# Three Uncomfortable Truths for Monetary Policy

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# Three uncomfortable truths

1. Inflation is taking too long to get back to target
2. Financial stresses could generate tensions between central banks' price and financial stability objectives
3. Central banks are likely to experience more upside inflation risks than before the pandemic

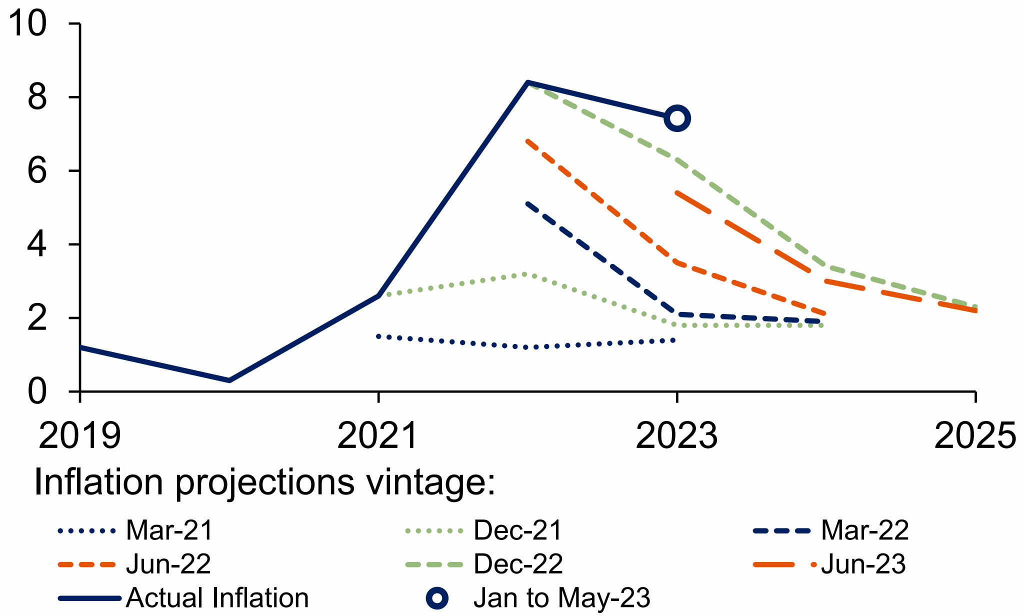
# #1. Inflation is taking too long to get back to target

# Waiting for Godot

## Bringing inflation back to target has proved elusive

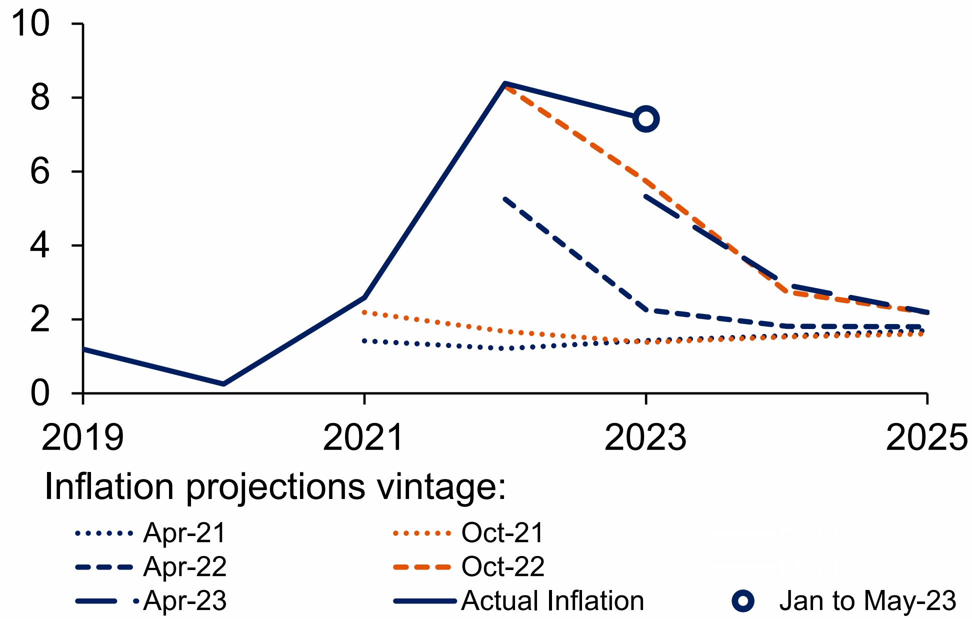
**ECB Inflation projections and actual inflation**

*(percent)*




**WEO Inflation projections and actual inflation**

*(percent)*



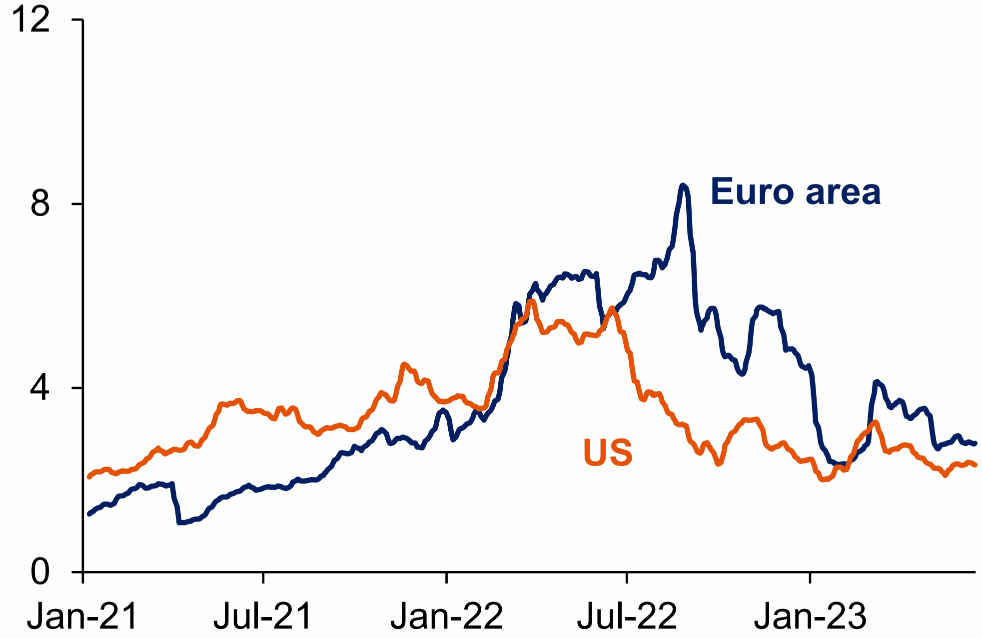

Sources: ECB Statistical Data Warehouse, IMF World Economic Outlook, and IMF staff calculations
Note: Inflation projections and actual inflation are annual, except Jan to May-23, which is the average of year-over-year inflation for the months of January to May 2023.

# Financial markets optimistic about inflation

## Markets have a benign inflation outlook…

**One-year inflation swaps for Euro area and US**

*(percent, 5-day moving average)*

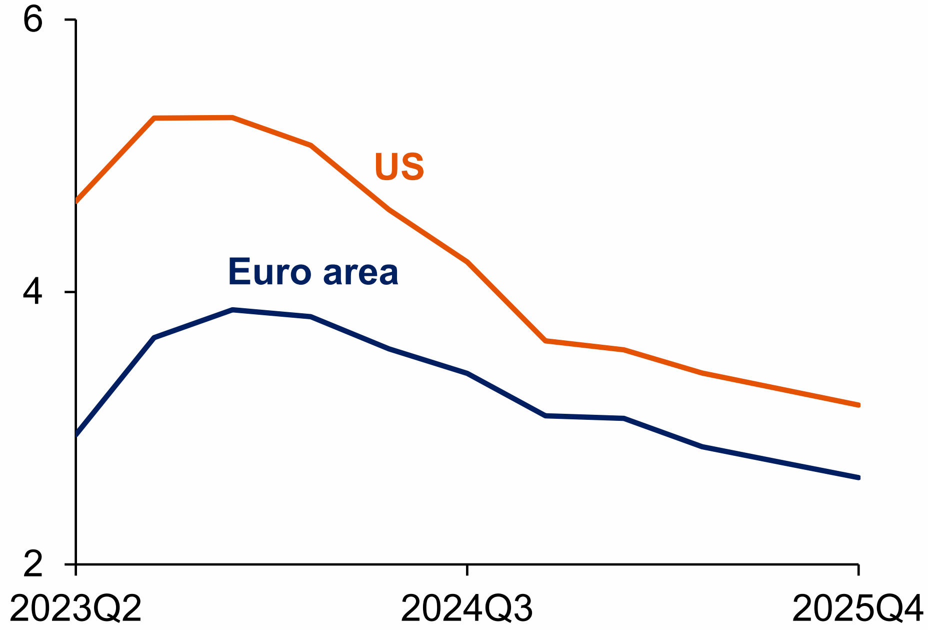



Sources: Bloomberg Finance L.P., and IMF staff calculations.
Last observation is June 15th, 2023.

## … and expect rates to decline soon

**Expected path for short-term interest rates**

*(percent, period average; June 16 to June 22, 2023)*



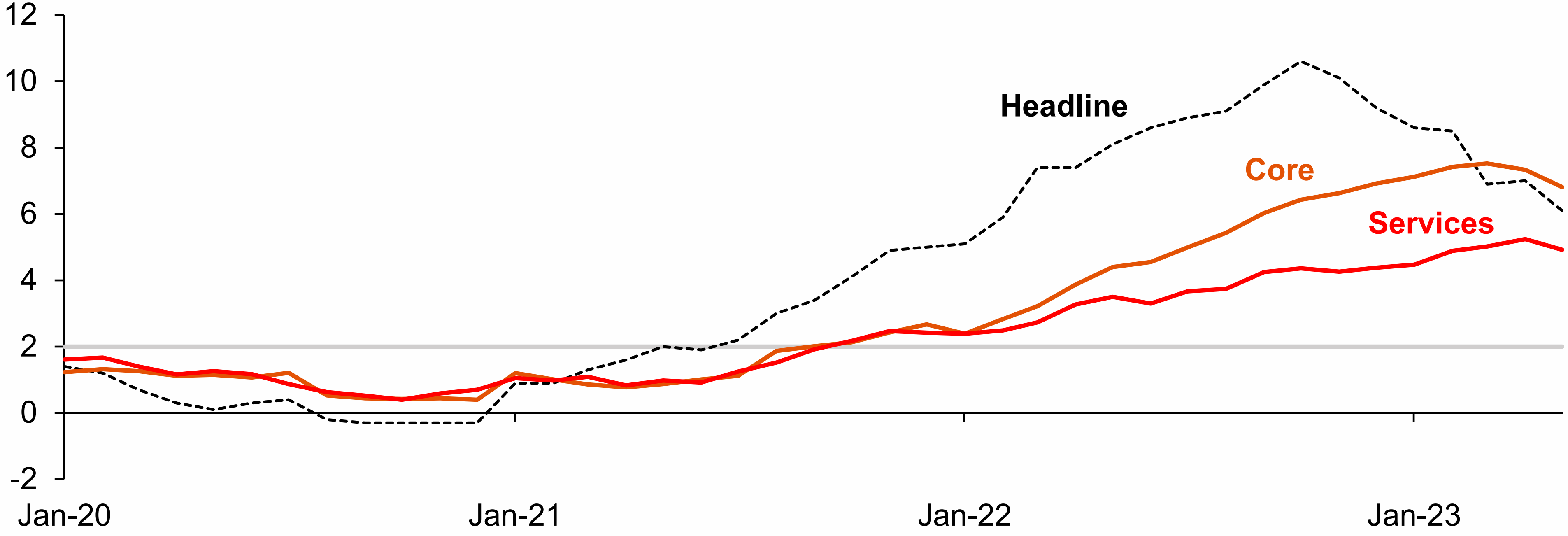

Sources: Bloomberg Finance L.P., and IMF staff calculations.
Note: The interest rate is the ESTR 1M forward rate for the euro area and the SOFR 1M forward rate for the United States.

# Inflation pressures remain broad-based

## While headline inflation has eased significantly, inflation in services has stayed high

**Euro area: headline, core, and services inflation**

*(percent)*

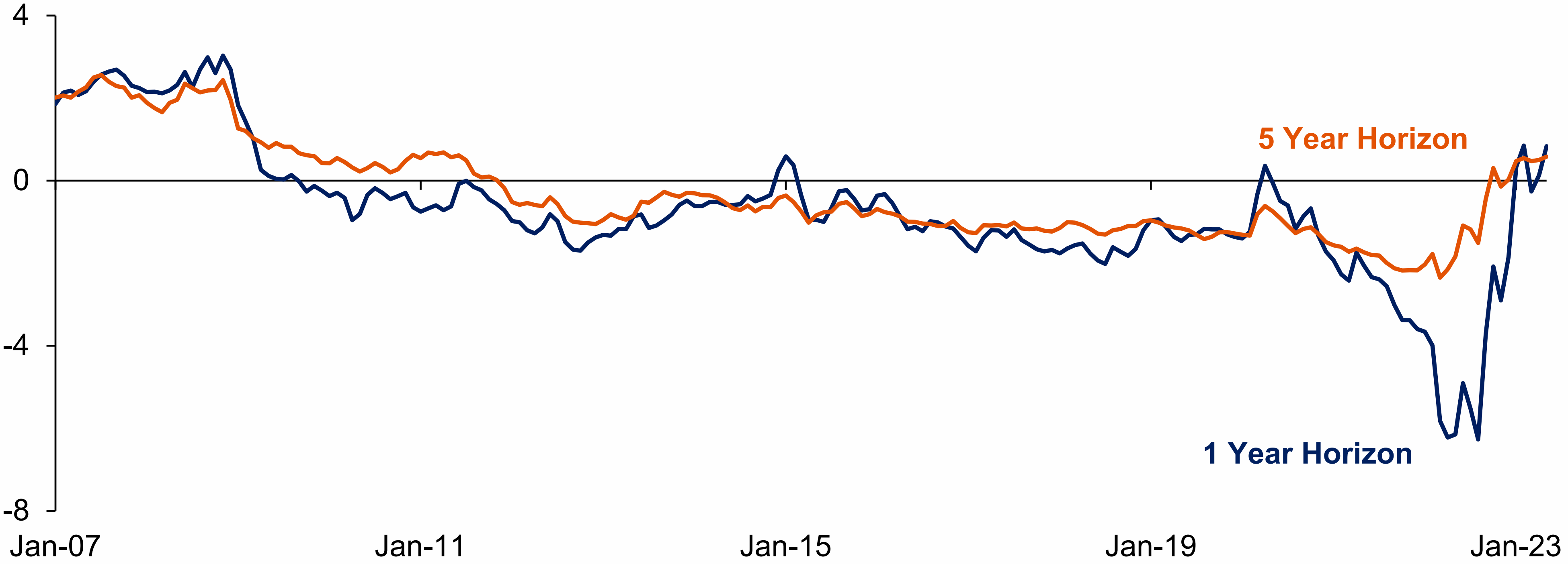



Source: ECB Statistical Data Warehouse
Note: Core inflation excludes energy and unprocessed food.

# Real rates sufficiently high?

**Euro area: real interest rate, market-expectations-based**

*(percentage points)*




Sources: Bloomberg Finance L.P., and IMF staff calculations
Note: The one-year real interest rate is the one-year interest rate based on interest rate swaps where the floating rate is the 3-month EURIBOR rate, less one-year ahead inflation expectations based on zero coupon inflation swaps.

# #2. Financial stresses could generate tensions between central banks' price and financial stability objectives

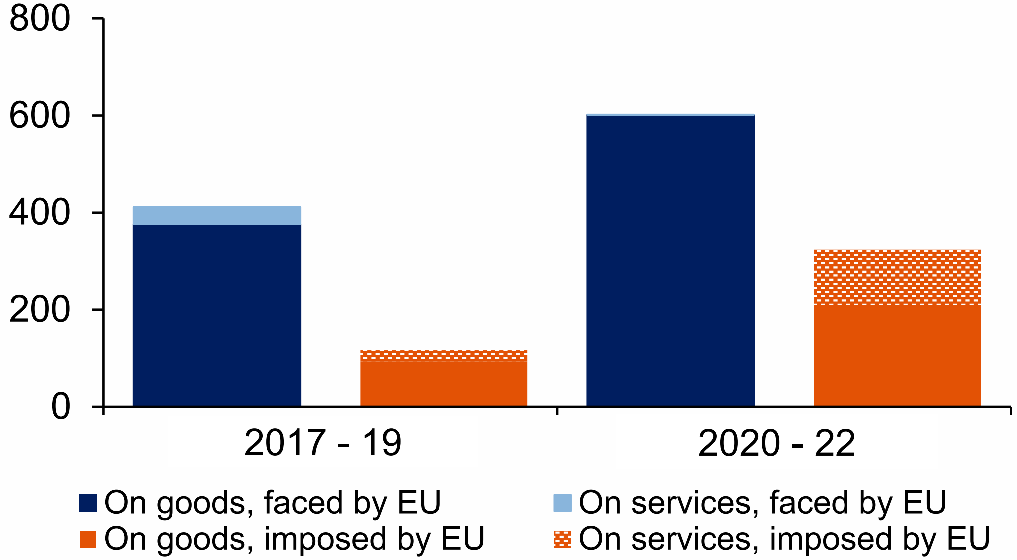
# #3. Central banks likely to experience more upside inflation risks than before the pandemic

# Supply shocks in the future could be more frequent and severe

## Trade and FDI restrictions have increased

**Trade and FDI restrictions**

*(Average number of new restrictions faced and imposed)*

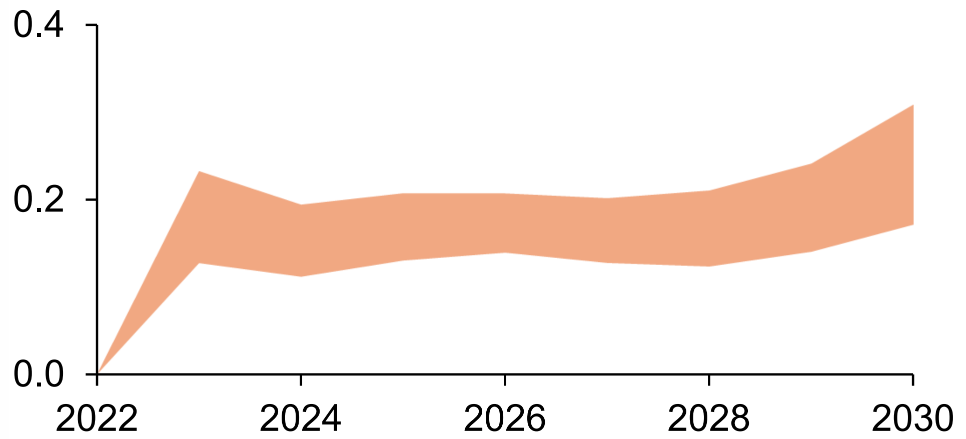



Sources: April 2023 Regional Economic Outlook for Europe

## The climate transition likely to be mildly inflationary, even with budget-neutral policies

**Euro area: Range of impact of GHG-emission-reducing package on headline inflation**

*(percentage points)*



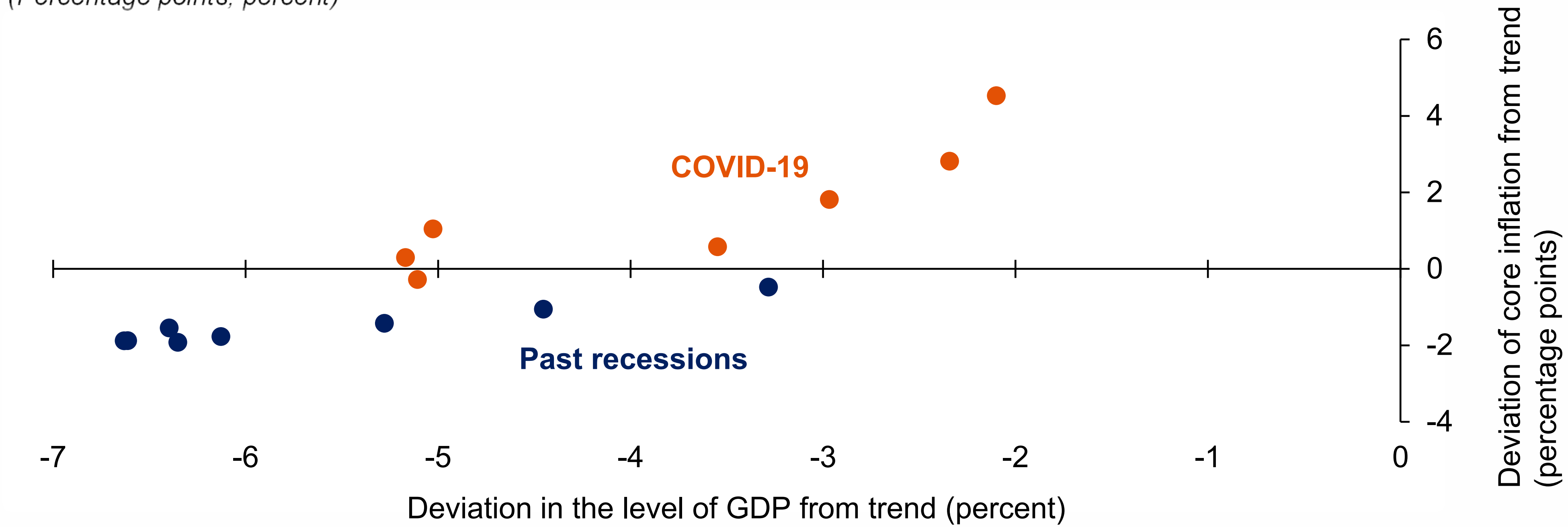

Sources: October 2022 World Economic Outlook, Carton and Natal (2022)
Note: The budget-neutral policy package includes GHG taxes and achieves a 25 percent reduction in emissions by 2030.

# Phillips Curve not reliably flat

## The Phillips curve steepened rapidly post-COVID-19

**Advanced economies: Deviations of core inflation and GDP from trend**

*(Percentage points; percent)*




Sources: Gudmundsson and others (forthcoming), Haver, IMF staff estimates.
Note: The chart shows the average response of core inflation and level of GDP to past recessions between 1990Q1 and 2022Q1 estimated using local projections on a panel of 30 advanced economies. Each data point represents the average GDP and inflation response across countries at each of the first seven quarters into a recession. For COVID-19, it shows the estimated responses from 2020Q3 to 2022Q1. Core inflation is measured as quarter-on-quarter change in core CPI expressed as annual rate.

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