Inflation is back, challenging central banks

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Ladies and gentlemen

Welcome to the presentation of our 92nd BIS Annual Economic Report. I am very glad that we can meet in person again after two years in a virtual format. The extraordinary times make it all the more important.

Why do I say extraordinary times? Well, let me take a moment to recap what has happened in the past few years.

Strongest global rebound in decades, surprising inflation

In my remarks at this event in 2019, I made several references to inflation and interest rates. At that time, the debate centred on how to bring inflation back up to target, and how to sustainably raise policy rates from very low levels to build buffers against the effective lower bound.

Since then, we have lived through the most severe global pandemic in a century, the largest economic contraction in 90 years and the strongest economic rebound in decades.

In the space of a few months, we went from fears of mass unemployment and a wave of business bankruptcies to a rapid, albeit uneven, recovery. Supply chains that had collapsed as firms cancelled orders were suddenly unable to meet demand. Bottlenecks emerged, particularly for durable goods. After breaching multi-decade lows, many commodity prices touched record highs. And concerns about deflation gave way to surprising inflation.

Amidst this already turbulent environment, the Russian invasion of Ukraine added to the inflationary pressures, particularly through its effects on food and energy markets. In much of the world, inflation is now at multi-decade highs. At the same time, growth projections, which were rosy just a few months ago, are quickly being downgraded.

The sudden shifts in economic momentum have naturally posed huge challenges for central banks and fiscal authorities. Policy settings designed to combat the sharp downturns of 2020 took time to unwind as conditions improved. In the meantime, they added impetus to the inflationary rise.

Most central banks have now firmly committed – through words and, increasingly, through actions – to bringing inflation back down to more acceptable levels. Thus, in 2022 we are still discussing inflation and interest rates. But in a very different sense and context than in 2019.

So where do we go from here?

The most urgent concern for central banks is the trajectory of inflation. The outlook is uncertain. But the most likely scenario is that inflation substantially overshoots most jurisdictions' targets for some time. The factors that raised inflation are still at work: the pass-through of higher commodity prices, strong goods demand and related strain on supply chains, sanctions and bottlenecks in key inputs, robust growth in many advanced economies supported by still negative real interest rates, and very tight labour markets. With the prospect of higher wages as workers look to make up for the purchasing power they lost, inflation could be high for long.

Of particular concern, persistently high inflation increases the risk of a shift from a low- to a high-inflation regime, as analysed in detail in Chapter II of the Report. Low-inflation regimes tend to have self-equilibrating properties. When inflation is low, price changes, including those of "salient" items such as energy, food and housing, tend to leave only a temporary imprint. Economy-wide inflation is less noticeable, but also less relevant. In contrast, in high-inflation regimes, households and firms pay more attention to individual price increases, especially of salient items. At the same time, the price changes of individual items become more representative of overall price pressures.

Importantly, transitions from low- to high-inflation regimes are self-reinforcing. As inflation rises, price increases come into sharper focus, and move out of the zone of "rational inattention". Employees exert more effort to recoup lost purchasing power, both actual and prospective. And firms seek to protect themselves from profit squeezes. This combination can lead to wage-price spirals and make a transition to a high-inflation regime more likely.

Now the lights are flashing red. Wage growth is already on an upward trajectory in some countries. In many, the bulk of wage renegotiations are still to come. Demands for compensation for past losses, indexation and a return to centralised wage bargaining have already surfaced. Similarly, firms are finding it easier to translate higher wages into higher prices given how generalised price pressures are and how resilient economic activity has been.

Other, more structural, developments increase the risk of a regime switch. The pandemic and the war raise the prospect of new modes of operation, a reorganisation of global value chains and deglobalisation. This means less secular downward pressure on prices. Fiscal policy is still expected to cushion the impact of price shocks for essential items, at least in the short run. But in the process, the adjustment to higher prices is just postponed, and public finances are strained further. If growth slows, fiscal deficits will remain high, further increasing public debt, with associated risks of higher inflation down the road.

Central banks are awake to the risks

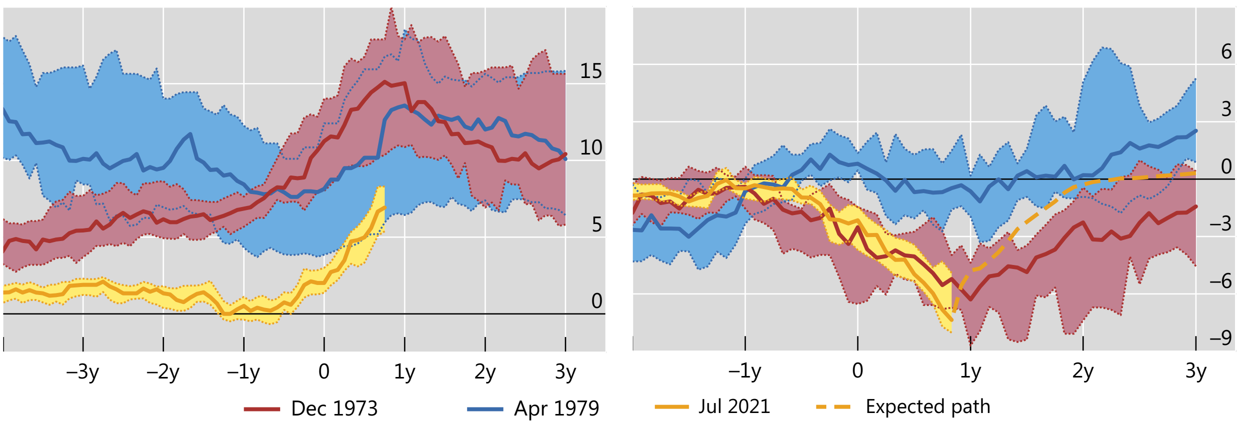
In emerging market economies, to stem inflation and limit currency depreciations, many central banks started raising policy rates last year. Advanced economies are quickly catching up. Eventually, tighter policy will reduce aggregate demand and slow economic growth, thereby easing price pressures. But time is of the essence. Inflation-adjusted (real) short-term interest rates are still falling as inflation has picked up more than policy rates.

To avoid entrenched high inflation, it will be important to heed the lessons of the 1970s. The aftermath of the oil crises of 1973 and 1979 saw persistently high inflation and low economic growth (Graph 1). Today, the oil price increase is relatively smaller and the energy intensity of GDP much less. At the same time, a much broader range of energy sources and agricultural commodities have seen sharp price increases. And supply disruptions for key products, such as fertilisers and metals, could lower future global output, adding to price pressures.

Heed the lessons from the 1970s and other periods[1]

In per cent — Graph 1

Median advanced economy inflation (from date) | Median advanced economy ex post real policy rate (from date)



[1] Shaded areas indicate 20th–80th percentiles.

Sources: Bloomberg; Consensus Economics; Datastream; Global Financial Data; national data; BIS.

The key positive development since the 1970s is no doubt improved monetary policy frameworks. Monetary goals and instruments are now much better defined. Institutional setups are more robust. And credibility is stronger. To avoid the risk of a regime switch, central banks need to communicate clearly and well the final goal: to bring inflation quickly back to target. And needless to say, they have to act in consequence. Experience shows that shorter and front-loaded tightening cycles tend to make soft landings more likely than shallower, but more drawn out, tightenings.

Can the global economy achieve a soft landing?

The starting conditions are challenging. Inflation today is higher than at the start of most previous tightening cycles. Public debt is also at a historical high in many countries. This makes it harder to raise interest rates without triggering market dysfunction. House prices and household debt are generally elevated. Corporate exposures have grown in many economies too.

There is a path ahead, but it is narrow. In part, it depends on whether supply shocks dissipate quickly. Combined with a moderate monetary tightening, this could temper demand and lower inflation without a major economic contraction. However, if the adverse shocks persist and aggregate demand does not slow down enough to alleviate price pressures, more tightening will be necessary and added pain will be unavoidable.

The key balancing act in calibrating the policy response centres on the financial sector-real economy nexus, with debt and asset prices as crucial levers.

One risk for advanced economies is that large drops in asset prices could trigger a sharp recession and financial stresses. Related financial stability risks can manifest themselves in unexpected places, notably among non-banks and through hidden leverage and liquidity mismatches. Non-banks have grown fast. But they are much less transparent and less closely regulated than their banking counterparts.

Emerging markets may be especially at risk. They will face tighter global financial conditions against a backdrop of significant vulnerabilities. Should the dollar appreciate further, pressures will mount for many. Despite having moved earlier and being better placed than in past tightening episodes, some emerging markets have no choice but to raise rates further, also as their real rates are still negative.

Tackling longer-term challenges

It is worth mentioning that over the past two years, both monetary and fiscal policies played a pivotal role in helping economies navigate through the unprecedented challenges that presented themselves. Even with debt at a historical peak, public debt servicing was easy, as real interest rates were generally negative and growth rates higher. But the support ran down the already limited policy space and added to concerns about fiscal sustainability.

In the short run, high inflation has lowered debt-to-GDP ratios.

But as monetary policy tightens, tensions with fiscal policy will emerge. As monetary normalisation gathers pace, growth rates will probably be closer to or even below interest rates. Consolidated fiscal balances will quickly deteriorate. Achieving fiscal sustainability is essential, not least to restore buffers in advance of future shocks and recessions. Maintaining central bank independence will also be critical, as many will make losses in the adjustment process, raising political economy concerns.

Boosting growth is critical to ameliorate these tensions. It calls for relying less on aggregate demand management and emphasising growth-friendly fiscal actions and broad structural reforms. Such measures have been absent for many years. But these are more important than ever, with fiscal and monetary policies having depleted much of their power to prop up GDP. Amid signs that globalisation may go into reverse, avoiding real and financial fragmentation is also essential. The active pursuit of shared sustainability goals could represent an important opportunity to reinvigorate growth.

Building the future monetary system

Let me now shift gears. Another major challenge that central banks have faced during recent years is the vigorous but chaotic eruption of cryptoassets, stablecoins and their evolution into decentralised finance (DeFi).

We meet at a time of turmoil for crypto. The recent Terra LUNA collapse is only the most spectacular one in the crypto world. Many lesser-known coins have seen price slumps of more than 90% from their peaks last year. However, focusing on prices alone would divert attention away from deeper lessons for the future monetary system.

There are many fundamental structural flaws with crypto. The prevalence of stablecoins indicates a pervasive need to piggyback on the credibility of fiat currencies. It also highlights crypto's lack of the nominal anchor that only central bank money can provide. Crypto has also quickly rediscovered a need for the unit of account function of central bank money. The proliferation of coins highlights the fragmentation of the crypto ecosystem, with many incompatible settlement layers jostling for a place in the limelight.

Nevertheless, we need to take note of the features of crypto that have captured the popular imagination. In spite of its fundamental flaws, crypto offers tantalising glimpses of potentially useful technical features. These could expand the capabilities of the current monetary system. The vision for the future monetary system laid out in Chapter III fuses these enhanced technical capabilities around the core of the trust provided by central bank money.

We lay out a metaphor for the future monetary system as a tree. Its solid trunk is the central bank. But it boasts a rich and vibrant ecosystem of private sector providers helping users to fulfil their economic needs. In this tree, the ecosystem is rooted, figuratively speaking, in the settlement on the central bank's balance sheet.

Some elements of the picture of the future monetary system entail a leap in terms of the institutions and arrangements that govern today's monetary system. Their use cases would need to be tested against the current system. However, the path to the future monetary system is a long one. If we are to make progress, we need to take the first steps now.

So, while the sound and fury of collapsing crypto prices grabs all the attention, it is incumbent on us in the central bank community to look ahead to these longer-term goals.

Conclusion

Let me conclude. There are not two ways about it. Today, tackling high inflation is the most urgent and important task for central banks. In some ways, monetary policy is in uncharted territory. Coming after a long period of low interest rates and out of the pandemic, households, firms and policymakers must relearn transmission channels and assess how the global economy adjusts to new demand configurations and supply shocks. While some economic slowdown is inevitable and indeed desirable, unexpectedly large spillbacks may follow from tighter global financial conditions.

Lacking clear vision about the future may counsel for caution and gradualism, as policy trade-offs are larger than in the past. But the premium is on timely and decisive, yet flexible, action. As the risk of a regime switch in inflation and related stagflation looms large, forceful action by central banks today is of the essence.

We should also accept the reality that if we want to have resilient, accelerated and sustainable economic growth in the future, with more opportunities for everyone, we need to depend less on the healing powers of fiscal and monetary policies. As fiscal and monetary policy space has been depleted, the baton needs to be passed to structural policies. These policies are harder to implement, both politically and technically. But the can should not be kicked forward forever.

Finally, it is up to central banks to play an active role in forging the future monetary system. This is especially so because it should have as key components central bank money and the institutional and operational infrastructure that central banks provide.

The fight against inflation and the forging of a future monetary system represent deeply intertwined challenges. Both issues address central banks’ most fundamental function – to preserve the value of and trust in the unit of account. This is what central banks were set up to do, and this is what society expects from us. I am sure we will deliver.