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Global Financial Stability Considerations for Monetary Policy in a High-Inflation Environment

Remarks by

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at

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I want to start by thanking Anna Kovner, Rochelle Edge, and Bill Bassett for organizing this conference. The current global environment highlights the importance of having strong analytic and empirical foundations to understand financial stability considerations for monetary policy, and the research presented today will help strengthen those foundations.¹ The global environment of high inflation and rising interest rates highlights the importance of paying attention to financial stability considerations for monetary policy. As monetary policy tightens globally to combat high inflation, it is important to consider how cross-border spillovers and spillbacks might interact with financial vulnerabilities.

Inflation is very high in the United States and abroad, and the risk of additional inflationary shocks cannot be ruled out. In August, CPI (consumer price index) inflation on a 12-month basis was 8.3 percent in the United States, 9.9 percent in the United Kingdom, 9.8 percent in Sweden, 9.1 percent in the euro area, 8.7 percent in Mexico, 7.0 percent in Canada, and 5.7 percent in Korea.

Central banks facing high inflation are tightening monetary policy rapidly to damp demand and bring it into alignment with supply, which is constrained in a variety of sectors. The process of resolving imbalances will be easier the more supply improves in markets for commodities, labor, and key intermediate inputs, as is generally expected, but there is a risk that supply disruptions could be prolonged or aggravated by Russia's war against Ukraine, COVID-19 lockdowns in China, or weather disruptions. Russia's war against Ukraine has generated spikes in prices for energy, food, and agricultural inputs. Most recently, inflation in Europe was pushed higher by Russia's cessation of natural gas deliveries through the Nord

¹ I want to thank Kurt Lewis and Shaghil Ahmed of the Federal Reserve Board for their assistance on these remarks. These views are my own and do not necessarily reflect those of the Federal Reserve Board or the Federal Open Market Committee.

Stream 1 pipeline, creating hardships for households and risking disruptions for some industries in the affected countries. China's COVID lockdown policy could also lead to supply disruptions if cases again increase. Separately, weather conditions in several areas, including China, Europe, and the United States, are exacerbating price pressures through disruptions to agriculture, shipping, and utilities.

Many central banks around the world have pivoted monetary policy strongly in order to maintain anchored expectations and forestall second-round effects from high inflation becoming embedded in wage and price setting. In the United States, the Federal Reserve has increased the federal funds rate target range by 300 basis points in the past seven months—a rapid pace by historical standards—and the Federal Open Market Committee's most recent Summary of Economic Projections indicates additional increases through the end of this year and into next year. In addition, beginning this month, balance sheet shrinkage accelerated to its maximum rate of up to \$60 billion in Treasury securities per month, and up to \$35 billion in agency mortgage-backed securities per month. Broader U.S. financial conditions have tightened rapidly: The 10-year Treasury yield has risen more than 200 basis points since the beginning of the year and is near its highest level in over a decade at 3.8 percent.

At a global level, monetary policy tightening is also proceeding at a rapid pace by historical standards. Including the Federal Reserve, nine central banks in advanced economies accounting for half of global GDP have raised rates by 125 basis points or more in the past six months.² Global financial conditions have likewise tightened. Yields on 10-year sovereign debt

² The central banks of the United States, the United Kingdom, Canada, the euro area, Australia, New Zealand, Norway, Sweden, and Switzerland together account for 49 percent of nominal global GDP measured in dollars at market exchange rates. Each of these central banks has raised its policy rate by at least 125 basis points in the past six months.

in the United States, Canada, the United Kingdom, and the largest euro area economies are higher year to date between 170 and 350 basis points.

It will take some time for the global tightening to have its full effect in many sectors. While the effect on financial conditions tends to be immediate or even anticipatory, the effects on activity and price setting in different sectors may occur with a lag, with highly interest-sensitive sectors such as housing adjusting quickly and less rate-sensitive sectors such as consumer spending on services adjusting more slowly.

In addition to the domestic effects from domestic tightening, there are cross-border effects of tightening through both trade and financial channels. U.S. monetary policy tightening reduces U.S. demand for foreign products, thus amplifying the effects of monetary tightening by foreign central banks. The same is true in reverse: Tightening in large jurisdictions abroad amplifies U.S. tightening by damping foreign demand for U.S. products.

Tightening in financial conditions similarly spills over to financial conditions elsewhere, which amplifies the tightening effects. These spillovers across jurisdictions are present for decreases in the size of the central bank balance sheet as well as for increases in the policy rate.³ Some estimates suggest that the spillovers of monetary policy surprises between more tightly linked advanced economies such as the United States and Europe could be about half the size of

³ See Lael Brainard (2015), “Unconventional Monetary Policy and Cross-Border Spillovers,” speech delivered at “Unconventional Monetary and Exchange Rate Policies,” 16th International Monetary Fund Jacques Polak Research Conference, Washington, November 6, <https://www.federalreserve.gov/newsevents/speech/brainard20151106a.htm>; and Lael Brainard (2017), “Cross-Border Spillovers of Balance Sheet Normalization,” speech delivered at the National Bureau of Economic Research’s Monetary Economics Summer Institute, Cambridge, Mass., July 13, <https://www.federalreserve.gov/newsevents/speech/brainard20170713a.htm>.

the own-country effect when measured in terms of relative changes in local currency bond yields.⁴

In contrast, spillovers through exchange rate channels tend to go in opposite directions. The Federal Reserve's broad nominal U.S. dollar index has appreciated over 10 percent year to date.⁵ On balance, dollar appreciation tends to reduce import prices in the United States. But in some other jurisdictions, the corresponding currency depreciation may contribute to inflationary pressures and require additional tightening to offset.

We are attentive to financial vulnerabilities that could be exacerbated by the advent of additional adverse shocks. For instance, in countries where sovereign or corporate debt levels are high, higher interest rates could increase debt-servicing burdens and concerns about debt sustainability, which could be exacerbated by currency depreciation. An increase in risk premiums could kick off deleveraging dynamics as financial intermediaries de-risk. And shallow liquidity in some markets could become an amplification channel in the event of further adverse shocks.

For some emerging economies, high interest rates in combination with weaker demand in advanced economies could increase capital outflow pressures, particularly commodity importers facing higher commodity prices and weaker exchange rates. And these pressures would be

⁴ A paper based on data between 2005 and 2017 found that about half of the reaction in German domestic yields spills over to U.S. yields following ECB announcements, which was nearly identical to the spillover from U.S. yields to German bund yields measured following Federal Open Market Committee announcements. See Stephanie E. Curcuru, Michiel De Pooter, and George Eckerd (2018), "Measuring Monetary Policy Spillovers between U.S. and German Bond Yields," International Finance Discussion Papers 1226 (Washington: Board of Governors of the Federal Reserve System, April), <https://doi.org/10.17016/IFDP.2018.1226>.

⁵ The Federal Reserve's broad trade-weighted dollar index is based on 26 currencies of major U.S. trading partners. It is published in Statistical Release H.10, "Foreign Exchange Rates," available on the Board's website at <https://www.federalreserve.gov/releases/h10/current/default.htm>.

particularly challenging for borrowers with currency mismatches between their assets and liabilities.

This is especially true at times when fiscal, macroprudential, and monetary buffers are more limited. Fiscal and monetary policy were both supportive in response to the pandemic, and both were naturally expected to reverse course as the recovery gathered steam. But the advent of the war has led to a significant hit to real incomes from large price increases in energy and other commodities in some of the most severely affected economies.

With respect to macroprudential buffers, nearly all of the jurisdictions that built countercyclical capital buffers before the pandemic released those buffers at the outset of the pandemic, and the buffers have not been fully replenished so far. A European Central Bank analysis concluded that the release of capital buffers increased headroom for banks relative to not only their regulatory thresholds, but also their internal risk controls, and enabled banks to continue providing credit to households and businesses.⁶

And of course, monetary policy is focused on restoring price stability in a high-inflation environment. As the program's first research paper illustrates, in circumstances in which macroprudential policy cannot on its own eliminate the amplification of shocks through financial vulnerabilities, in a low-inflation environment, monetary policy has been relatively more accommodative than would be prescribed by a conventional monetary policy rule in order to reduce the likelihood of adverse output and employment outcomes.⁷ But in a high-inflation

⁶ These findings were part of a box in the ECB's May 2022 *Financial Stability Review* titled "Transmission and Effectiveness of Capital-Based Macroprudential Policies." See European Central Bank (2022), *Financial Stability Review* (Frankfurt: ECB, May), pp. 93–95, https://www.ecb.europa.eu/pub/financial-stability/fsr/focus/2022/html/ecb.fsrbox202205_08~7c0f8067de.en.html. The countercyclical buffer has not been activated in the United States.

⁷ See Tobias Adrian and Fernando Duarte (2016), "Financial Vulnerability and Monetary Policy," Staff Reports 804 (New York: Federal Reserve Bank of New York, December; revised November 2020), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr804.pdf?la=en.

environment, monetary policy is restrictive to restore price stability and maintain anchored inflation expectations.

The Federal Reserve’s policy deliberations are informed by analysis of how U.S. developments may affect the global financial system and how foreign developments in turn affect the U.S. economic outlook and risks to the financial system. We engage in frequent and transparent communications with monetary policy officials from other countries about the evolution of the outlook in each economy and the implications for policy. We meet regularly not only with monetary policy officials from different countries, but also with fiscal and financial stability officials in a variety of international settings, which helps us to take into account cross-border spillovers and financial vulnerabilities in our respective forecasts, risk scenarios, and policy deliberations.⁸

High inflation imposes significant hardships by eroding purchasing power, especially for those households that spend the greatest share of their incomes on essentials like food, housing, and transportation.⁹ Following a period where a combination of high demand and a lengthy sequence of adverse supply shocks to goods, labor, and commodities drove inflation to multidecade highs, monetary policymakers are taking a risk-management posture to guard against risks of longer-term inflation expectations moving above target, which would make it more difficult to bring inflation down.

⁸ See Richard H. Clarida (2021), “Perspectives on Global Monetary Policy Coordination, Cooperation, and Correlation,” speech delivered at the “Macroeconomic Policy and Global Economic Recovery” 2021 Asia Economic Policy Conference, sponsored by the Federal Reserve Bank of San Francisco Center for Pacific Basin Studies, San Francisco (via webcast), November 19, <https://www.federalreserve.gov/newsevents/speech/clarida20211119a.htm>.

⁹ See Lael Brainard (2022), “Variation in the Inflation Experiences of Households,” speech delivered at the Spring 2022 Institute Research Conference, Opportunity and Inclusive Growth Institute, Federal Reserve Bank of Minneapolis, Minneapolis (via webcast), April 5, <https://www.federalreserve.gov/newsevents/speech/brainard20220405a.htm>.

In the modal outlook, monetary policy tightening to temper demand, in combination with improvements in supply, is expected to reduce demand–supply imbalances and reduce inflation over time.¹⁰ The real yield curve is now in solidly positive territory at all but the very shortest maturities, and with the additional tightening and deceleration in inflation that is expected over coming quarters, the entire real curve will soon move into positive territory.

It will take time for the full effect of tighter financial conditions to work through different sectors and to bring inflation down. Monetary policy will need to be restrictive for some time to have confidence that inflation is moving back to target. For these reasons, we are committed to avoiding pulling back prematurely. We also recognize that risks may become more two sided at some point. Uncertainty is currently high, and there are a range of estimates around the appropriate destination of the target range for the cycle. Proceeding deliberately and in a data-dependent manner will enable us to learn how economic activity and inflation are adjusting to the cumulative tightening and to update our assessments of the level of the policy rate that will need to be maintained for some time to bring inflation back to 2 percent.

¹⁰ See, for example, the year-to-date improvement in the Federal Reserve Bank of New York’s Global Supply Chain Pressure Index, available on the Bank’s website at <https://www.newyorkfed.org/research/policy/gscpi#/interactive>.