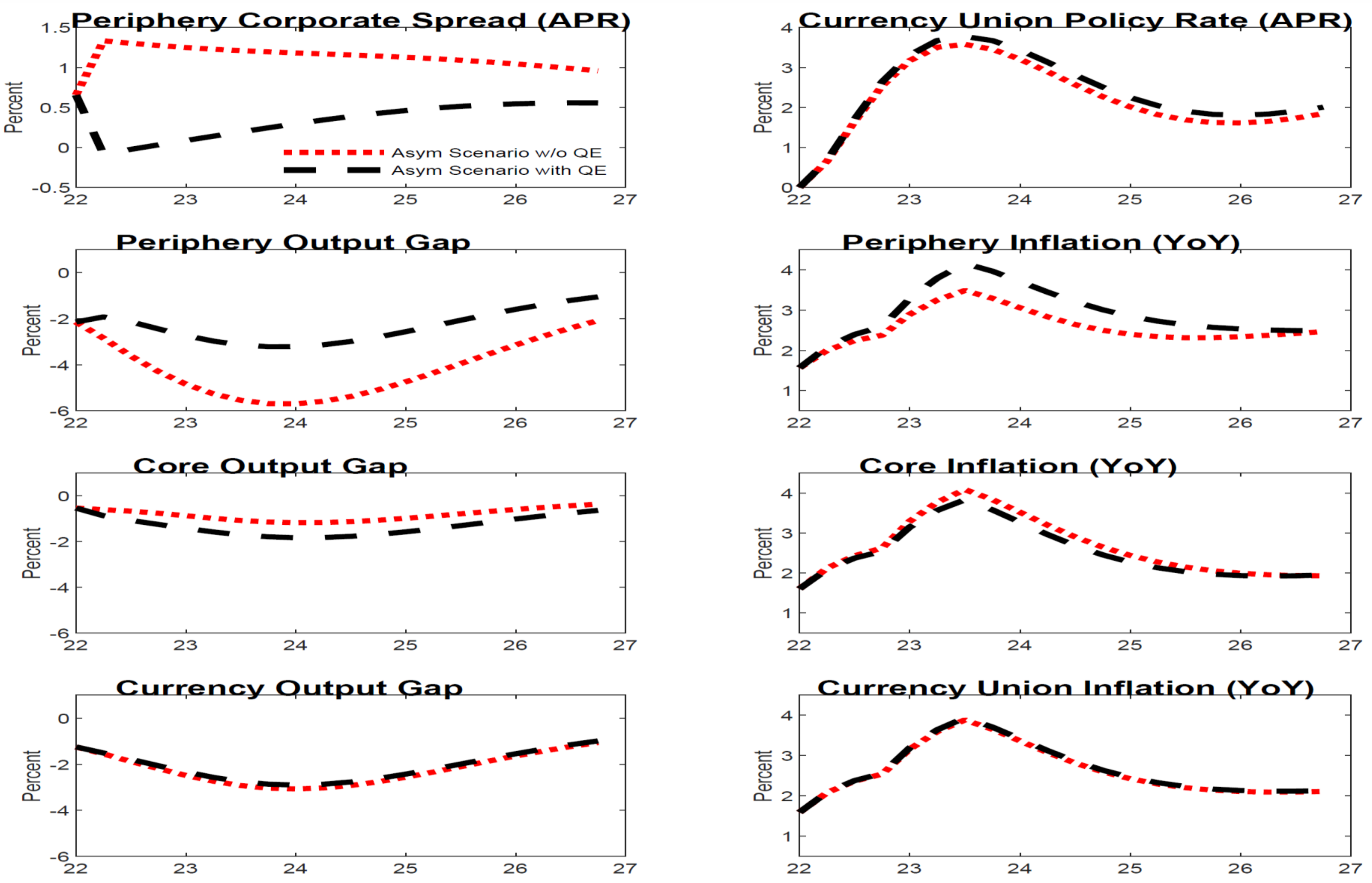
- Pre-covid “confluence” of objectives: central banks could ease policy rates to ease financial stresses, and this reduces risk that inflation drifts down
- With high inflation: more tensions between objectives
  - Price stability requires interest rates to rise
  - But this causes large increases in 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



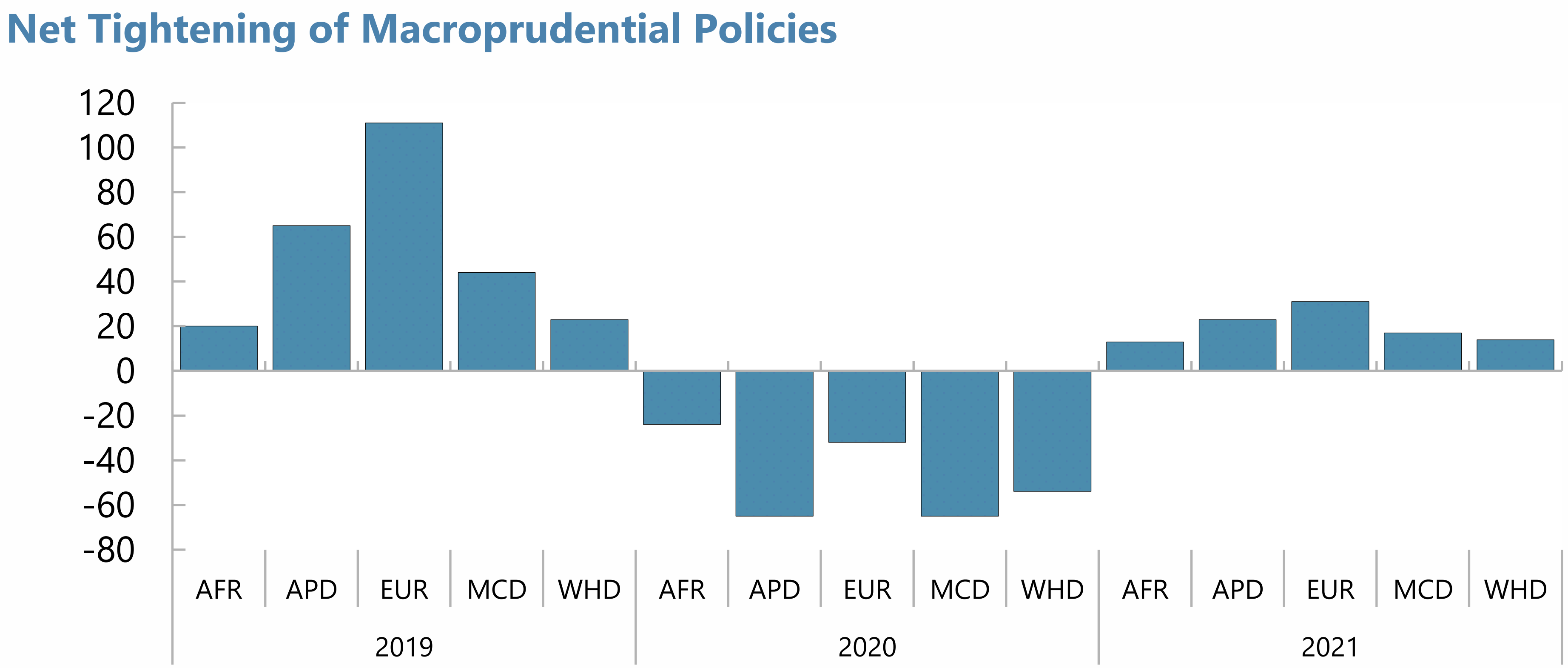
Limitations of additional tools

- **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



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