**Inflation Shock and Monetary Policy**

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This chapter focuses on inflation and monetary policy in the Central and Eastern European (CEE) region in the period before and in the months following the Russian-Ukrainian war. The statistics describing inflationary trends, when compared with other nominal and real economic indicators, show that the root of the process lies in the energy crisis that erupted before the war. The CEE countries that are not members of the euro zone have been subject to excess price pressures due to the depreciation of their currencies. The paradoxical effect of exchange rate depreciation is that it fuels inflation by increasing competitiveness and thus nominal incomes. In countries where the labour market is already tight, this spill-over effect can be observed.

The markets in the CEE region are somewhat more closely linked to the Russian-Ukrainian region than the Western European markets. Not only is their exposure to energy markets more significant, but also, for example, their exposure to agriculture. The mass influx of refugees fleeing the war is also putting a significant strain on some countries' budgets and labour markets.

Monetary policies from the COVID period have brought with them loose conditions in which the impact of an otherwise justified tightening is questionable. At least this is evidenced by the fact that the pass-through of interest rates to bank deposits and bank loans has been slow, in fact slower than the process of price increases. The implication is that real interest rates have in fact been falling recently, which is not cooling but rather fuelling price rises.

In addition to monetary policies, various government measures are trying to curb price increases. Almost all countries have introduced price caps or other measures in the energy market, mainly to help households. Similar measures have been introduced in some economies in the food market. However, the beneficial effect of these measures is questionable, as suppressed prices lead to stockpiling, queuing and shortages, while prices of substitutes are shown to rise more than average. Political economy considerations of governments, even in cases where the government's authority is otherwise substantial, run counter to monetary policy actions. This disrupts the consistency between monetary policy and fiscal policy at a time when it is most needed.

The implication of these observations is that, even if the war conflict does not abate, the inflationary process can be persistent. Already, the stickiness of inflationary expectations can be seen in the pricing behaviour of economic agents and in wage agreements. Although real economies have currently avoided a recession, a decline in macro supply is expected, which will fuel price increases in the short term. In the longer term, the recovery will be conditional on a resurgence or resumption of physical capital investment, for which the external financing in the current geopolitical context is uncertain.

The sections of this chapter will be outlined as follows:

We will provide a short assessment on the state of the CEE economies in the aftermath of the covid crisis in order to provide an overview of how much they managed to recover and how resilient they might be to an external shock.

In the next section we will focus on disentangling the key drivers of inflation with an emphasis on quantifying how much the rise in energy prices, the downturn of exchange rate, the war shock, changes in inflation expectations, the inflationary pressure of wage hikes and political factors contributed to the rising inflation we observe today.

In the third section, we will assess the stance of monetary policy authorities in response to the inflation shock. This will be done by providing an overview of monetary policy tools used to combat the rapidly growing prices as well as empirically assessing the deviations from Taylor rules to assess monetary policy stance. This section will also include two further analyses in which we address short- and long-term inflation expectation stability, as well as assessing how effective these economies have been at stopping the rising inflation.

These parts of our chapter will primarily rely on macroeconomic aggregates retrieved from the IMF databases, as well as data on expectations from the Consensus Forecasts. The rise in geopolitical tensions can be measured using the work of Caldara and Iacoviello (2022).

The final section will conclude our analysis, as well as provide detailed policy recommendations for each country based on our results and findings.