Christine Lagarde: Policymaking in a new risk environment

Speech by Ms Christine Lagarde, President of the European Central Bank, at the 30th Dubrovnik Economic Conference, Dubrovnik, 14 June 2024.

* * *

It is a pleasure to be here in Dubrovnik.

To this day, the stunning beauty of this city evokes the words of one of its most famous poets, Ivan Gunduli: "O lijepa, o draga, o slatka slobodo".[1]

These words may be centuries old, but they remain as fresh as ever for those who have the good fortune to experience Dubrovnik first-hand.

The programme for the 30th Dubrovnik Economic Conference offers a snapshot of policymaking in a world of transition. And this world of transition is, increasingly, a world of profound uncertainty for economic policymakers.

If you look back at the speeches of former central bankers – as I'm sure many of you enjoy doing – policymakers in every era claim that the world has never been more uncertain.

And indeed the world is not necessarily more tumultuous than in the past, but the nature of the risks we are facing is unusual.

Increasingly, volatility in growth and inflation will not only be driven by the business cycle, which we understand relatively well, or even by the financial cycle, which we understand less well but can at least try to pre-empt.

It will also be driven by a pair of major structural forces that we have next to no experience of: geopolitical fragmentation and climate change.

The fragmenting of a previously highly globalised world is a type of risk that advanced economies have not faced since the period after the First World War. And a rapidly changing climate is a risk that we have not seen for millennia.

The unusual risk environment

Three factors make these risks special for policymakers.

First, they are particularly difficult to quantify and forecast.

We saw this in Europe after the Russian invasion of Ukraine, but more generally geopolitical risks create various types of spillovers that are hard to map out ex ante.

That said, there are some recent studies that try to quantify the impact of conflicts. One study, for example, estimates that for countries that are geographically close to a war zone, output falls by more than 10% over five years and inflation rises by 5 percentage points on average.[2] Another finds that firms with greater exposure to geopolitical risk experience an increased probability of default, lower market valuations and higher financing costs.[3]

Climate change is similarly hard to forecast, as is visible for example in the struggles the insurance industry is facing to accurately price climate risks.

An increasing frequency of extreme weather events means that claims costs no longer correspond to the historical data used to price risk. Last year set a record for the highest number of insured natural catastrophes yet.[4]

And climate change increases uncertainty about inflation, too: ECB research finds that extreme summer heat could ultimately push up food inflation in the euro area by between one and two percentage points.[5]

The second factor that makes these risks special is that they reinforce each other.

A weakening multilateral order not only makes it more difficult to agree on collective climate action, but it also increasingly threatens to disrupt the flow of clean technology that is necessary to lower the cost and accelerate the speed of the green transition globally.

With China now becoming the dominant supplier of solar panels, battery cells and electric vehicles, we are seeing an increasing trade-off between faster decarbonisation and greater economic security as countries seek to reduce their dependencies.

In turn, unmitigated climate change could strengthen fragmentary forces. For instance, an uneven distribution of extreme weather events may induce disorderly migration flows, straining international relations and encouraging policymakers to establish more barriers.

One recent paper estimates that a changing climate could impel significant numbers of working-age people to migrate over the course of this century.[6]

The third factor is that both risks are characterised by potential "tipping points" – that is, non-linearities – beyond which it would be very difficult to turn back.

If the multilateral order were to break down, history suggests that the opportunity to rebuild it again may be a long time coming. Indeed, every major overhaul of the international order, be it the Congress of Vienna in the nineteenth century or the Bretton Woods Conference in the twentieth, was typically preceded and enabled by a major war.

And were global heating to reach a certain level, we may see irreversible transformations. For example, as warmer weather causes permafrost in polar regions to thaw, stored methane is released into the atmosphere. This causes further heating, and a self-reinforcing feedback loop emerges.

Policymaking in an uncertain world

So what can we do to make our policies robust in this environment?

Certainly, the best-case scenario would be for countries to "carve out" areas that will be spared from geopolitical rivalry, such as working together towards net zero, and to find ways to increase mutual economic security without fragmenting world trade.

But if we are realistic, we must admit that with each passing day this scenario looks less likely. The World Bank finds that almost 3,000 trade restrictions were imposed last year – five times the amount in 2015.[7] And 2023 was the hottest year on record.[8]

So policymakers need to be prepared for a "second-best" scenario in which these risks do start to reinforce each other and tipping points draw closer. This scenario is likely to create two tensions for central banks that we will need to address.

The first tension is between what we can observe and what we can project.

The last few years have shown that making policy based on projections alone is likely to be misleading. For instance, there were certain periods when recent inflation was the most informative signal about future inflation, and so the best policy was to overweigh recent data relative to a necessarily uncertain forecast.

But as major shocks passed we saw forecasts becoming more accurate. In 2023, for example, we saw a reduction of about 70% in the average absolute error in our staff projections relative to 2022, one quarter ahead. Relying too much on current data in this setting would have been equally misguided and led to policy falling behind the curve.

The challenge for policymakers is that it is not always easy to know in real-time which regime you are in, especially around turning points. And we cannot be changing our mind from one day to the next on what kinds of data are most important to us.

For inflation expectations to remain anchored in an environment of structural changes and less quantifiable shocks, people need to be able to broadly predict our reaction function and know what developments we will tolerate and what we will not.

That is why I have argued that, in the future, we will need to have ex ante policy frameworks that combine both forward-looking and current-looking elements.

We need forecasts of the medium term, but we also need to be alert to the fact that available models have been "educated" using data from previous structural regimes that may no longer be valid. So, analysing current data and identifying persistent components allows us to account for structural changes and forecast the future in a more robust way.

This is essentially the approach the ECB has been using since March last year, when we deployed a three-sided reaction function to make our decisions more robust: a forward-looking component – our inflation projections – and two more current-looking ones, the dynamics of underlying inflation and the strength of monetary policy transmission.

We have also made more use of scenario analysis to help us understand the risks around our projections if certain assumptions turn out differently.

This framework served us well in calibrating when to stop raising rates, how long to hold them constant and, most recently, when to start cutting them. And for the time being, we will continue to use it to set the rate path in an uncertain environment.

The second tension is between independence and interdependence.

Central banks make decisions independently, but those decisions are interdependent with the actions of other authorities. When policies are well aligned, that interdependence can lead to virtuous circles which help all authorities deliver on their objectives.

For example, increasing government investment to reduce energy supply constraints may make medium-term inflation lower and less volatile. That would, in turn, warrant lower policy rates over time, encouraging more investment, and so on.

But faced with "existential" risks like geopolitical conflict and climate change, it is natural for people to ask whether central banks can contribute more explicitly.

In my view, the answer to this question has two parts.

First, the evidence we have so far suggests that the new types of shocks we are facing are likely to put upward pressure on prices, at least initially.

One recent study based on data since 1900 finds that geopolitical risks lead to high inflation, lower economic activity and a fall in international trade.[9] And climate change is likely to initially appear as a negative supply shock – although over time investment in renewables, grids and storage will lead to lower and more stable energy prices.

In this setting, it is important that we continue to focus on inflation and stabilise inflation expectations at our target. We know that the public detests high inflation, and allowing it to become embedded in the economy would disrupt our politics and undermine all other geopolitical and climate goals.

However – and this is my second point – as a changing climate and geopolitical fragmentation have implications for our mandate, there is scope for action within our mandate. Let me give you a few examples.

The ECB now measures and monitors climate-related risks, and we have incorporated climate change considerations into our collateral framework.

Currency swap lines are vital instruments in helping to reduce volatility, but they too have a geopolitical impact as they can strengthen the dynamics of major international currencies.[10]

And given the dominance of non-European digital payment firms, the launch of a digital euro would protect the strategic autonomy of European payments and monetary sovereignty, providing a fall-back solution if geopolitical tensions intensify.[11]

Conclusion

Let me conclude.

Policymakers today are grappling with new kinds of risks. While the best-case scenario would be for policymakers to work together to prevent these risks from materialising, we need to be prepared for a "second-best" world.

That will be a world marked by higher levels of uncertainty and volatility, and it will create tensions for central banks that we will have to resolve.

But at the same time, I am reminded of the words of the Croatian poet Antun Branko Šimi: "Man, be careful not to walk small under the stars." Policymakers are not prisoners of fate, and there is scope for action.

We can find balanced ways to move forwards – ways that account for the new environment, but that also allow us to continue delivering on our mandate.

---

[1] From Ivan Gunduli's play "Dubravka". The phrase can be translated as "Oh beautiful, oh dear, oh sweet freedom".

[2] Federle, J. et al. (2024), "The Price of War", *Discussion Paper Series*, No DP18834, Centre for Economic Policy Research, 14 February.

[3] D'Orazio, A., Ferriani, F. and Gazzani, A. (2024), "Geoeconomic fragmentation and firms' financial performance", *VoxEU*, 18 March.

[4] Swiss Re Group (2024), "New record of 142 natural catastrophes accumulates to USD 108 billion insured losses in 2023, finds Swiss Re Institute", press release, 26 March.

[5] Kotz, M. et al. (2023), "The impact of global warming on inflation: averages, seasonality and extremes", *Working Paper Series*, No 2821, ECB, Frankfurt am Main, May.

[6] Burzyski, M. et al. (2022), "Climate Change, Inequality, and Human Migration", *Journal of the European Economic Association*, Vol. 20, Issue 3, June.

[7] Kose, M.A. and Mulabdic, A. (2024), "Global trade has nearly flatlined. Populism is taking a toll on growth", *World Bank Blogs*, 22 February.

[8] National Centers For Environmental Information (2024), "2023 was the warmest year in the modern temperature record", 17 January.

[9] Caldara, D. et al. (2024), "Do Geopolitical Risks Raise or Lower Inflation?", 22 April.

[10] As I have argued in the past. See Lagarde, C. (2023), "Central banks in a fragmenting world", speech at the Council on Foreign Relations' C. Peter McColough Series on International Economics, 17 April.

[11] Lagarde, C. and Panetta, F. (2022), "Key objectives of the digital euro", *The ECB Blog*, 13 July.