Petar Chobanov: Back to basics - interest rates, price stability and supply side shocks

Speech by Mr Petar Chobanov, Deputy Governor of the Bulgarian National Bank, at the Central & Eastern European Forum, organised by the Financial Times, Vienna, 14 January 2026.

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Introduction

After a decade of low inflation, unconventional instruments, and repeated encounters with the effective lower bound, the post-pandemic inflation surge has forced central banks to rediscover some old truths. Among them: that interest rates still matter; that price stability remains the indispensable anchor of macroeconomic stability; and that supply-side shocks, while not new, pose renewed challenges in a world of tighter constraints.

My remarks today will focus on three themes:

1. What the recent inflation episode has taught us about supply shocks and monetary policy;
2. Why "looking through" supply-driven inflation is no longer a default option;
3. What "back to basics" should mean for the conduct of interest rate policy going forward.

1. Supply shocks are back – but the world has changed

Supply shocks have always been part of the macroeconomic landscape. Energy price spikes, food shortages, and disruptions to global production chains are hardly novel phenomena. What is different today is the environment in which these shocks occur. We are operating in economies facing:

Slower trend growth

- Ageing populations and tighter labour markets;
- More fragmented trade and geopolitics;
- Greater exposure to climate-related shocks.

In such a world, supply is less elastic and less able to absorb disturbances. As a result, in the post-COVID period shocks have not arrived in isolation. Instead, they have overlapped and reinforced one another, repeatedly pushing inflation above target before previous shocks had fully unwound. Looking ahead, there are strong reasons to expect this pattern to continue. This matters because monetary policy frameworks developed in the pre-pandemic era implicitly assumed a world in which supply shocks were:

- Mostly transitory;
- Weakly transmitted into wages and expectations;

- Occurring against a backdrop of strong central bank credibility.

Those assumptions can no longer be taken for granted.

2. The limits of "looking through" supply-driven inflation

For decades, central banks were taught - and rightly so - that monetary policy should respond differently to supply shocks than to demand shocks. When inflation rises because oil prices jump or supply chains are disrupted, tightening policy aggressively risks compounding output losses without materially improving inflation outcomes. As long as expectations remain anchored, allowing inflation to temporarily deviate from target is consistent with a medium-term price stability mandate.

However, the recent high inflation episode has reminded us of a critical condition embedded in that logic: "looking through" only works when inflation expectations are firmly anchored and shocks do not trigger changes in the behaviour of economic agents.

The succession of supply shocks matters because it fundamentally alters inflation dynamics. When inflation remains high for an extended period, wage resistance tends to strengthen, as workers seek to recoup real income losses accumulated across successive shocks. At the same time, firms may engage in profit margin protection, especially in sectors with pricing power or limited competition. In periods of tight labour markets these behaviours reinforce further, generating second-round effects. Inflation risks becoming self-reinforcing.

In such circumstances, the central bank faces a regime shift:

- The Phillips curve steepens;
- Expectations become more sensitive to realised inflation;
- Delay becomes more costly than action;

The key lesson is that recurrent supply shocks can give rise to endogenous inflation persistence once second-round effects take hold - not because any individual shock is permanent, but because repeated disturbances prevent the economy from returning to equilibrium. Under such conditions, monetary policy may need to lean against inflation, even if its initial impulse is supply-driven, to forestall a transition to a high-inflation regime.

3. Interest rates still matter - and credibility is earned through action

A second lesson from recent experience is that interest rate policy remains the central bank's primary and most powerful tool. Faced with the risk of de-anchoring, central banks across the world undertook the most synchronised tightening cycle in decades. This was neither painless nor without risks. But it was necessary.

What ultimately stabilised inflation was not communication alone, nor forward guidance, nor balance sheet policies - but the clear and sustained adjustment of the policy rate into restrictive territory. This underscores a basic but sometimes forgotten principle: credibility is not inherited; it is continuously earned. When inflation is low, credibility allows flexibility. When inflation is high, credibility requires resolve.

4. What "back to basics" should mean going forward

So what does "back to basics" imply for the future conduct of monetary policy? Let me highlight four implications.

First, price stability must remain the unequivocal nominal anchor. Attempts to dilute or redefine it in response to repeated shocks risk undermining the very trust that allows monetary policy to function effectively.

Second, interest rate policy must be guided by regime awareness, not shock labels. The key question is not whether inflation is supply- or demand-driven, but whether expectations, wages and pricing behaviour are consistent with a return to target.

Third, monetary policy cannot substitute for supply-side reforms – but it cannot wait for them either. Structural policies are essential to improve resilience, productivity and energy security. But central banks must act within their mandate and time horizon.

Fourth, analytical capacity matters more than ever. In a world of frequent and interacting shocks, central banks need better tools to assess persistence, non-linearities and feedback loops between inflation and expectations.

Conclusion

Going back to basics does not mean nostalgia for a simpler world. It means clarity about objectives, realism about trade-offs, and discipline in the use of our instruments. Interest rates remain central. Price stability remains foundational. And supply shocks - while unavoidable - must not be allowed to erode trust in the value of money. That, ultimately, is the basic task of a central bank.