Opening Remarks at Advances in Monetary Economics Conference

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Hello and good morning to everyone.

I am Tobias Adrian, Financial Counselor and Director of the Monetary and Capital Markets Department at the IMF.

It is a great pleasure to welcome you to the third edition of the “Advances in Monetary Economics” conference organized by the Monetary and Capital Markets Department jointly with the Research Department here at the IMF.

The purpose of this conference series is to highlight new research and spur discussions on topics relevant for the conduct of monetary policy. In the current inflationary environment, it is particularly important to obtain insights from rigorous academic research, and I hope this conference will provide a fruitful forum. This year’s conference focuses on topical issues for monetary policy: the drivers of inflation dynamics and inflation expectations; monetary policy tradeoffs under uncertainty; as well as spillovers and emerging market issues. Let me touch briefly on each of these issues and how they will be covered in each of the sessions.

The first session of today’s conference will feature two papers discussing inflation pass-through to wages, as well as how price changes impact firms’ expectations using a new dataset from Chile. Both of these papers are timely, given the inflation surge, but the current juncture is also unique. The COVID-19 pandemic likely reduced both potential labor supply—as workers exited the labor force—as well as potential output. One implication of this that policymakers are currently grappling with is the likelihood that the natural rate of unemployment—the rate of unemployment at which inflation is not accelerating—is higher than prior to the pandemic, creating a tighter labor market. Further supply shocks through capacity constraints at the sectoral level, global supply chain disruptions, as well as commodity shocks from the war in Ukraine have all contributed to rising prices. At the same time, we have an unprecedently large demand shock. Pent-up consumption demand and savings by consumers, in combination with aggressive monetary and fiscal policies aimed at mitigating the COVID recession and speeding the recovery, have fueled the recent rise in inflation as well. How inflation dynamics persist and how these will feed through into expectations is of primary importance for policymakers.

Inflation was initially expected to decline rapidly once supply shocks eased. Apart from the unique combination of shocks driving the surge in inflation, policymakers and market participants alike consistently underestimated inflation, in part due to the one of the pre-COVID building blocks of current modeling frameworks: the flat Phillips curve. The Phillips curve relates real activity to inflation, and empirical evidence has consistently suggested—at least, prior to the COVID pandemic—that the slope of this equation is very low. Central banks took advantage of this empirical fact to aggressively loosen monetary policy after recessions, since there did not seem to be a risk of broad-based inflation overshooting its target as a necessary tradeoff to reducing unemployment and increasing output. As a

result, inflation forecasts tended to under-predict inflation. Now, new ways of thinking about the Phillips curve relationship are necessary.

The second session of this conference addresses this structural modeling issue through different approaches. One paper presents a plucking model, where the economy can fluctuate asymmetrically around the natural rate of unemployment, implying the policymaker's ability to influence the average level of activity. A second paper explores the implications from a kinked Phillips curve as a way of explaining the current inflationary environment.

In response to the surge in inflation, central banks have tightened aggressively, both through actions and communications—much faster than anticipated at the end of last year. Even if inflation comes down more quickly than central banks envision, inflation risks appear to be strongly tilted to the upside: there is a substantial risk that high inflation becomes entrenched and that inflation expectations deanchor. This is evidenced by market-based expectations of inflation, where significant odds are placed on the possibility that inflation will exceed central bank targets for several years. As a consequence, central banks will have to be more resolute and tighten more aggressively to cool demand, raising unemployment, and, in a context of already poor liquidity, implying significant spillovers to emerging market economies.

Our third session, therefore, focuses on spillovers to emerging market economies. Less well-anchored inflation expectations, more precarious fiscal positions, and exposure to commodity price shocks and exchange rate pressures imply worse policy tradeoffs for EM central banks in the effort to combat inflation. In this session, we will have two papers that explore some implications of monetary policy for exchange rates, as well as some spillovers from US monetary policy to emerging market economies.

A final panel with policymakers and academics will discuss some views on inflation, while critically assessing the hitherto monetary response to the surge in inflation, as well as lessons for policy in the near term. The panel will also discuss the interactions between fiscal and monetary policies in the current environment with high commodity shocks.

The topics to be covered in today's conference are challenging but extremely relevant for policy in the medium term. We hope that this conference will continue to offer a forum for fruitful discussion to push our thinking on these issues forward. We have an excellent lineup of speakers that I look forward to hearing from today, and I would like to encourage audience participation at every stage today.

With that, let me welcome you again and give the floor to Chris Erceg, Deputy Director in MCM who will moderate the first session today.