MONETARY POLICY: FROM THE PANDEMIC CRISIS TO NEW CHALLENGES THE ECB AND ITS WATCHERS XXII

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> 17th of March, 2022 Panel debate Frankfurt, Germany

The Phillips curve framework

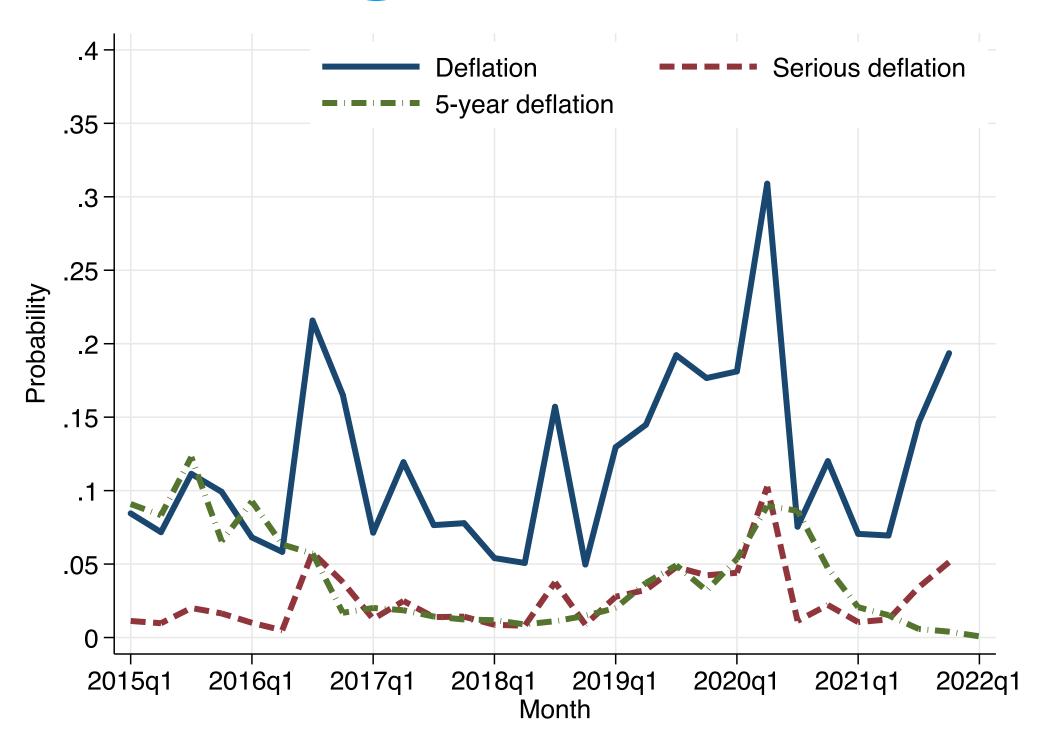
$$\pi = \pi^e + \beta(y - y^*) + \varepsilon$$

Inflation = Expected Inflation + Activity "gap" + Cost-push shock

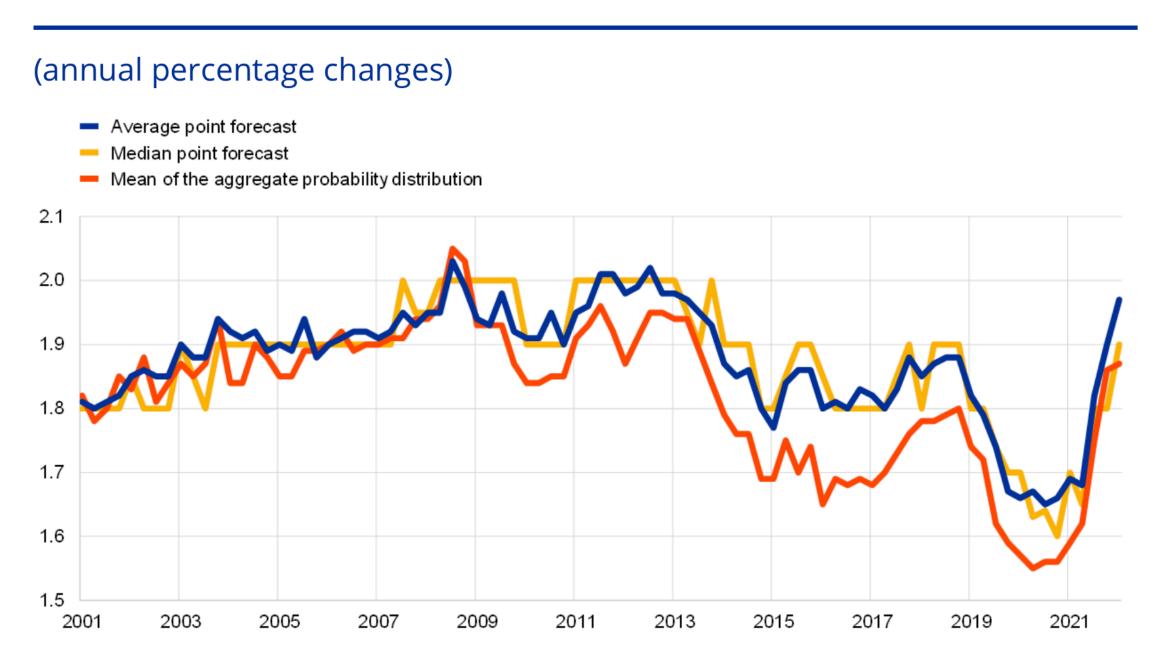
- By itself, an <u>organizing framework</u>, not a model (just part of one)
 - Measurement
 - Separate terms
 - Causality
- Horizon: in long-run, only expected term survives
- Focus on tail risks: deflation and high inflation

Challenge 9-12 months ago

$$\pi = \pi^e + \beta(y - y^*) + \varepsilon$$



Longer-term inflation expectations



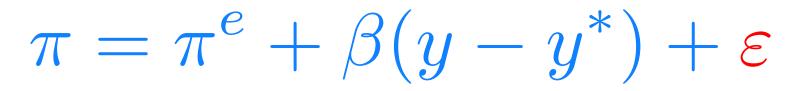
Re-anchor inflation expectations to be on average 2%: loose policy

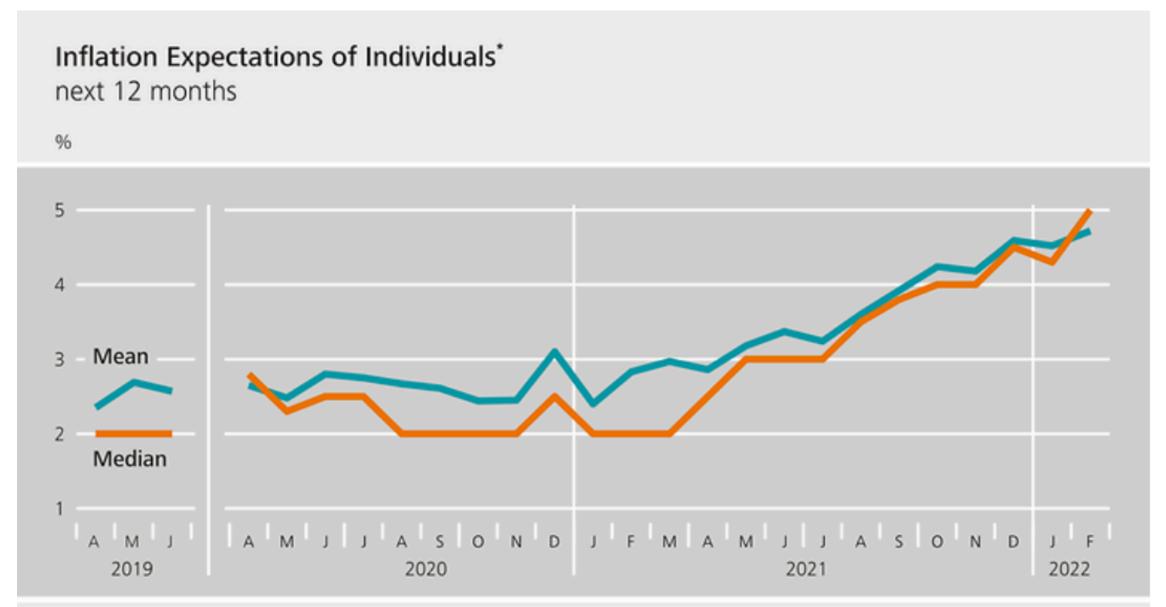
Practice: consider base effects, some catch up

Theory: r*, liquidity traps.

History: Japan 2001

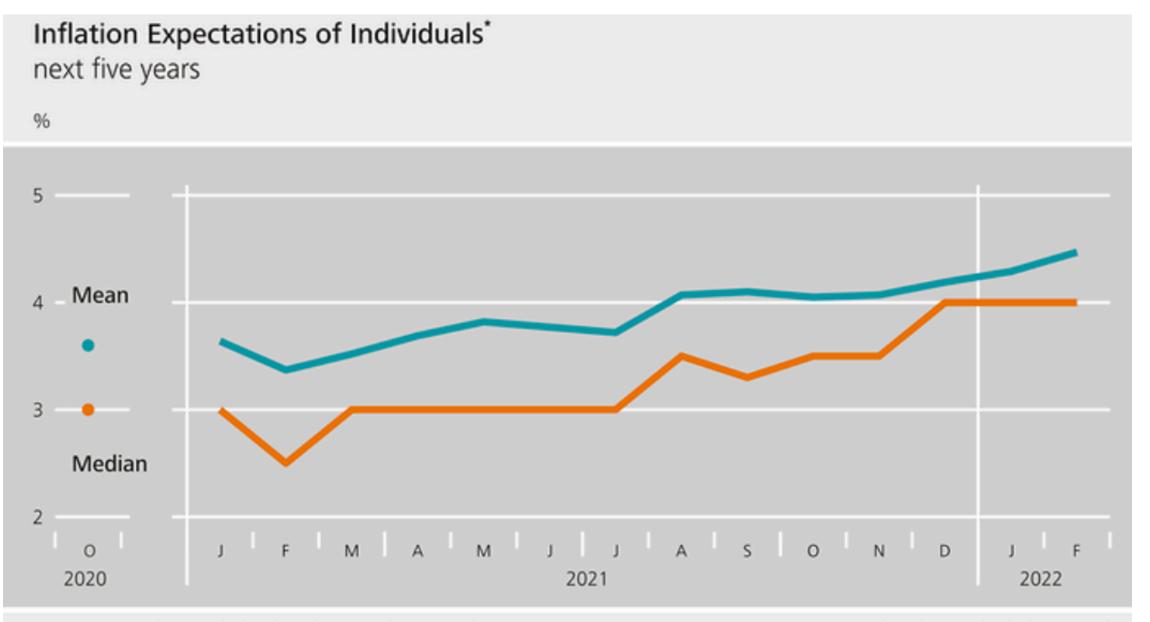
Challenge 3-6 months ago





Source: Deutsche Bundesbank Online Panel Households (BOP-HH). * Question: What do you think the rate of inflation/deflation will roughly be over the next twelve months? Calculations are based on inflation expectations within the interval – 12% to + 12%. Respondents are given the following note: Inflation is the percentage increase in the general price level. It is usually measured by the consumer price index.

Deutsche Bundesbank



Source: Deutsche Bundesbank Online Panel Households (BOP-HH). * Question to participants: What value do you think the rate of inflation or deflation will take on average over the next five years? Calculations are based on inflation expectations within the interval – 12% to + 12%.

Deutsche Bundesbank

Bottlenecks interpreted as shocks

Emphasis: filter out relative prices, bet they are temporary. Loose

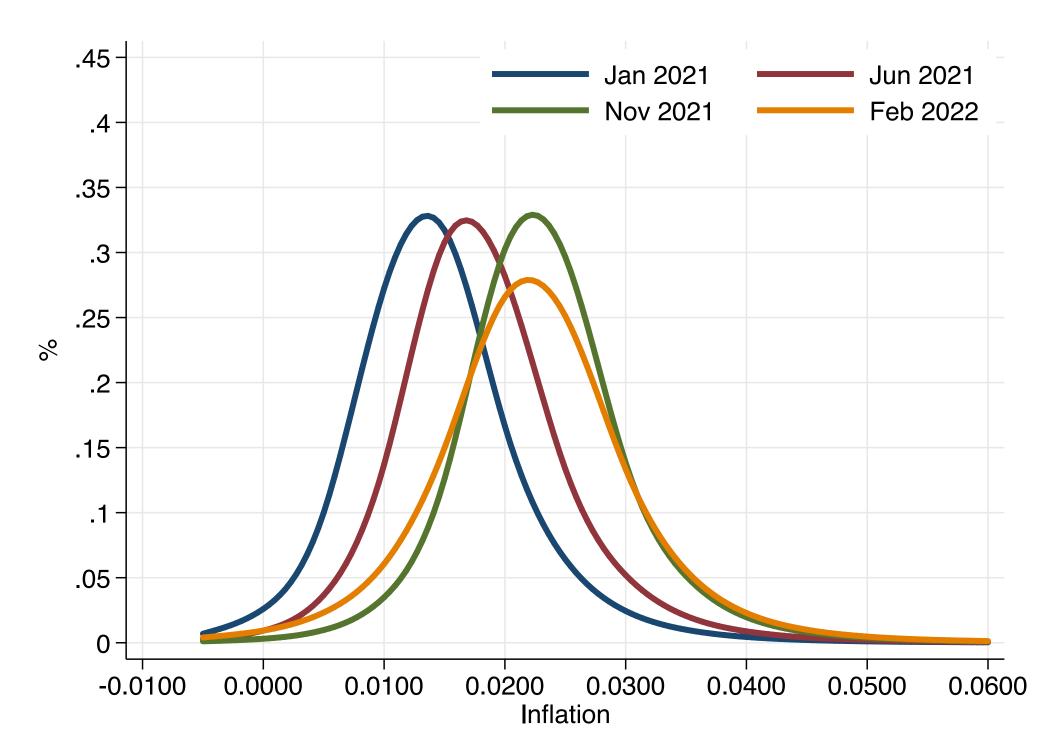
But: people form expectations on prices, rise in mean and fall in skew. Gradual

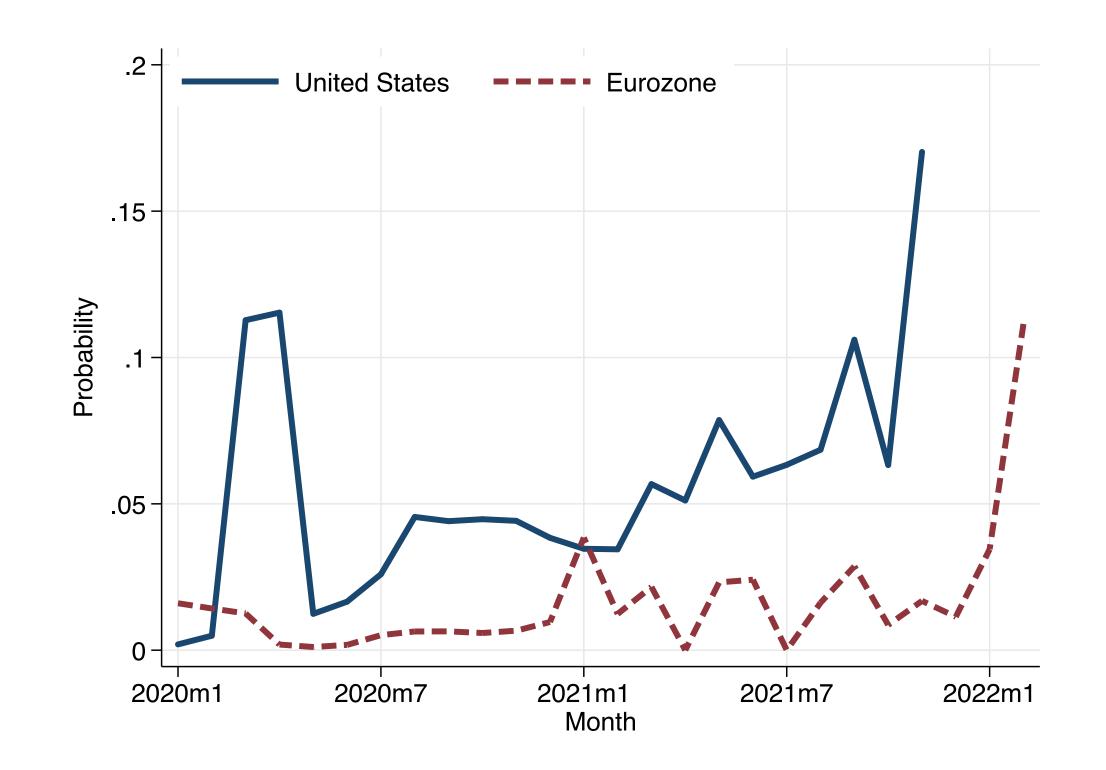
But: if shocks to production potential, keep inflation on target. Tighten

Sources: Bumdesbank

Challenge today

$$\pi = \pi^e + \beta(y - y^*) + \varepsilon$$





Large, maybe persistent, energy shock

Focus on core, don't make the classic oil⇒tighten⇒recession. Gradual

Trade off higher inflation for smaller recession only gos so far. Tighten

Expectations unanchoring, inattention and hockey sticks. Hard tighten

Sources: Hilscher, Raviv Reis (2022),