

Global shocks, policy spillovers and geo-strategic risks: how to coordinate policies

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Outline

1. Are we faced with global stagflation?
2. Deglobalization: nature and effects
3. Policy spillovers and coordination – appropriate response to Silvergate Bank, SVB, Signature Bank, Credit Suisse etc.
4. Central bank policy response to energy security, green issues and geostrategic challenges

1. Are we faced with global stagflation?

- Secular stagnation – quite likely for most AEs, China and trade-and-FDI-dependent EMDEs.
 - Demographics; de-globalization; climate change and environmental constraints; political resistance to growing inequality; excessive debt.
- Episodic/transitory stagflation driven by adverse supply shocks or combined negative supply and demand shocks – almost certainly.
- Secular stagflation – very unlikely. Long-run above-target inflation is a monetary policy choice few AE central banks are likely to make. And they have the policy tools to prevent it – there is no upper bound on the policy rate – no *EUB*.

Note: unless otherwise stated, what follows applies to AEs only.

1. Are we faced with global stagflation?

- In the near future (1 or 2 years), yes for most AEs.
 - Behind the inflation curve; more restrictive monetary policy; financial fragility (Silvergate, SVB, Signature and more to come in US and elsewhere (Credit Suisse)).

1. ARE WE FACED WITH GLOBAL STAGFLATION?

The record: RELEARNING INFLATION CONTROL

- U.S.; February 2023: CPI: 6.0%; CPI Core: 5.5%; January 2023: PCE 5.4% (Dec. 2022 PCE: 5.3%); January 2023 PCE Core: 4.7% (December 2022 PCE Core: 4.6%).
- Euro area; February 2023: HICP: 8.5% (December 2022: 9.2%); HICP Core: 5.6% (December 2022: 5.2%).
- UK; CPIH, January 2023 8.8% (December 2022: 9.2%; October 2022: 9.6%); CPIH Core, January 2023: 5.3%; (December 2022: 5.8%; October 2022: 5.8%).
- UK; CPI; January 2023: 10.1% (December 2022: 10.5%; October 2022: 11.1%); CPI Core, January 2023: 5.8%; (December 2022: 6.3%; October 2022: 6.5%).
- Japan; January 2023: CPI: 4.3% (December 2022: 4.0%); January 2023: CPI “Core” 4.2%; (December 2022: 4.0%); true CPI Core, January 2023: 3.2%; (December 2022: 3.0%).
- Canada; January 2023: CPI: 5.9%; CPI-trim 5.1%

1. ARE WE FACED WITH GLOBAL STAGFLATION?

RELEARNING INFLATION CONTROL

- What does the Taylor Rule suggest?

$$i_t = r_t^N + \hat{\pi} + \alpha(\pi_t - \hat{\pi}) + \beta gap$$

- i : nominal policy rate; r^N : short neutral real interest rate; π : actual inflation rate;
 $\hat{\pi}$: target rate of inflation; gap : percentage difference between actual and real GDP.

Assume $\alpha = 1.5$; $\beta = 1$; $r^N = 0.50$; $\hat{\pi} : 2.00$

Short neutral nominal interest rate: $R_t^N = r_t^N + \hat{\pi} = 2.50\%$

[Goodhart \(February 2022\)](#); for U.S. $i > 6\%$; for UK $i \approx 5\%$

For US core PCE ; Eurozone core HICP; UK core CPIH; Japan CPI core; Canada CPI-trim.

1. ARE WE FACED WITH GLOBAL STAGFLATION?

RELEARNING INFLATION CONTROL

			$\alpha = 1.5$	$\beta = 0.5$
	i (%)	R^N (%)	$\pi - \hat{\pi}$ (%)	gap (%)
Fed	6.55 (4.50-4.75)	2.50	2.70	0.00
ECB	7.90 (3.50)	2.50	3.60	0.00
BoE	6.95 (4.00)	2.50	3.30	-1.00
BoJ	3.80 (-0.10)	2.50	1.20	-1.00
BoC	7.15 (4.50)	2.50	3.10	0.00

1. ARE WE FACED WITH GLOBAL STAGFLATION?

RELEARNING INFLATION CONTROL

- Note: Taylor Rule ignores financial stability considerations, including international repercussions of large/fast policy rate hikes by leading AE central banks (Fed & ECB especially).

- Solution: dynamic (partial adjustment) Taylor rule:

$$i_t = \gamma \left(r_t^N + \hat{\pi} + \alpha(\pi_t - \hat{\pi}_t) + \beta gap \right) + (1 - \gamma)i_{t-1}$$

$$0 < \gamma \leq 1$$

- For this to fit the data, $\gamma\alpha < 1$
- Why are the central banks still behind the curve – both as regards interest rates and balance sheet size?
 1. Persistent errors in analysis and forecasting.
 2. Fear of domestic financial instability from rapid policy rate hikes and large asset sales (SVB, Signature, Credit Suisse etc.).
 3. Fear of international repercussions (especially in externally vulnerable EMDEs).
 4. Fear of complicating the funding of fiscal deficits and public debt servicing - fiscal dominance.
 5. Reluctance/unwillingness to engineer the slowdown in aggregate demand (possibly a recession) required to achieve a sustainable reduction in the inflation rate. Hoping for painless or immaculate disinflation. Unfortunately, this is the exception, not the rule.

1. ARE WE FACED WITH GLOBAL STAGFLATION?

RELEARNING INFLATION CONTROL

- Risk of additional transitory stagflation episodes
 - Escalation of Ukraine war, including Russia exercising the tactical nuclear option
 - PRC invasion of Taiwan (when rather than if)
 - The next global pandemic (when rather than if)
- Secular inflation and secular stagflation are a monetary policy choice. In the medium and long run the inflation targets will be met in most AEs.

2. DE-GLOBALISATION

- Pandemic-driven supply chain disruptions have strengthened “just in case” supply chain and inventory management versus “just in time” management.
- This argues in favor of diversifying supply chains to address all relevant dimensions of risk. Re-shoring is not in general the right response.
- The deepening and widening cold war between the U.S. and China calls for friend-shoring of strategic commodities, goods, services and financial linkages and will lead to a bifurcation of the global economy (trade, finance (including fdi), technology transfer) into a U.S.-oriented Western Block (U.S., Canada, most of Europe, Japan, Taiwan, Australia, New Zealand, South Korea) and a China-oriented Eastern Block (China, Russia plus satellites, Iran and North Korea).
- Nations outside the Western and Eastern Blocks will try to maintain trade, financial and technology links with both blocks, which will become increasingly difficult.
- The bifurcation of the global economy will be a contributing factor to secular stagnation.

3. POLICY SPILLOVERS AND

- ## COORDINATION
- Monetary policy spillovers between AEs are a material issue only where they impact financial stability.
 - Address domestic financial stability issues
 - through enhanced LoLR and MMLR operations
 - Guaranteeing all deposits
 - More stringent regulation of banks and NBFIs
 - Spillovers from AE monetary policy to EMDEs are a material issue. It often calls for more gradual policies (a lower value of α).
 - International LoLR operations
 - US dollar standing swap lines with ECB, BoE, BoC, BoJ and SNB now make (unlimited) 7-day maturity liquidity available daily instead of weekly. Duration of swaps can be extended.
 - Extend temporary bilateral US dollar liquidity swap lines beyond the previous maximum 14 central banks – only two of which were EMDEs (Brazil and Mexico).
 - Extend Repo facilities (FIMA (now a standing facility) and EUREP). Only overnight thus far (but can be rolled over).
 - Additional SDR allocations by the IMF – targeted at EMDEs, unlike the US\$650 bn General Allocation of August 2021, which allocated the new SDRs in proportion to existing quota shares.
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3. POLICY SPILLOVERS AND COORDINATION

- Use MMLR interventions to guarantee effective transmission of monetary policy to all Eurozone member states when systemic financial markets threaten to become disorderly and dysfunctional.
 - Selective re-investment of PEPP redemptions
 - Recovery and Resilience Facility – limited flexibility; unclear how much of the grants and loans have already been committed
 - EFSM – too small
 - ESM – requires EFSF/ESM programme
 - Outright Monetary Transactions - requires EFSF/ESM programme
 - Transmission Protection Instrument - user-friendly version of OMT (does not require EFSF/ESM programme)
- Create orderly sovereign debt restructuring mechanisms
 - Only allow debt instruments with appropriate CACs
 - Official creditors pari passu with private creditors (no preferred creditor status for national or international public entities).
 - Create a formal SDRM for the Eurozone

4. ENERGY SECURITY, GREEN AND OTHER ESG ISSUES AND GEOSTRATEGIC CHALLENGES

Central banks should only add energy security, green and other ESG issues and geostrategic challenges to their objective function in a lexicographic manner. These objectives ought to be ordered as follows:

1. Financial stability
 2. Price stability or a dual mandate (maximum employment and stable prices).
 3. All things bright and beautiful, including energy security, climate change and global warming and the pursuit of geostrategic objectives
- Central banks should be fully aware of the implications of energy insecurity, climate change, other ESG manifestations for their financial stability and price stability (or dual) mandates.

4. ENERGY SECURITY, GREEN AND OTHER ESG ISSUES AND GEOSTRATEGIC CHALLENGES

Central banks, as supervisors and regulators should make sure their supervisees and regulated entities are prepared for the consequences for their financial risk and return configurations of global warming and increasing frequency and severity of extreme weather events.

They should redesign rules and regulations to optimize the adaptation of their supervisees and regulated entities to the changing climate and environment. One example is a focus on stranded asset risks associated with the pursuit of green and blue objectives by private and other public entities.

- Central banks should only target mitigation of the wider economic and social damage caused by climate change, loss of biodiversity, energy insecurity etc. if this can be done subject to (without prejudice to) the most effective pursuit of financial stability and price stability (or the dual mandate). With limited instruments, the solution to the assignment problem is clear.
- Central banks cannot escape an active role in the imposition and enforcement of financial sanctions motivated by geostrategic challenges (e.g. freezing about \$300 billion of financial assets (gold and forex reserves) held abroad by Russia's central bank.
- In practice, since their regulatory and supervisory instrument set is limited, this means that central banks should not pursue ESG objectives, say by imposing higher capital requirements on brown investments than on green investments or by accepting green bonds as collateral on better terms (smaller haircuts) than brown bonds with the same financial risk and return characteristics.

4. ENERGY SECURITY, GREEN AND OTHER ESG ISSUES AND GEOSTRATEGIC CHALLENGES.

Energy insecurity, climate change and geopolitical challenges can influence in many ways the transmission mechanism of monetary policy in the pursuit of price stability or a dual mandate. They can do this either through aggregate supply or aggregate demand or both. Clearly, central banks should be fully aware of these potential sources of major shocks and allow for them in the design of their monetary policy rules for policy interest rates, the size and composition of their balance sheets, yield curve control & forward guidance for all instruments.

- But again, they should only target the fundamental drivers of these shocks if they can do so without prejudice to their financial stability mandate and their price stability or dual mandate.
- Adaption: yes; mitigation: highly unlikely.