

IMF deputy chief outlines “uncomfortable truths” about inflation and financial instability

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International Monetary Fund deputy head Gita Gopinath has added her voice to those warning that inflation may persist longer than expected and the interest rate hikes by central banks could set off a crisis for heavily indebted countries and the financial system more broadly.

Gopinath’s warnings came in a major speech in which she pointed to “three uncomfortable truths” delivered to the annual forum conducted by the European Central Bank in Sintra, Portugal earlier this week.

She said policymakers could be faced with a stark choice between lifting interest rates in the so-called fight against inflation and risking a financial crash in heavily indebted countries. The crisis would not be confined to indebted emerging market countries but could extend to Europe where government debt levels have increased.

“We are not there yet, but that’s a possibility,” she told the *Financial Times*. Under these conditions it may be necessary to ease back on rate rises.

The first uncomfortable truth, she said, was the recognition that “inflation is taking too long to get down to target ... and that means we risk inflation getting entrenched.”

Accordingly, central banks may have to adjust their monetary policy to “account for financial stress.” But there would have to be a “high bar” before central banks pulled back on rises.

As with all representatives of finance capital, Gopinath made it clear the IMF has its eyes firmly fixed on wages, even though their rate of increase is well below inflation. The ECB “should be prepared to react forcefully” to persistent inflation despite the risk

of weaker growth and “much more cooling” in the labour market—a code phrase for rising unemployment.

She noted that while the ECB had raised its base interest rate by 4 percentage points in a year—the most in its history—economic activity had slowed only modestly, and unemployment was low.

Wages were rising, she said, but not enough to reverse the “sharp decline” in real wages over the past two years. Gopinath did not refer to why, largely because it would be politically inept to point to the critical role of the trade union bureaucracy in imposing sub-inflation wage agreements.

However, there are fears as to how long this can continue.

“What is worrisome is that sustained high inflation could change inflation dynamics and make the task of bringing down inflation more difficult. Given the massive decline in real wages since the pandemic, some wage catchup is to be expected,” she said.

Gopinath echoed a point raised in the annual report of the Bank for International Settlements that reductions in government spending could be used to ensure that wages struggles do not escalate, enabling interest rate hikes to be eased to avert financial instability.

As usual, this program was couched in terms aimed at trying to obscure its essential class dynamic.

“Some side effects of fighting inflation with monetary policy [the dangers to financial stability] could be reduced by giving fiscal policy a bigger role. Indeed, economic conditions call for fiscal tightening. It could help cool demand and reduce the need for rising interest rates, especially if done in concert by a broad group of countries,” she said.

In other words, use government spending cuts to slow

the economy and put downward pressure on wage demands so that interest rate hikes could be less than they otherwise would need to be.

The second uncomfortable truth was that the central bank's anti-inflation policies—lifting interest rates—could endanger financial stability.

“If inflation persists and central banks need to tighten more than markets expect, today's modestly tight financial conditions could give way to a rapid repricing of assets and a sharp rise in credit spreads,” she said, citing the recent experiences of financial turbulence caused by higher rates in South Korea, the UK and the US.

If financial stresses remained modest, central banks should not have too much difficulty in maintaining stability but not if the crisis broadened, she explained.

“The situation becomes much more difficult if financial stresses threaten to morph into a systemic crisis. Critically, forestalling a crisis may go beyond what central banks can do alone. While they can extend broad-based liquidity support to solvent banks they cannot support insolvent banks, firms or households,” she said.

The fact that the IMF has raised the issue of insolvency, albeit in a somewhat guarded manner, is indicative of the discussion going on behind closed doors in the major financial and economic institutions, notwithstanding the repeated assertions following every bailout operation, that the banking system is “sound” and “resilient.”

The third uncomfortable truth was that there were more upside risks to inflation than before the pandemic. Not least, this is because of the changes in the economy it had caused, with the result that supply shocks will persist.

“Despite a considerable easing of pandemic-related supply pressures, the restructuring of global supply chains that was intensified by the pandemic and the war, coupled with geo-economic fragmentation, may cause ongoing disruptions to global supply,” she said, as many countries were turning to inward looking policies that led to rising production costs.

The effects of climate change were “also likely to amplify short-term fluctuations in inflation and output.”

Gopinath left no doubt about what the policy response to such developments, expressing in their own way the worsening crisis of the capitalist profit system,

had to be: deepening attacks on the working class to make it pay.

Central bankers had to respond “more aggressively” if supply shocks were broad-based and act in the same fashion if there was a strong economy and “workers are less willing to accept real wage declines.”



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