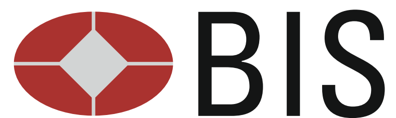

Have the nature and magnitude of economic cycles changed? Supply headwinds and monetary policy

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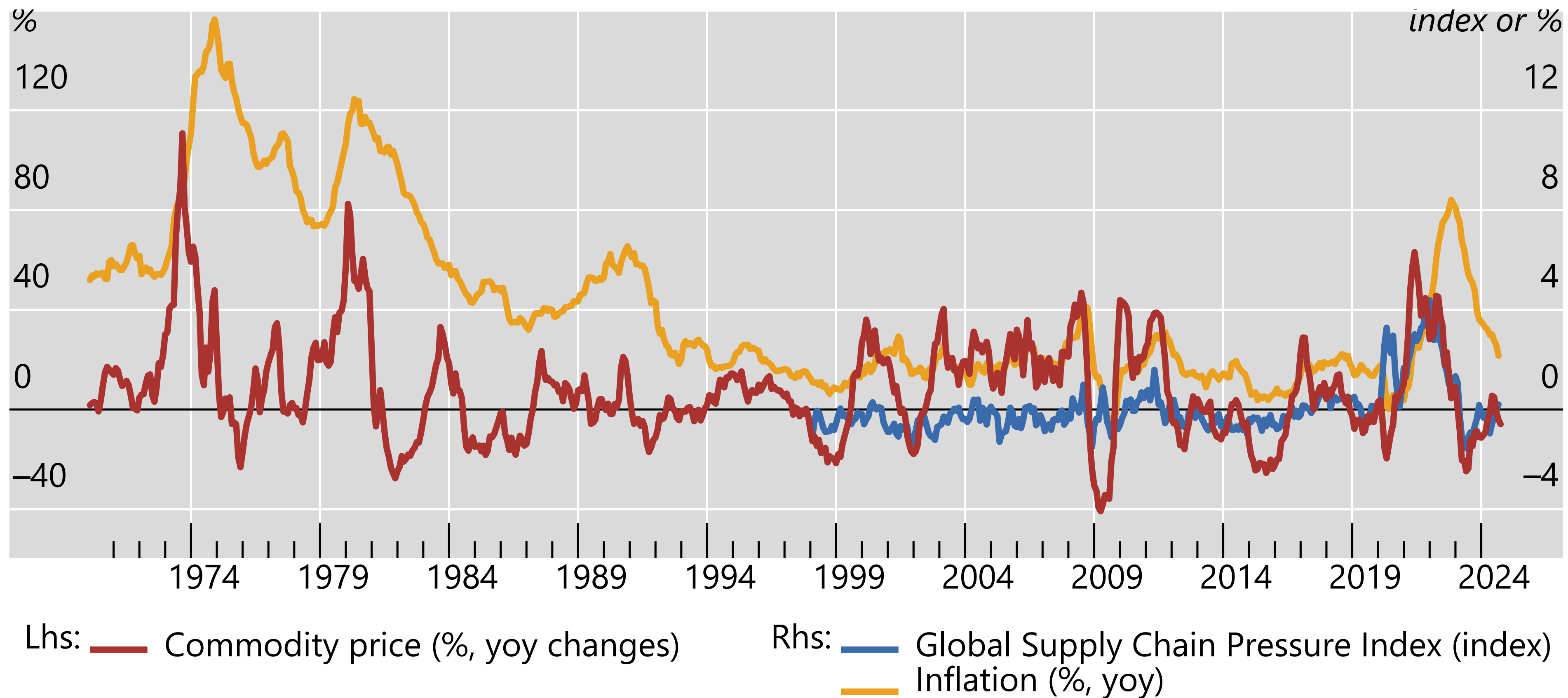
Backdrop



- Post-pandemic inflation surge was associated with major supply headwinds
- Following three decades of low and stable inflation in advanced economies associated with supply tailwinds (in particular globalisation)

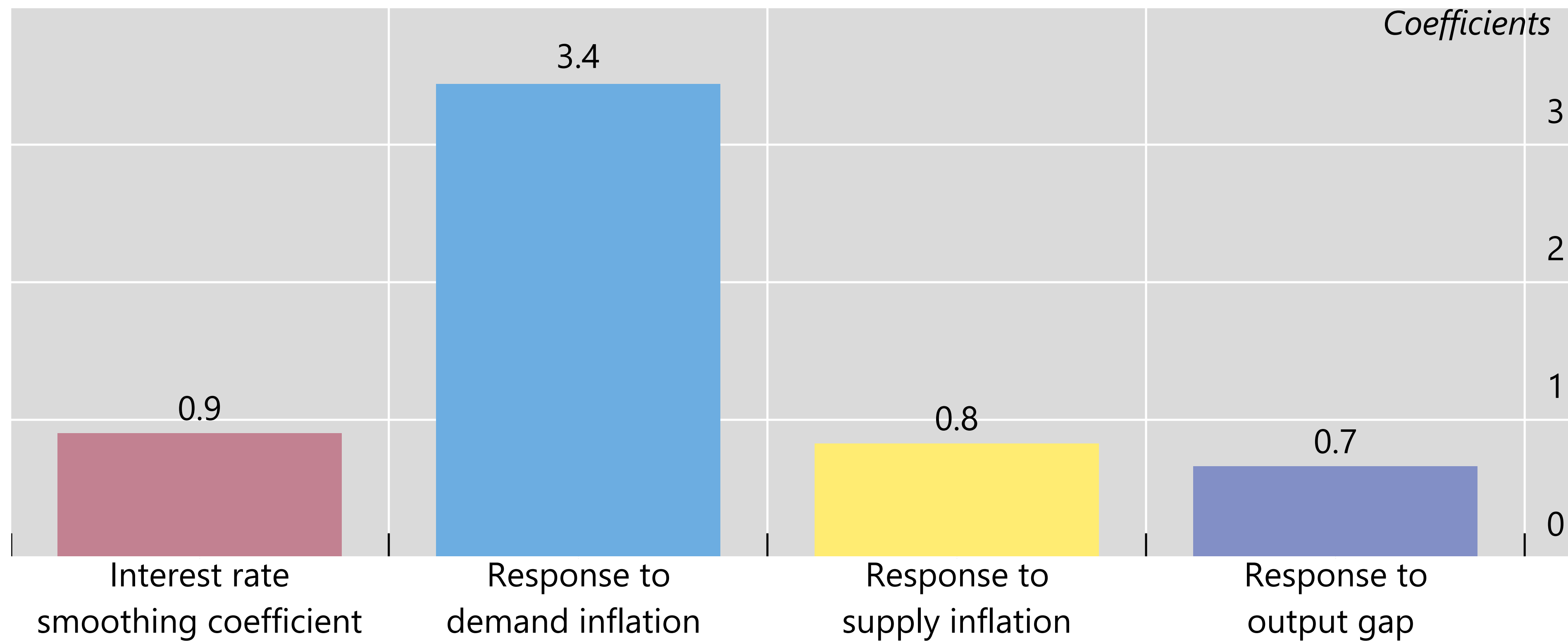
Risk of larger and more frequent adverse supply shocks

- Geopolitical tensions may prove to be persistent or even increase further
- Supply shocks could also come in new guises due to the green transition and climate change
- Adverse supply shocks may also become more persistent and have long-lasting or even permanent effects on production capacity

Less elastic and more restrained supply

- Several factors may render supply less elastic and restrain it
  - Globalisation has slowed in recent years and is potentially already in retreat
  - Adverse demographic trends with shrinking labour force
- Less elastic supply implies that all shocks, both demand and supply, would have larger effects on inflation
- More restrained supply could also imply greater underlying inflationary pressures

Monetary policy and supply shocks: the practice of "looking through"



- Central banks reacted much less to supply-driven inflation than to demand-driven inflation

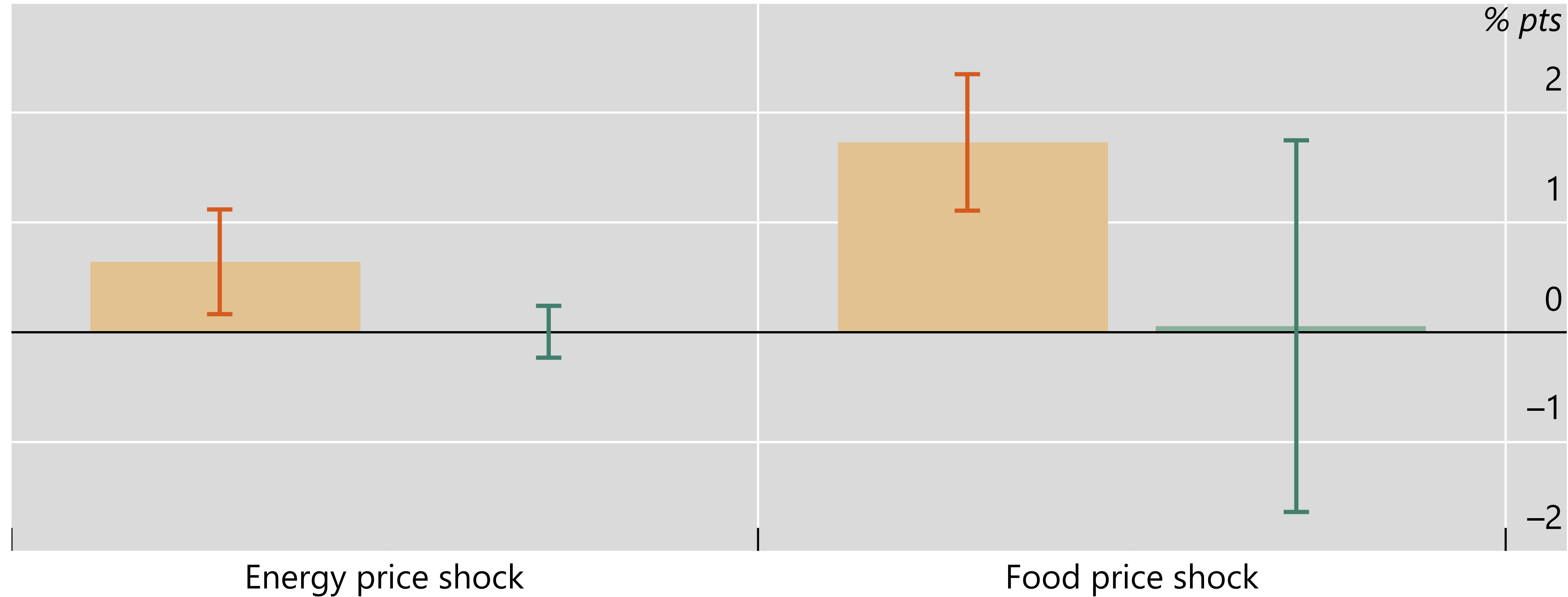
What can explain the “look through” approach? And what might have changed?

1. Supply shocks have tended to be transitory
   - Especially commodity price shocks
     - Could become more persistent

2. Trade-offs associated with supply shocks
   - Adverse supply shocks push prices up and output down
     - Could improve on the back of steeper AS/Phillips curves

3. Anchored inflation expectations
   - Low risk of second-round effects when inflation expectations are anchored
     - Could increase on the back of more frequent adverse shocks and greater underlying inflationary pressures

Commodity price shocks raise inflation expectations when inflation is already high



- When households and businesses are already feeling the effects of inflation, de-anchoring risk is higher

Implications for monetary policy

- Possibly lesser scope to look through adverse supply shocks (and to accommodate/engineer expansionary demand shocks)
- Bright side: Stabilising inflation could have more limited effects on real activity if Phillips curves are steeper