Interview with John Bluedorn, Deputy Division Chief in the Research Department, International Monetary Fund

The Outlook for Global Inflation & Monetary Policy

By *Japan SPOTLIGHT*

As the Ukraine War continues, fuel and food costs are pushing inflation higher. Inflation will accelerate wage increases and monetary policy authorities around the world are concerned about a wage-price spiral. According to economic theory, robust demand could further accelerate inflation, and in responding to it monetary policy may as well maintain high interest rates, whereas otherwise it could be loosened. Where are we now?

This is the key question in predicting the future of the global economy. We held a Q&A session by e-mail with the International Monetary Fund's (IMF) deputy division chief in the Research Department, John Bluedorn.

(Interviewed on May 29, 2023)

Assessment of the Current Global Economy

JS: How do you assess the latest situation of the global economy? Would it be right to say that a stronger overall economy than we had expected retarded the timing of loosening tight monetary policies due to continued concerns about inflation?


John Bluedorn

Bluedorn: The global economy is experiencing a gradual recovery from both the pandemic and Russia's invasion of Ukraine. China's economy is rebounding and supply chain disruptions are unwinding, while energy and food markets' dislocations caused by the war are receding. Most central banks have tightened their monetary policies, and inflation is expected to return toward targets. Global growth is expected to bottom out at 2.8% this year and rise modestly to 3% next year. Though more slowly than initially anticipated, global inflation will fall from 8.7% last year to 7% this year and 4.9% in 2024.

JS: Why do you think global economic growth was more robust than expected?

Bluedorn: Global economic growth is experiencing a gradual recovery due to several factors. Firstly, China's reopened economy is rebounding strongly, positively impacting the global economy. Secondly, many emerging markets and developing economies are picking up, with year-end-to-year-end growth accelerating to 4.5% in 2023 from 2.8% in 2022. Additionally, supply chain disruptions caused by the pandemic are unwinding, and dislocations to energy and food markets caused by the war are receding. These factors have contributed to the gradual recovery of the global economy.

JS: In particular, we see robust growth in employment and the unemployment rate is being kept low in spite of low economic growth. Why do you think this has happened?

Bluedorn: Most advanced economies have robust employment growth, and the unemployment rate remains low despite low economic growth. This phenomenon is likely due to several factors.

Firstly, the gradual recovery of the global economy has led to increased demand for goods and services, which has positively impacted employment growth. The strong labor markets in most advanced economies have also contributed to stronger-than-expected aggregate demand, further supporting economic growth.

Secondly, the pandemic has caused a significant disruption to labor markets, with many workers losing their jobs. As a result, there is still significant slack in labor markets, which has allowed employers to increase employment without significant increases in wages. This has contributed to keeping the unemployment rate low, even in the face of low economic growth.

Finally, some factors could explain why employers are willing to hire more workers despite low economic growth, such as increased productivity, automation, and lower labor costs.

Role of Monetary Policy

JS: This labor market situation could trigger wage rises and revive concerns about a wage-price spiral and inflation. Would monetary policy be the only way to modify these concerns?

Bluedorn: The labor market situation could trigger wage rises and concerns about a wage-price spiral and inflation, but the risk of an uncontrolled wage-price spiral is not a major concern at this point. Corporate margins have surged in recent years, and they should be able to absorb much of the rising labor costs on average, provided that inflation expectations remain well-anchored. Monetary policy may play a role in modifying concerns about a wage-price spiral and inflation, but other factors, such as corporate margins and inflation expectations, are also important. Policymakers need a steady hand and clear communication, and fiscal policy can also play an active role in supporting monetary policy.

JS: Could continuing tight monetary policies to cope with such a wage-price spiral result in a hard landing for the global economy?

Bluedorn: As previously mentioned, the risk of an uncontrolled wage-price spiral is not a major concern. Policymakers need a steady hand and clear communication. A coordinated and measured approach is necessary to address concerns about a wage-price spiral and inflation without risking a hard landing for the global economy. Fiscal policy can also play an active role in supporting monetary policy, and regulators and supervisors should act to ensure that remaining financial fragilities do not turn into a full-blown crisis.

JS: How could we avoid such a hard landing?

Bluedorn: To avoid a hard landing for the global economy, we suggest a coordinated approach by policymakers, which includes focusing on financial stability, bringing inflation down, supporting monetary policy with fiscal policy, strengthening financial oversight, allowing exchange rates to adjust as much as possible, ensuring proper access to the Global Financial Safety Net, and avoiding geopolitical tensions.

Role of BOJ under New Chairman's Leadership

JS: What role do you think the Bank of Japan (BOJ) should play in stabilizing the global economy with its new chairman?

Bluedorn: Growth in Japan is expected to remain relatively modest in 2023 and 2024 at around 1.3% and 1%, respectively. However, the underlying inflation momentum has picked up, with core inflation reaching a four-decade high in April. In our latest projection, inflation is expected to gradually come down and fall below the 2% target by the end of 2024. But there are significant risks to our inflation forecast. On the upside, wage growth may accelerate faster than expected given the strong results from the spring wage negotiation. On the downside, the risk of a slowdown in the global economy remains. In this context, monetary policy should remain accommodative, but the central bank should allow greater flexibility in longer-term yields and allow market forces to play out.

Adverse Effects of Tight Monetary Policy

JS: High interest rates could increase government debt and cause fiscal instability. Would this lead to a weaker currency and raise inflation further?

Bluedorn: IMF staff calculations suggest that the effects of recent increases in inflation and nominal interest rates on debt service burdens may be rather limited for most advanced economies and emerging market and developing economies with strong institutions. In particular, an increase in the real spot market rate of a 10-year government bond feeds into effective rates (the rate that is relevant for servicing debt burdens) far less than one-for-one. In addition, central bank credibility may help to keep inflation expectations anchored. Hence, higher interest rates only permeate slowly into debt service costs and would not lead to raising inflation further. Over a longer timeframe, and once inflation pressures have subsided, equilibrium real interest rates are expected to remain at low levels due to structural forces, which should also help to keep in check real debt servicing costs.

External Balances & Monetary Policy

JS: Should countries with current surpluses and stronger currencies continue to stimulate the economy with loose monetary policies and active fiscal policies to achieve balanced global growth?

Bluedorn: Macroeconomic policies should be used to achieve domestic objectives, primarily stimulating growth and keeping inflation in check. From this perspective, countries in which growth remains below potential should continue supporting the economy through fiscal policy, especially if there is available fiscal space, while at the same time putting in place credible plans for medium-term reduction of public debt. With inflation still high all over the world, there is a case for exiting from loose monetary policy.

However, the pace of monetary tightening will depend on country-specific circumstances and can be more gradual in cases in which economic activity needs to be supported and inflation expectations are well anchored. Even though supportive fiscal and monetary policies are aimed at domestic objectives, they would most likely contribute to reducing current account surpluses – by increasing domestic consumption and investment, and therefore imports – and thereby contribute to achieving a more balanced global growth and reducing global current account imbalances. Those policies also contribute to depreciating the currency. It is important to keep in mind, however, that for important reserve currencies which play a major role in international trade and finance, the value of the currency is determined not only by domestic policies but also by global market sentiment, including through so-called safe haven effects.

Macropolicy Cooperation to Restore Economic Stability

JS: What do you think would be the best means of macropolicy cooperation among nations to achieve global economic stability under inflation?

Bluedorn: Global economic stability under inflation requires a coordinated and measured approach by policymakers across nations. Possible macroeconomic policy cooperation among the nations that can contribute to global economic stability under inflation include:

Coordinated monetary policy: Central banks across nations should coordinate their monetary policies to ensure that inflation is kept under control, while avoiding any sudden shocks to the global financial system.

Fiscal stimulus: Governments can implement fiscal stimulus policies to support demand in their economies and promote growth, while avoiding excessive debt buildup.

Financial regulation: Policymakers should ensure that the global financial system is well-regulated and monitored to prevent the buildup of systemic risks and the emergence of financial crises.

Exchange rate management: Countries should avoid competitive devaluations and ensure that exchange rates are allowed to adjust based on market conditions, while preventing exchange rate volatility that can contribute to global economic instability.

International cooperation: Policymakers should work together to promote global cooperation and collaboration across countries and regions, as well as a focus on addressing the root causes of geopolitical tensions and instability.

Overall, a coordinated approach that balances monetary and fiscal policy, strengthens financial oversight, and promotes international cooperation can help achieve global economic stability under inflation. JS

Questions by Naoyuki Haraoka, editor-in-chief of *Japan SPOTLIGHT*.