



Navigating fragmentation, conflict, and large shocks

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Overview and key issues

Direct and broader effects of Russia's invasion of Ukraine:

- Direct effects on Ukraine, neighbors, and the global economy
- Turning point for geoeconomic fragmentation and military spending
- Likely to make global economy more shock-prone

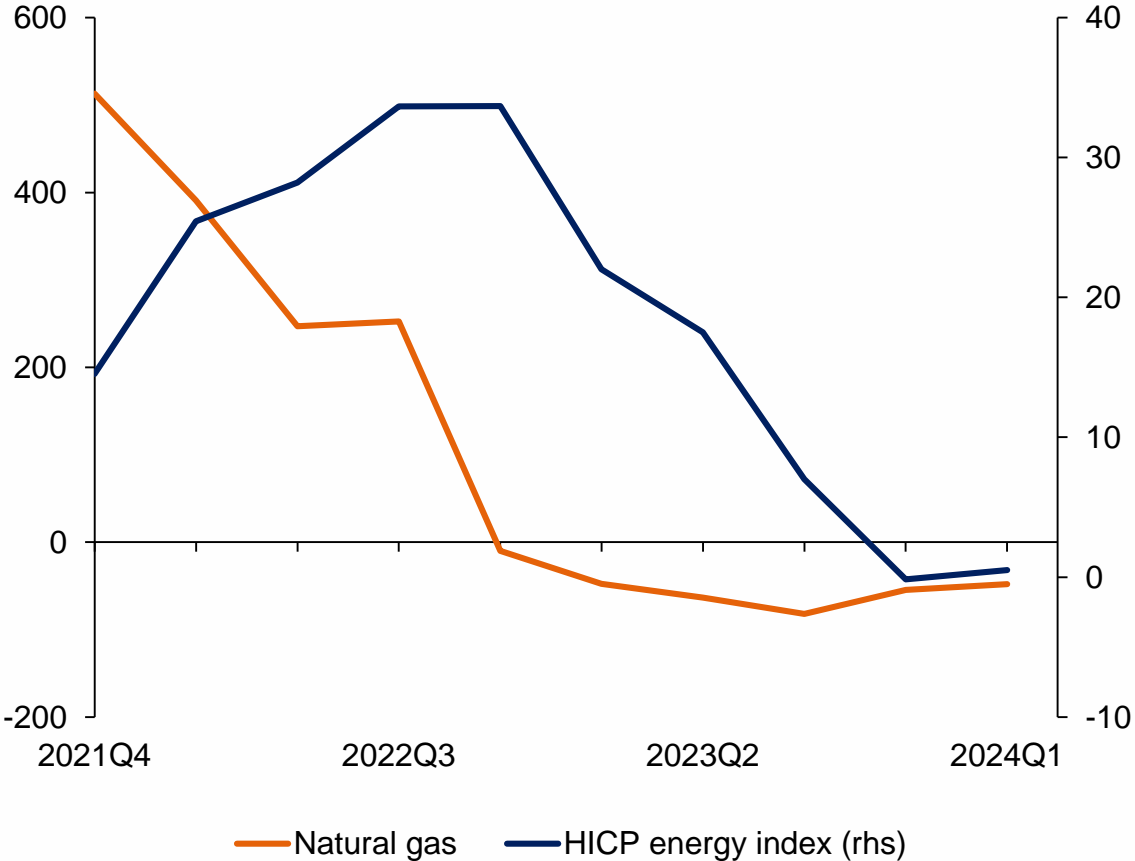
Policy implications:

- How should central banks conduct monetary policy in this environment?
- What is the role of additional tools such as foreign exchange intervention?
- How should fiscal, financial, and structural policies support economic and financial stability?

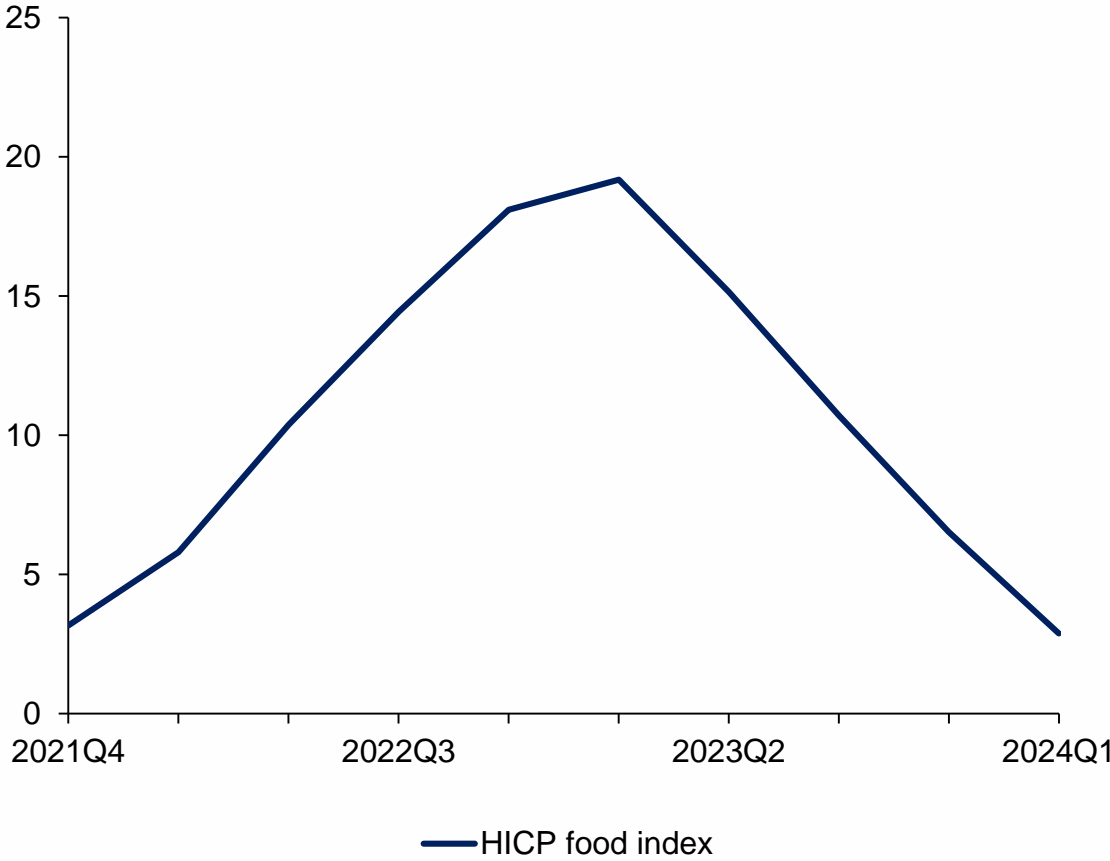
Effects of the war

Europe was hit by energy and food price shocks...

Growth in energy prices
(year-over-year, percent, EU aggregate)



Growth in food prices
(year-over-year, percent, EU aggregate)



Source: IMF Primary Commodity Price System, Haver Analytics, and IMF staff calculations

Source: Haver Analytics and IMF staff calculations

...which has contributed to inflation surges, especially in the CESEE region

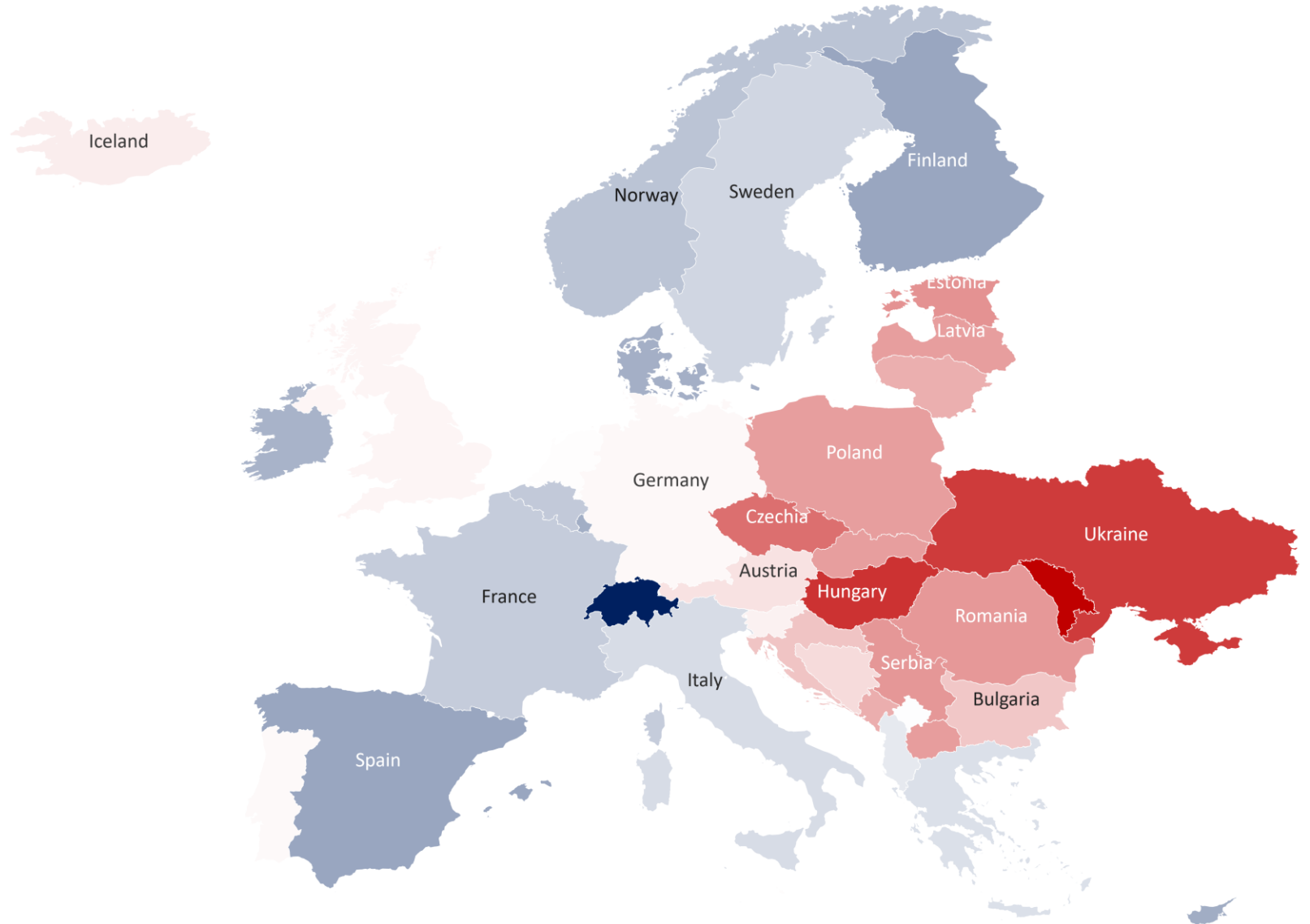
Headline inflation
(percent)

Cumulative index increase since December 2021



5%

40%



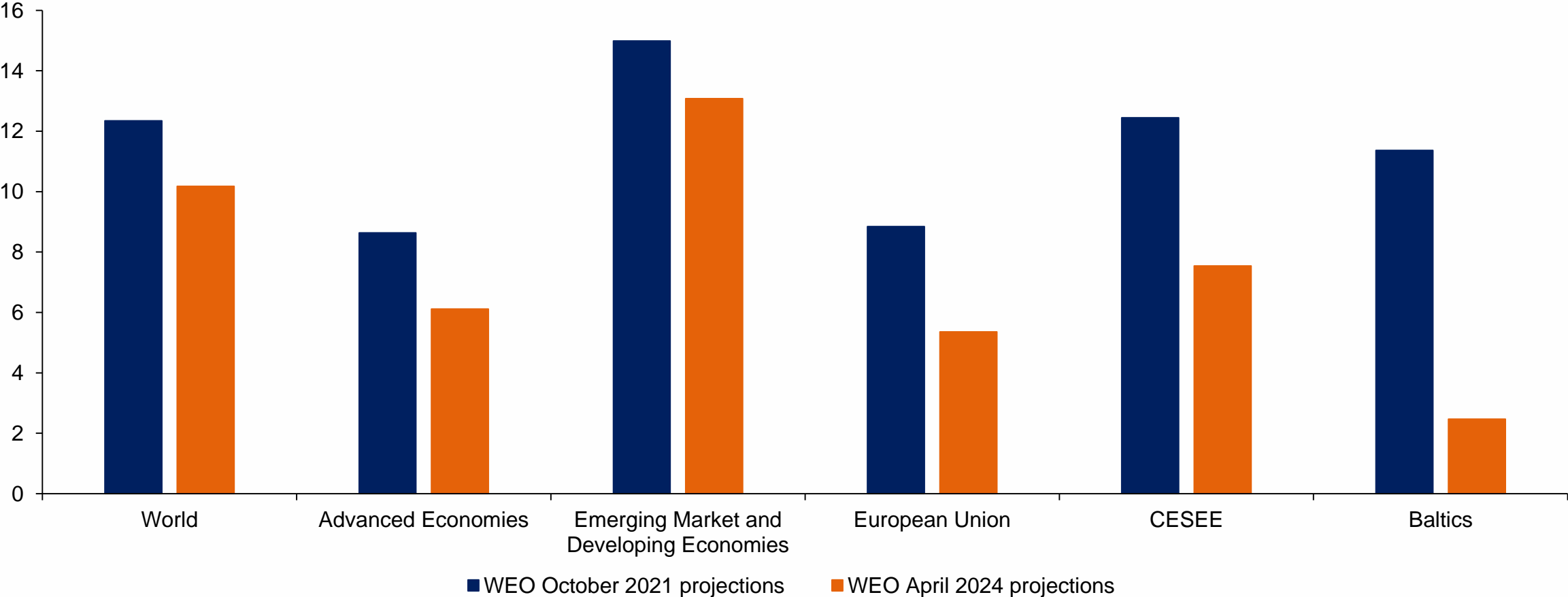
Source: Haver Analytics and IMF staff calculations

Note: HICP headline index. For BIH, GBR, MLD and UKR, national CPI indices are used.

Neighboring countries have experienced the largest setbacks to growth...

Real GDP Growth

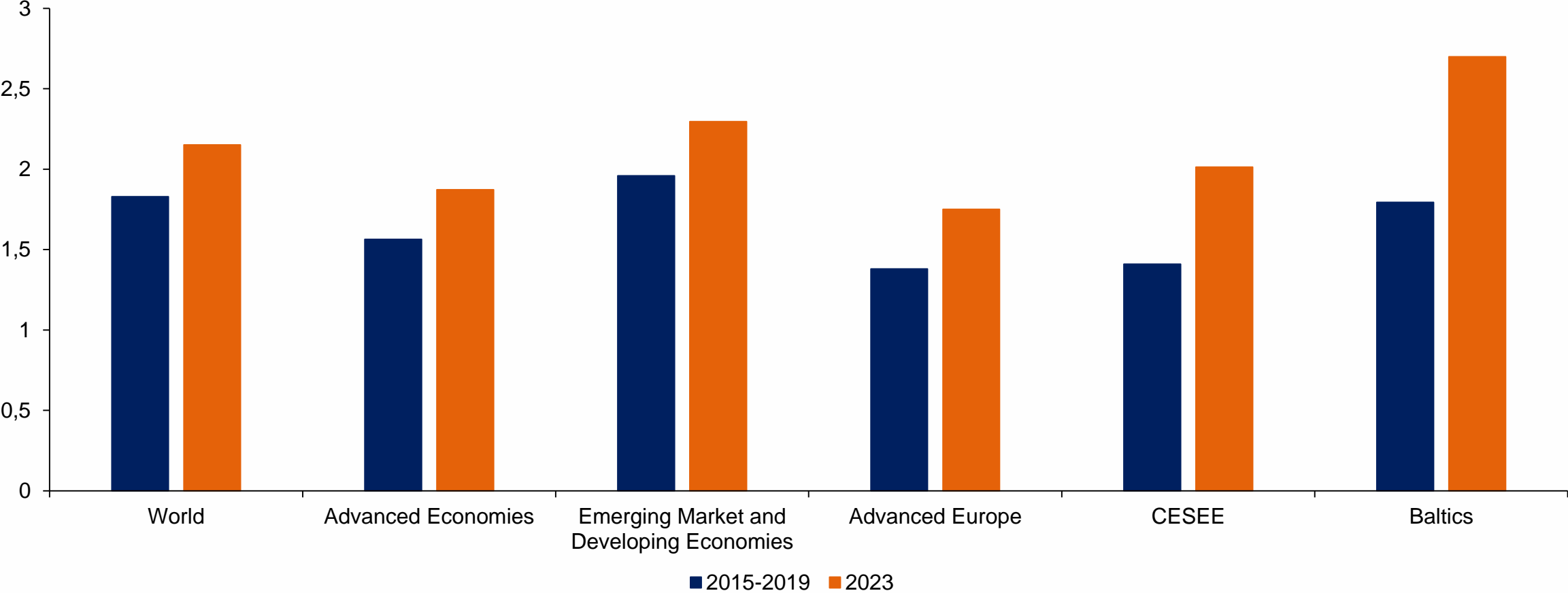
(cumulative growth, 2022-2024, percent, by WEO vintage)



Sources: World Economic Outlook and IMF staff estimates
Note: Central, Eastern and South-Eastern Europe (CESEE) excludes RUS, TUR, UKR, BLR, and MDA.

...while defense spending has been rising

Defense spending
(percent of GDP)

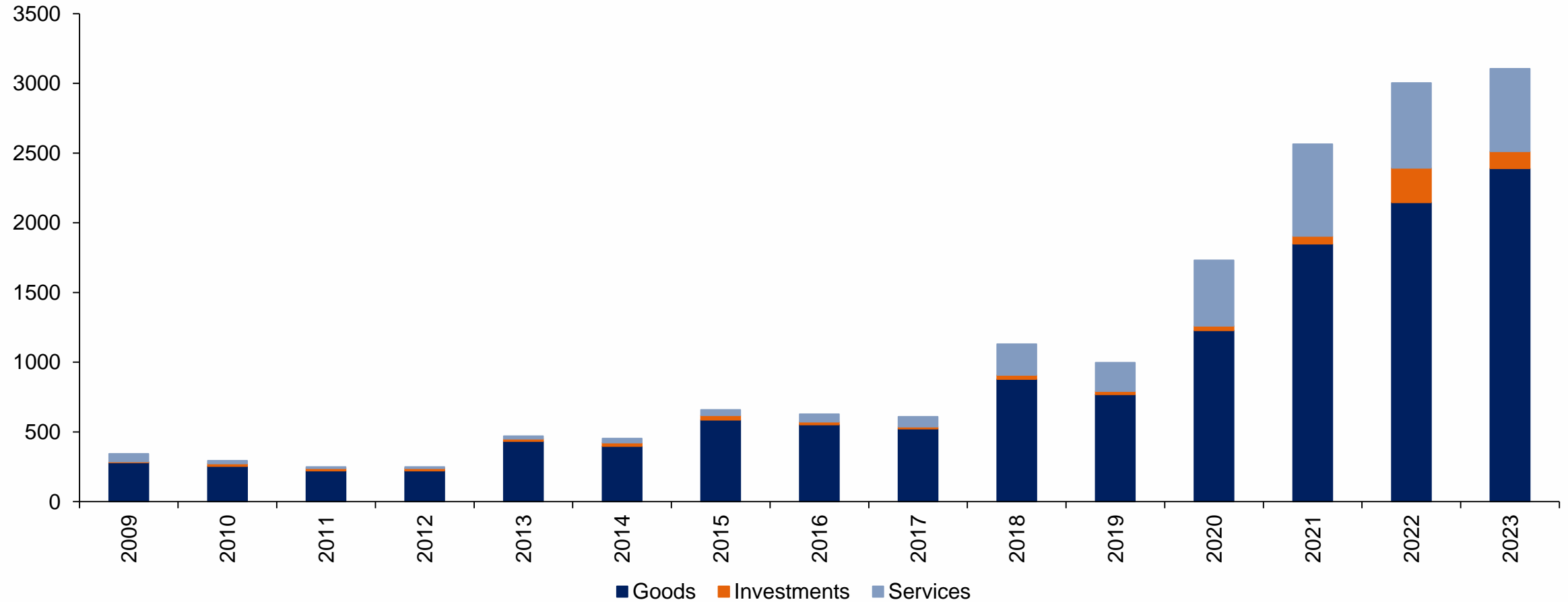


Sources: SIPRI, World Economic Outlook, and IMF staff calculations
Note: Central, Eastern and South-Eastern Europe (CESEE) excludes RUS, TUR, UKR, BLR, and MDA.

Fragmentation

A turning point for global fragmentation

New trade restrictions (number)



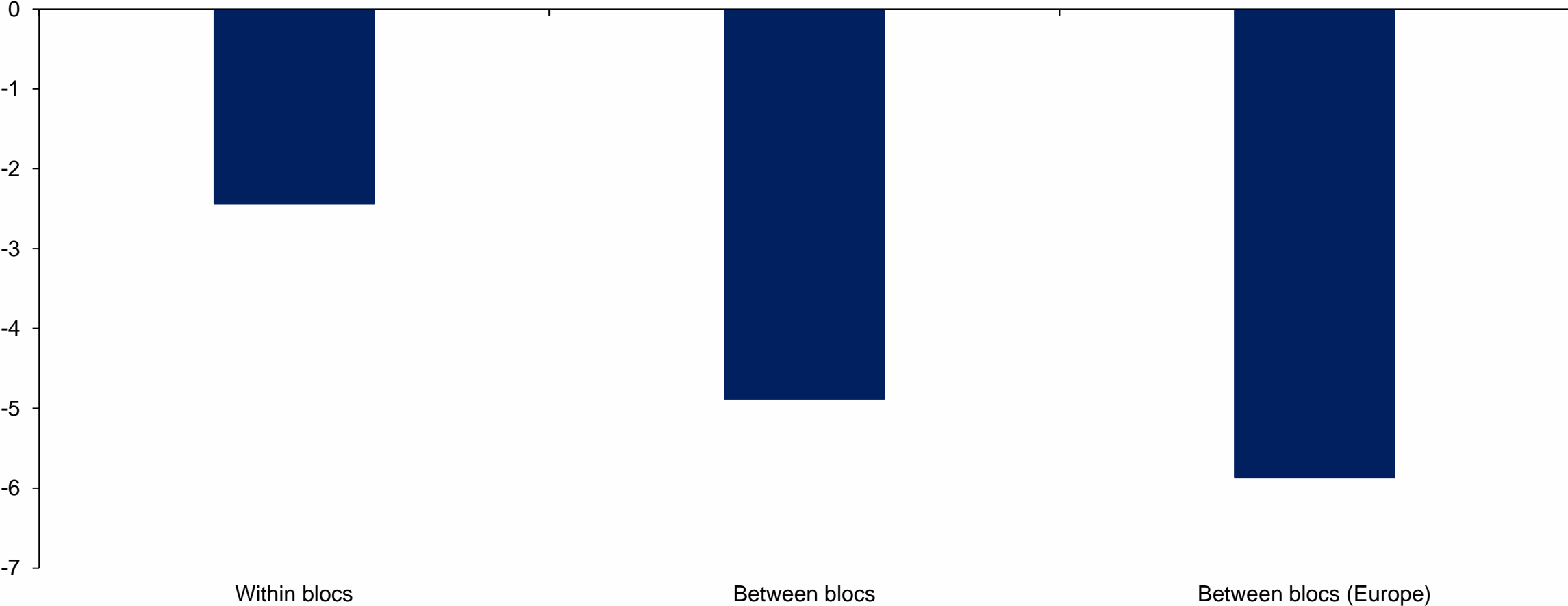
Source: Global Trade Alert

Note: Data accessed March 6, 2024; includes adjustment for reporting lags.

Fault lines in trade are emerging, with Europe more affected than other regions

Changes in trade growth

(difference between pre-war and post-war period, percentage points)

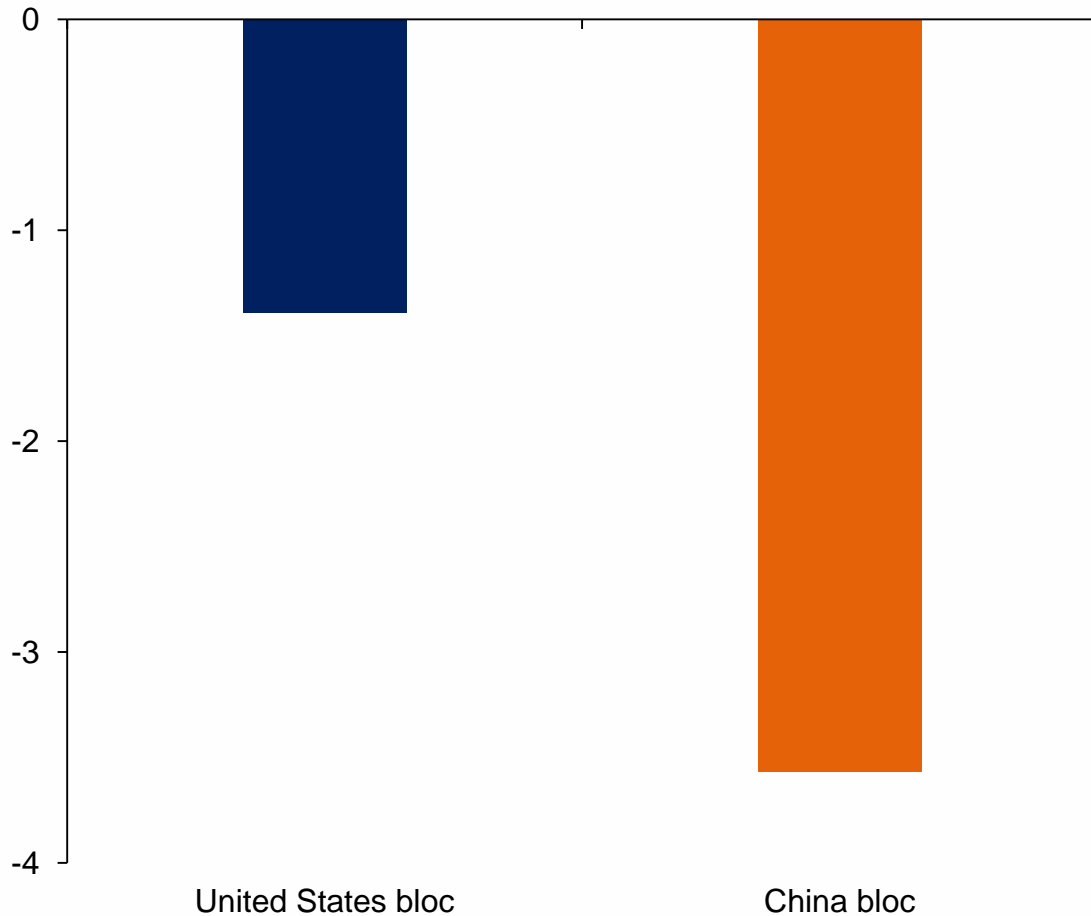


Source: Gopinath, Gourinchas, Presbitero and Topalova (2024); IMF staff calculations

Note: The chart plots the average trade growth during 2022Q2-2023Q3 minus the average trade growth during 2017Q1-2022Q1. Europe includes EU27 and CHE, GBR, ISL, NOR.

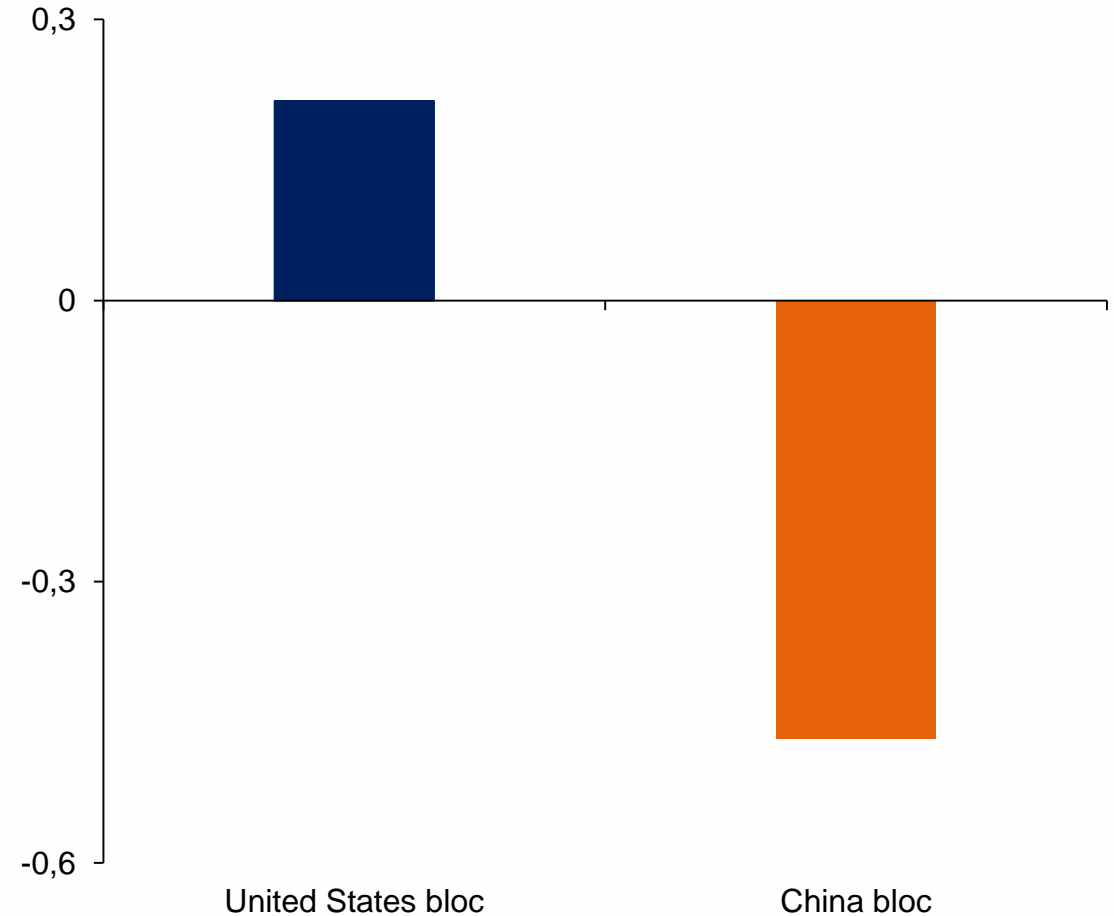
Fragmentation may impact output and the natural rate...

Long-term output impacts in an FDI fragmentation scenario
(percent deviation from baseline)



Source: IMF World Economic Outlook, April 2023, Chapter 4, and IMF staff calculations

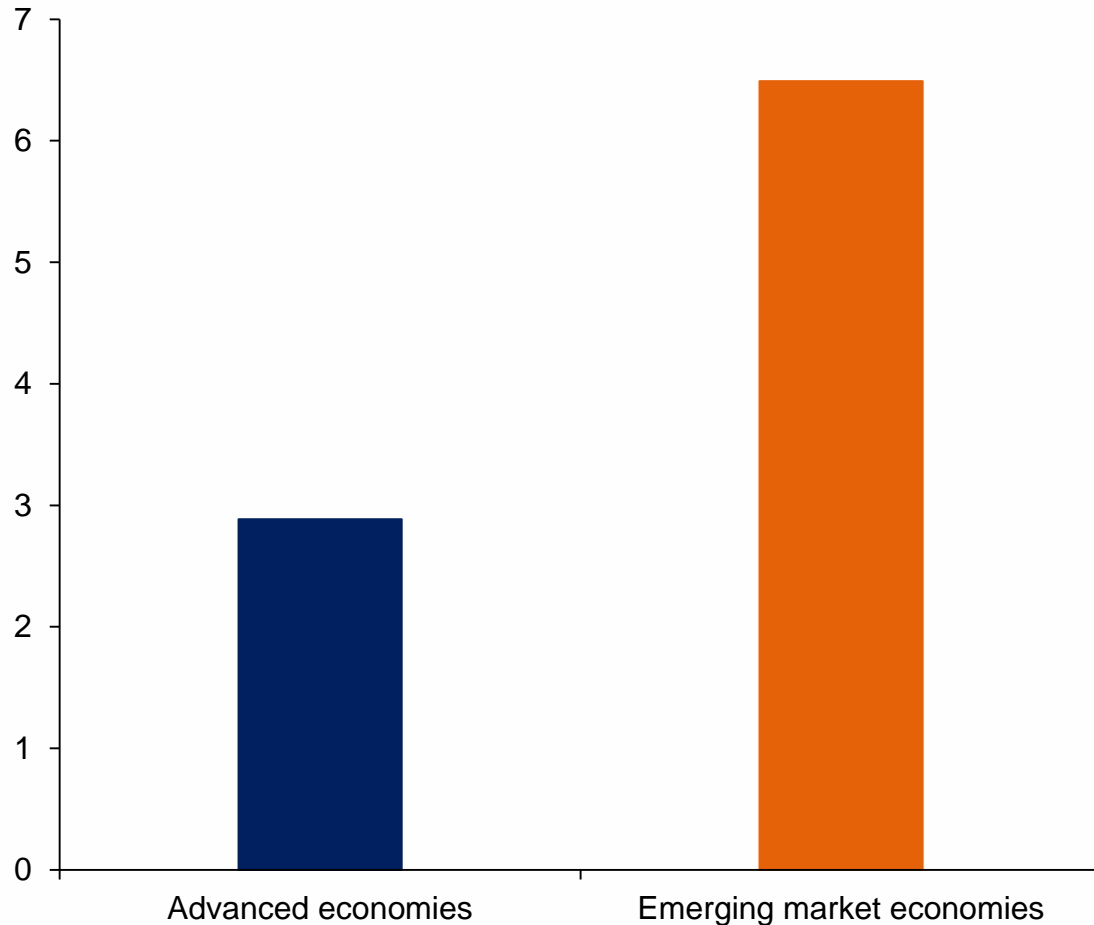
Long-term impacts on real interest rates in a financial fragmentation scenario
(deviation from baseline, in percentage points)



Source: IMF World Economic Outlook, April 2023, Chapter 2

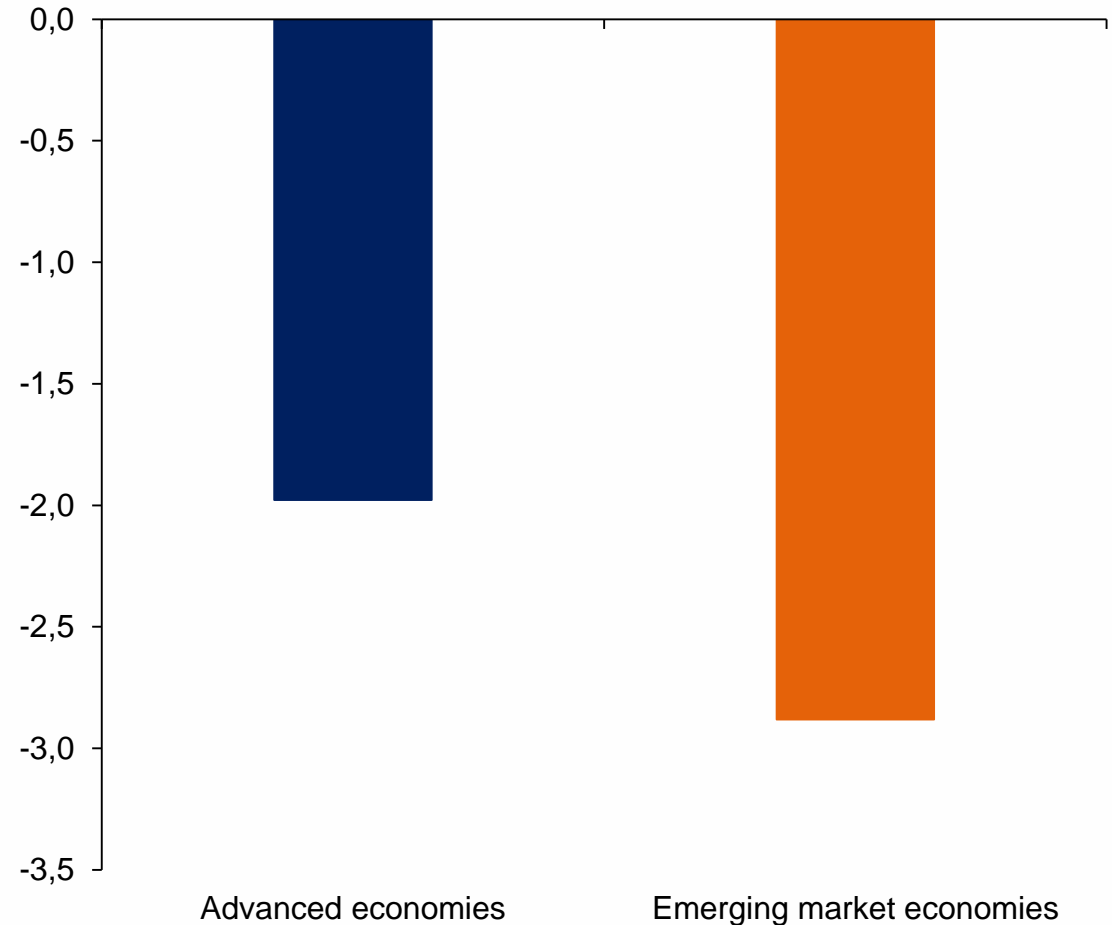
...make capital flows more volatile...

Change in capital flow volatility associated with increased concentration of financial partners
(percentage points of GDP)



Source: IMF Global Financial Stability Review, April 2023, Chapter 3

Change in capital flows associated with increased geopolitical distance from financial partners
(percentage points of GDP)

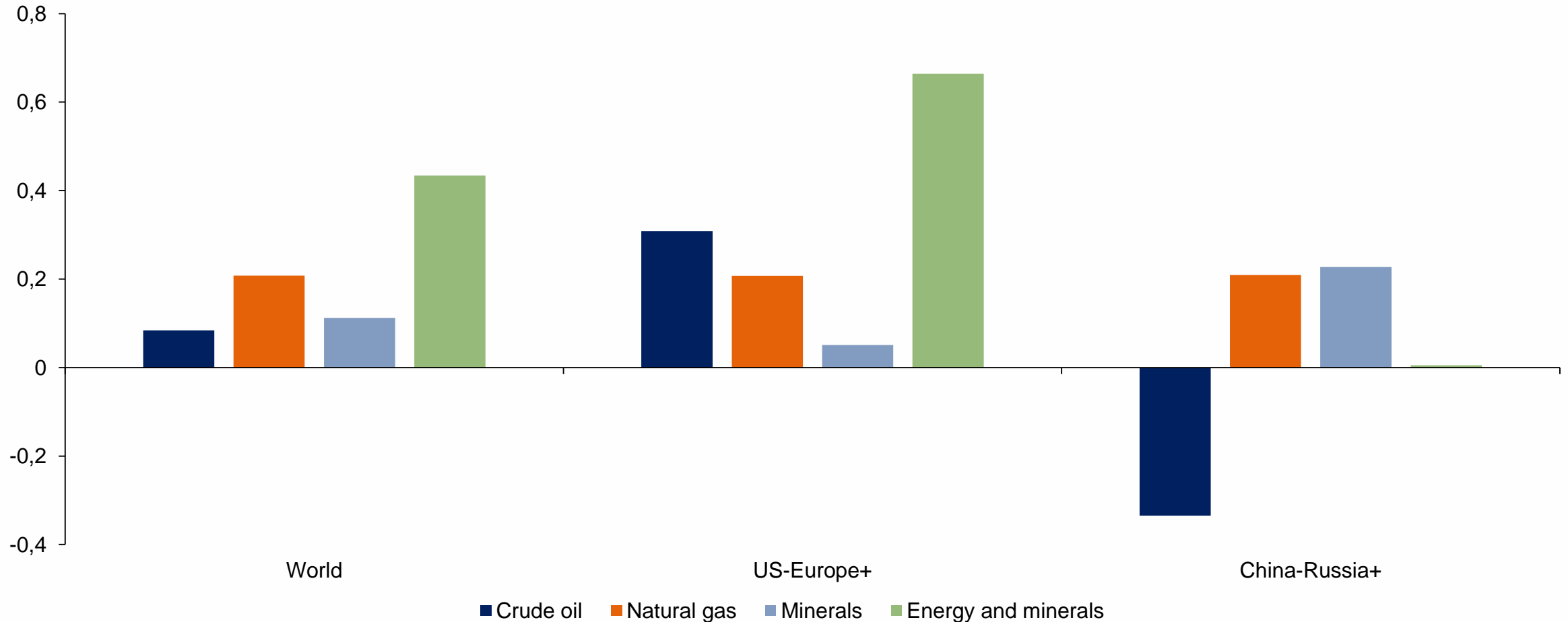


Source: IMF Global Financial Stability Review, April 2023, Chapter 3

...and unleash inflationary forces

Short-term inflation impacts in scenarios involving fragmentation in commodity markets

(deviation from baseline, in percentage points)



Source: IMF World Economic Outlook, October 2023, Chapter 3

Policy implications

How should CBs respond to inflationary pressures associated with fragmentation and conflict?

Implications for transmission:

- Bigger, more persistent shocks → inflation more likely to deviate from target
- Long periods of high inflation may change structure of the economy:
 - Higher “intrinsic” persistence (e.g., more indexation)
 - Bigger relative price changes → more demands for wage catch-up

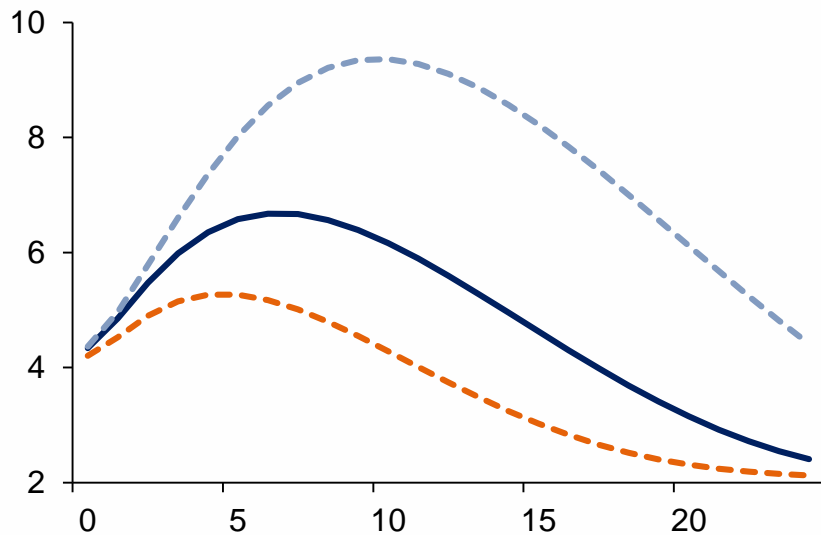
Policy implications:

- Be cautious about “looking through” supply shocks
- Take more account of tail risks, not just central forecast
- Need to get better at identifying & communicating risks (Bernanke 2024, Schnabel 2024)

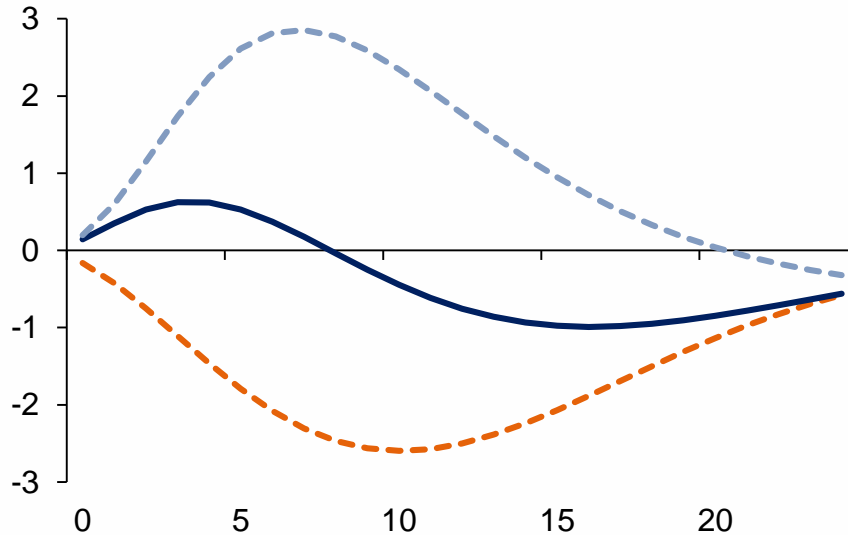
Risk management in action

- Consider **forecast-based rules** in a simple model where:
 - Persistence of supply shocks is unknown
 - Indexation intensifies if inflation has been running far above target
- Putting some weight on near-term forecasts and realized inflation may be warranted

Inflation
(percent)



Real GDP
(percent deviation from baseline)



- CB targets realized inflation
- CB targets one-year forecast
- CB targets two-year forecast

Source: Erceg, Lindé & Trabandt (2024)

Critical to be ready for capital flow volatility

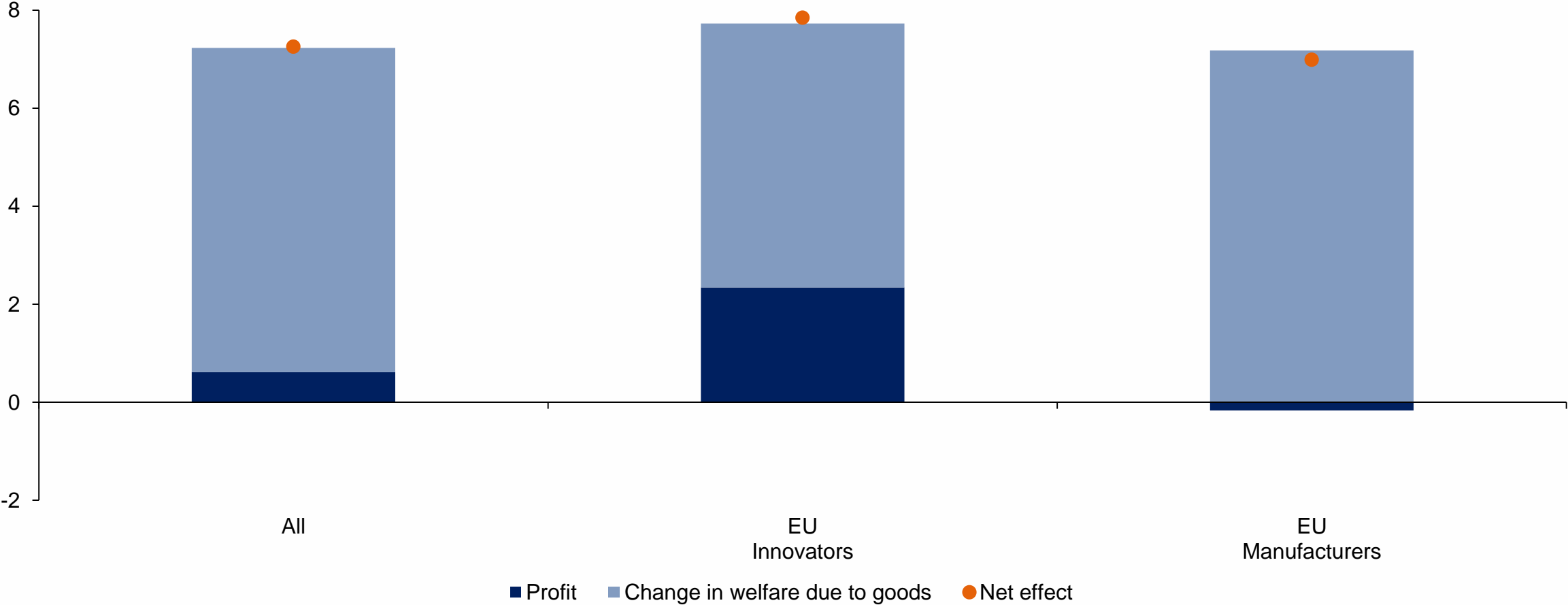
- In some cases, FXI/CFMs may help improve trade-offs and manage volatile capital flows
- Fund's **Integrated Policy Framework (IPF)** helps to identify relevant shocks and frictions:
 - Deep FX market + modest financial stress → flexible exchange rate typically desirable
 - Shallow FX market + significant stresses → stronger case for FXI
- Need to be attentive to intertemporal trade-offs (e.g., when reserves are limited)

Financial and fiscal policies also have key roles to play...

Financial-sector policy priorities	Fiscal policy priorities
<ul style="list-style-type: none">• Deepen monitoring of key risks:<ul style="list-style-type: none">• Bank-sovereign nexus• Non-banks• Payment systems• Ensure adequate prudential buffers• Formulate effective resolution plans and ensure ELA readiness• Invest in cyber resilience	<ul style="list-style-type: none">• Avoid working at cross-purposes with MP• Balance defense spending with debt sustainability and protection of vulnerable households:<ul style="list-style-type: none">• Broaden tax base• Pare back on non-defense spending

...as do structural policies

Impact of reducing cost of trade and multinational production within the EU by 10 percent
(percent of GDP)



Source: IMF staff calculations
Note: Membership in each group is based on individual countries' manufacturing R&D shares.

Concluding remarks

Lessons from Ukraine's remarkable response

- Macro stability central to economic security
- Agility in policy responses: quick action, innovation
- Strong coordination of fiscal and monetary policies
- Engaging international community for support
- Gradual and principled restoration of pre-war policy frameworks