Inflation Scares

OCTOBER 2021 WEO CHAPTER 2

Francesca Caselli (co-lead), Sonali Das, Christoffer Koch, Prachi Mishra (co-lead), and Philippe Wingender

With contributions from Chunya Bu and support from Youyou Huang and Cynthia Nyakeri
Rising inflation since beginning of 2021

Consumer Price Inflation
(Median, year-over-year percent change)

Sources: Haver Analytics; IMF, CPI database; and IMF staff calculations.
Note: The vertical line indicates February 2020. AEs = advanced economies; CPI = consumer price index; EMs = emerging market economies; LIDCs = low-income developing countries.
Recoveries induce mild and short-lived inflation impulse

- In AEs, a moderately positive inflation impulse in the short term.
- In EMs, a stronger inflation impulse in the short term (about 50 bps in 2021)
- Large uncertainty, including on measurement of output gaps
- Significant degree of heterogeneity, with U.S. driving short-term inflation dynamics

**Slack-Induced Inflation Dynamics from Structural Phillips Curve in Advanced Economies**

(Percentage points)

- 0.23
- 0.14
- 0.05
- 0.00
- -0.01
- -0.01
- -0.02

Sources: Haver Analytics; and IMF staff calculations
Note: The bars represent the inflation impulse from changes in the unemployment gap based on the October 2021 World Economic Outlook vintage and the structural Phillips curve estimation described in the chapter. The vertical lines represent the interquartile ranges. PPP = purchasing power parity.
Sectoral inflation dynamics in a historical perspective

- Sectoral inflation dispersion subdued by historical standards, especially compared with the GFC
- Largely due to smaller and shorter-lived swings in fuel, food and housing prices

Sources: Haver Analytics; IMF, CPI database; and IMF staff calculations.

Note: In panel 1, the solid line represents the cross-country mean of sectoral inflation dispersion; shaded area represents the 10th–90th percentile range. The sectoral inflation dispersion is calculated as the standard deviation of sectoral inflation weighted by consumption shares. Panel 2 presents averages weighted by country's purchasing-power-parity GDP.
Risk scenarios: Adverse sectoral and commodity price shocks, and additional expectations de-anchoring

Headline Inflation and Inflation Expectation Outlook with Adverse Sectoral and Commodity Price Shocks (Percent)

1. Advanced Economies

2. Emerging Market and Developing Economies

3. Mean forecast
4. Median forecast
5. 10th–90th percentile range
6. 25th–75th percentile range

Source: Consensus Economics; Haver Analytics; IMF, CPI database; and IMF staff estimates.

Note: The lines are averages weighted by countries’ purchasing-power-parity GDP. Sectoral dispersion and commodity price shocks are assumed to be drawn from the top 75 percent of the predictive distributions for 12 consecutive months from July 2021 to June 2022. Adaptive expectations assume that inflation is driven by one-year-ahead inflation expectations instead of the conventional three-year-ahead horizon for 12 consecutive months from July 2021 to June 2022. AEs = advanced economies; EMDEs = emerging market and developing economies. See Online Annex 2.1.
Historical episodes of inflation acceleration

- Inflation acceleration episodes:
  - Are associated with large exchange rate depreciations
  - Preceded by an increase in fiscal and current account deficits in EMs

- Case studies on high inflation episodes:
  - Persistent “inflation scares” can lead to higher inflation expectations
  - Strong policy action was often needed

![Inflation Episodes Chart]

Inflation Episodes
(Percentage points)

- NEER (Percent change)
- Current account (Percent of GDP)
- Fiscal balance (Percent of GDP)
- Three-year-ahead inflation expectations (Percentage points)

Sources: Bloomberg Finance L.P.; Consensus Economics; Haver Analytics; and IMF staff calculations.

Note: The chart presents the difference in the three-quarter averages just prior to the start of an inflation acceleration episode (from $t-3$ to $t-1$) compared with the previous six-quarter averages ($t-9$ to $t-4$). NEER = nominal effective exchange rate.
Policy implications

- Policymakers need to walk a tightrope between acting patiently to support the recovery and at the same time preparing to act quickly if inflation expectations show signs of de-anchoring
  - Although central banks can generally look through transitory inflation pressures and avoid tightening until there is more clarity on underlying price dynamics, they should be prepared to act quickly if the recovery strengthens faster than expected or risks of rising inflation expectations become tangible

- Clear and state-contingent forward guidance and communication are key
  - To avoid taper-tantrum-like scenarios during periods of policy normalization from AE central banks

- Strong fiscal credibility is important for inflation anchoring. Fiscal policies should adhere to sustainable medium-term frameworks

- Policies should be mindful of the unusual short-term dynamics and uncertainties surrounding potential output
World Economic Outlook
October 2021

THANK YOU!