Monetary Policy Under Pressure and the Path Ahead

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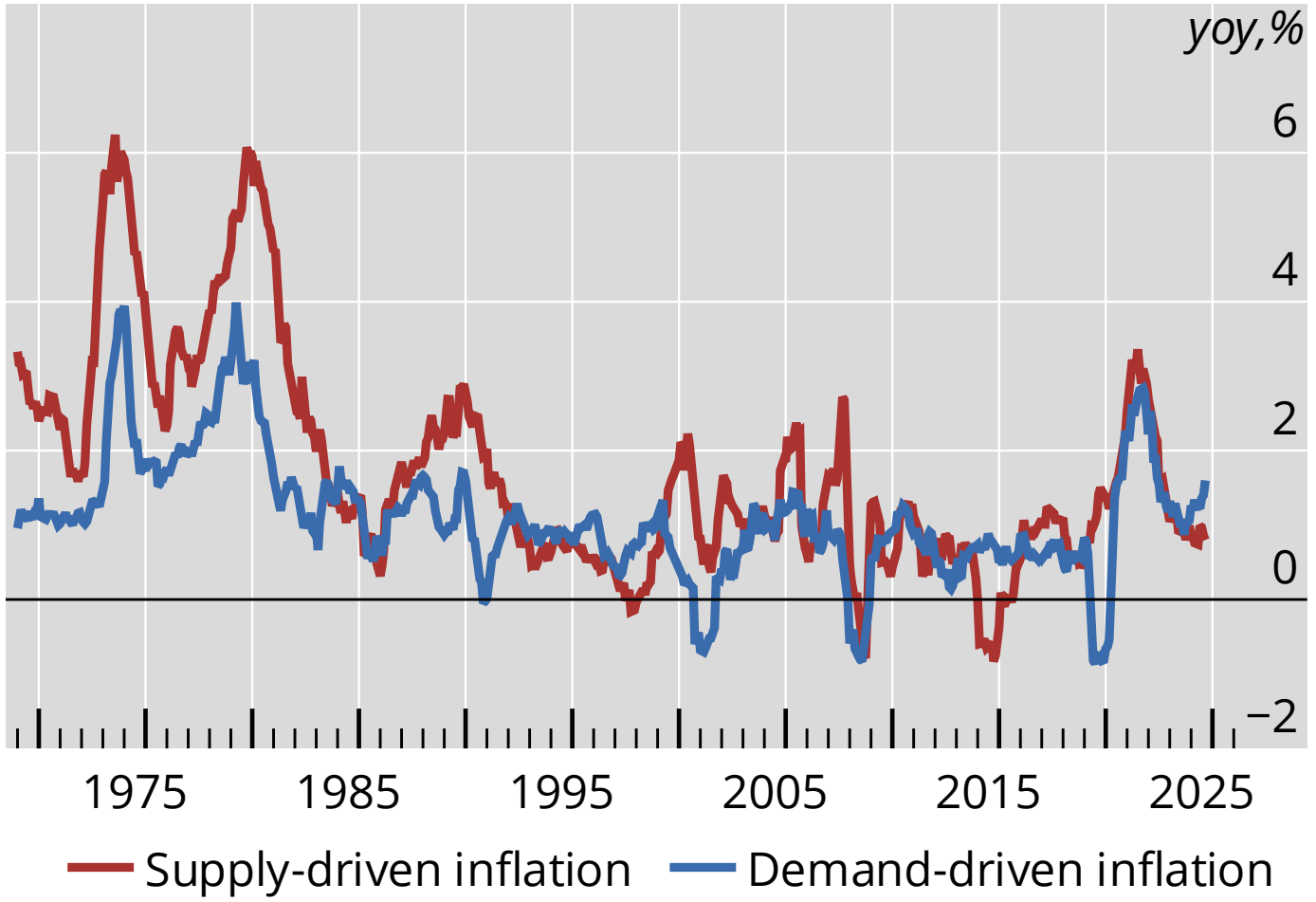
The views expressed here are those of the presenter and do not necessarily reflect those of the BIS.

- Monetary policy and supply-driven inflation
- Monetary policy and fiscally driven inflation
- The “affordability crisis”

Monetary policy and supply-driven inflation

Supply- and demand-driven inflation in the United States



Source: Shapiro (2025)

- Risk of more frequent adverse supply shocks in the wake of geopolitical tensions and climate change/green transition

- Supply may become less elastic due to deglobalisation and shrinking labour forces
  - All shocks, both demand and supply, would have larger effects on inflation
  - Potentially greater underlying inflationary pressures

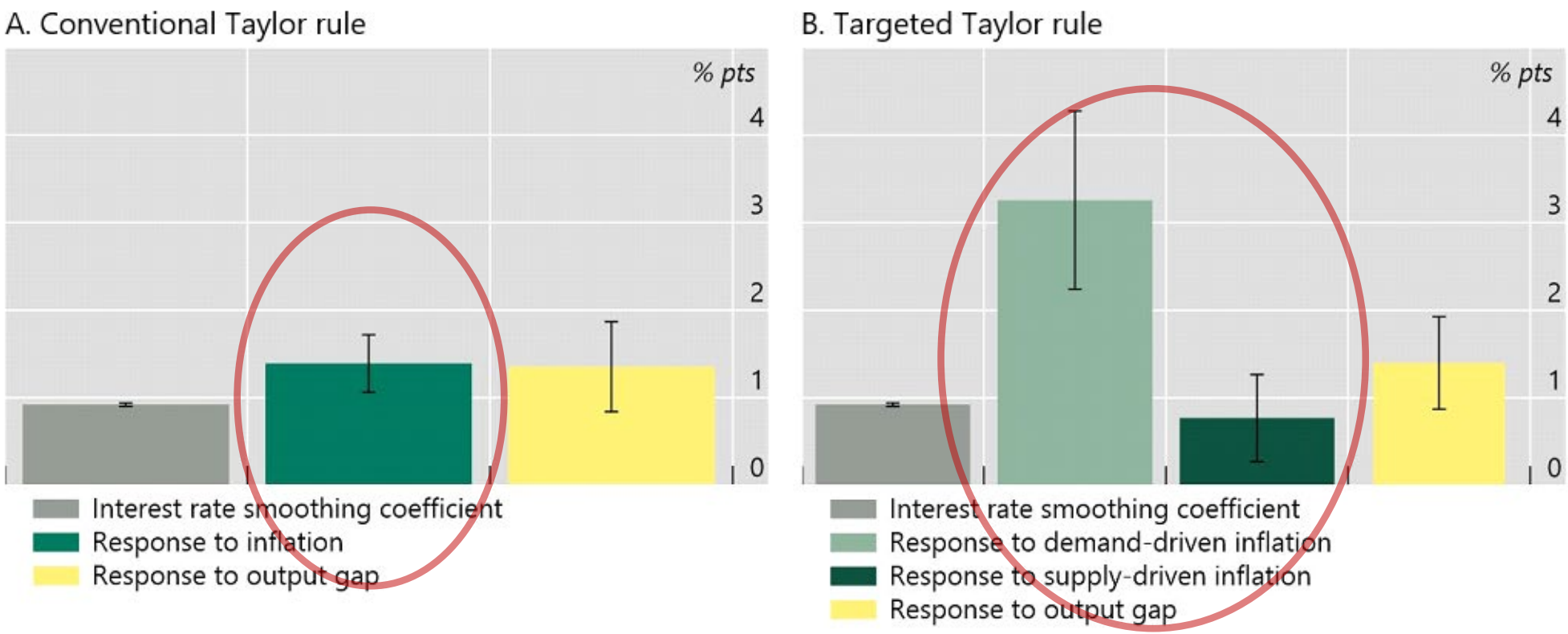
Theory

- Transitory nature of supply shocks such as commodities shocks
- Trade-offs between inflation and output stability
- Precondition: Inflation expectations remain well-anchored

Central bank "doctrine"

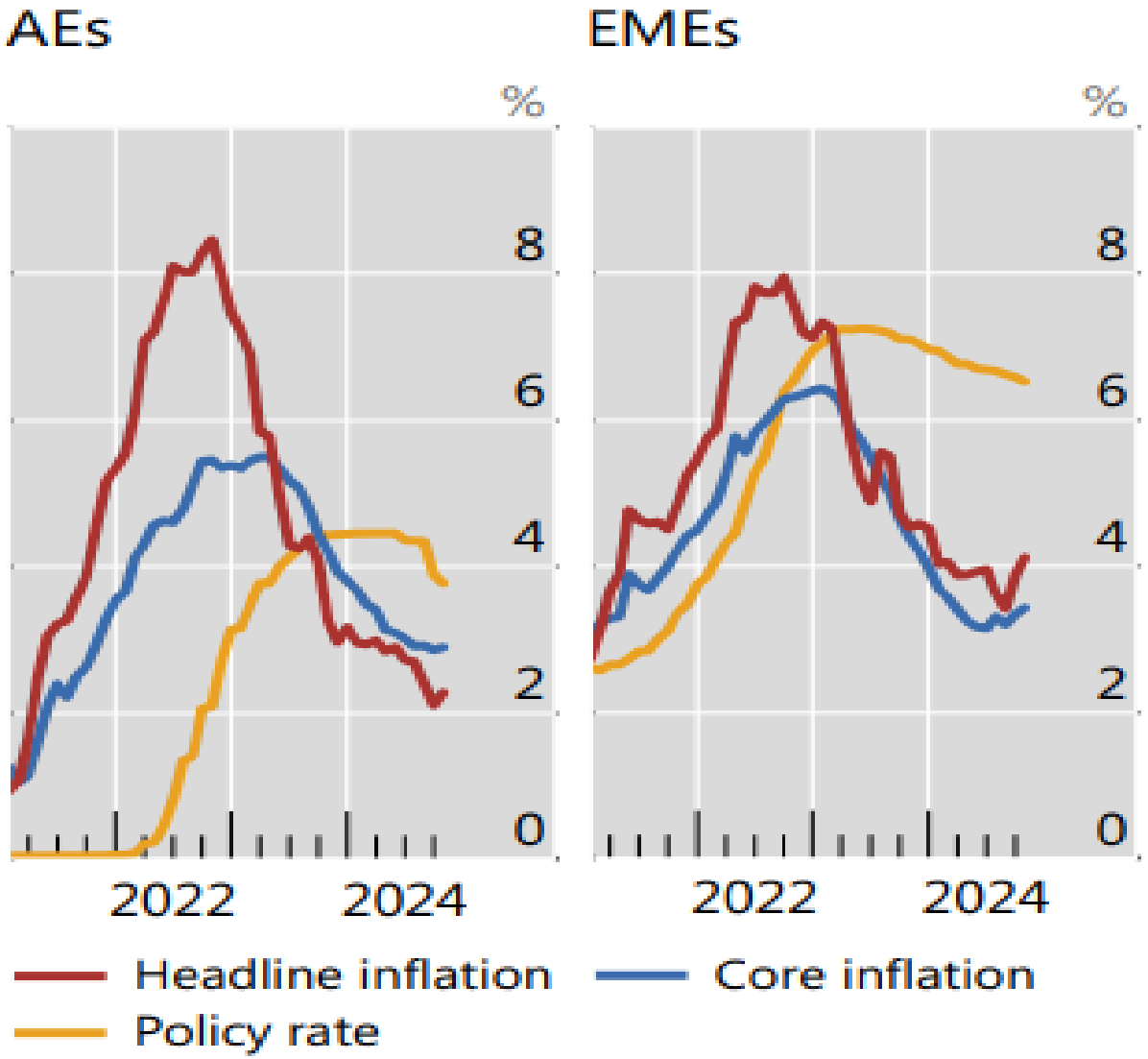
- "Standard monetary prescription is to "look through" commodities price shocks." (Brainard (2022))
- "The response to the inflationary effects of supply shocks should be attenuated. (…) Supply shocks that drive inflation high enough can affect the longer-term inflation expectations. Monetary policy must forthrightly address risks of de-anchoring of expectations." (Powell (2023))

Taylor rules: panel estimates for AU, CA, EA, GB, KR, SE and US



Source: Hofmann, Manea and Mojon (2024)

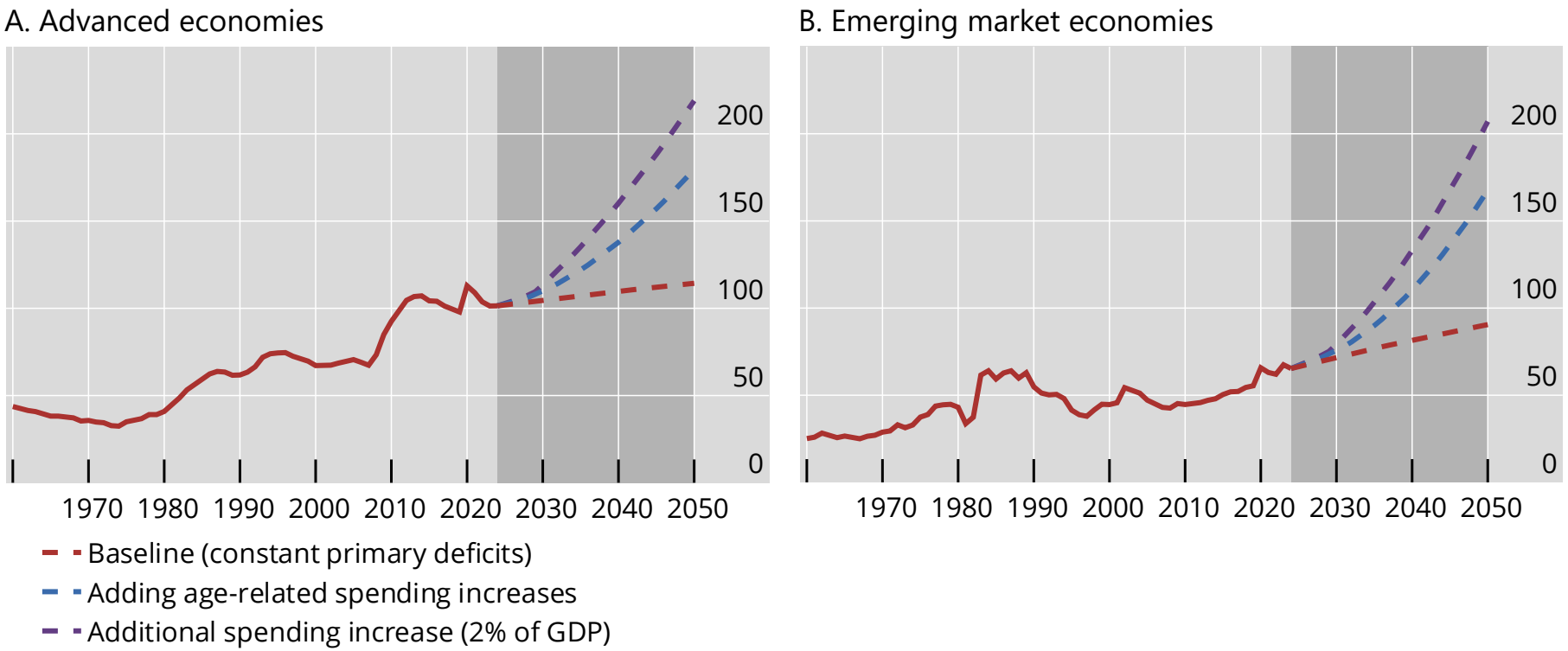
Monetary policy responses to the inflation surge



Monetary policy and fiscally driven inflation

Public debt projections

As a percentage of GDP

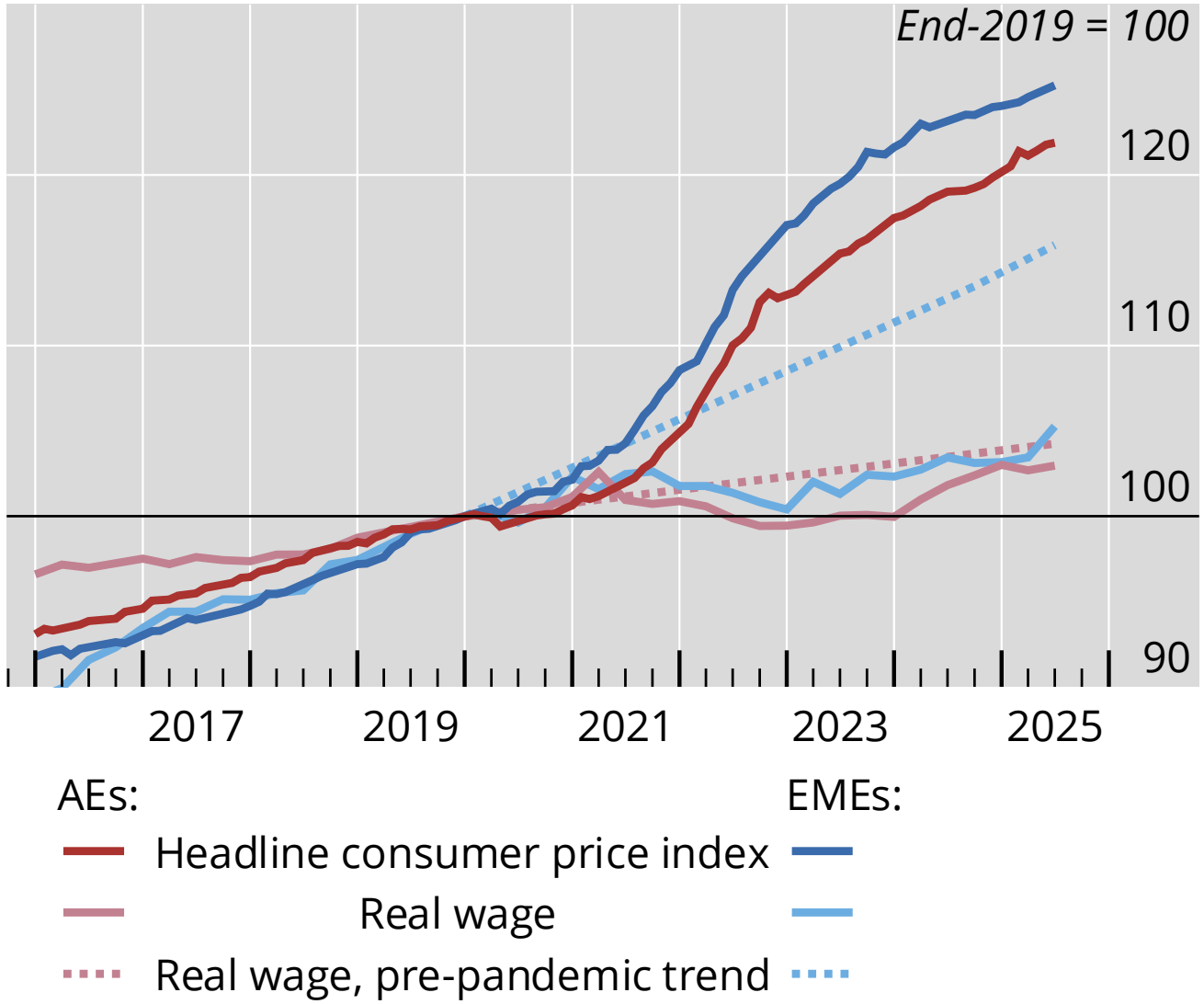


- Theory of partial fiscal backing: Monetary policy accommodates unfunded fiscal shocks (Smets and Wouters (2024))

- Alternative/complementary narrative of the inflation surge

- Fiscal shocks may become more unfunded going forward

The “affordability crisis”



Source: Hofmann/Munakata/Rosewall/Sandri (2025)

- Price level surge may dent trust in money and in central banks
  - Household expectations are not anchored (Coibion/Gorodnichenko (2025))
  - Households often prefer lower inflation rates than central banks target (Pfajfar and Winkler (2025))

- Central banks are well aware of the risks as reflected in recent framework reviews
  - Removing loosening biases in the formulation of strategies that aimed at addressing ZLB constraints