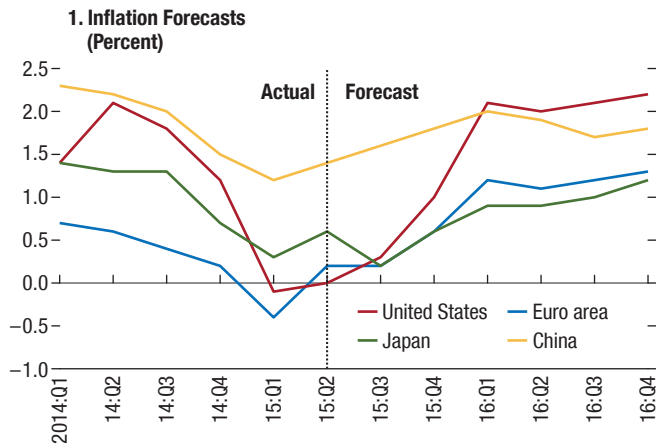


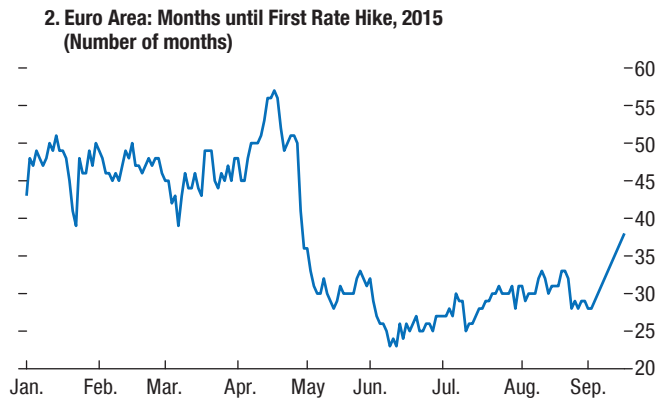
Figure 1.3. Inflation, Monetary Policy, and Policy Rate Normalization

Headline inflation is projected to gradually rise in advanced economies...



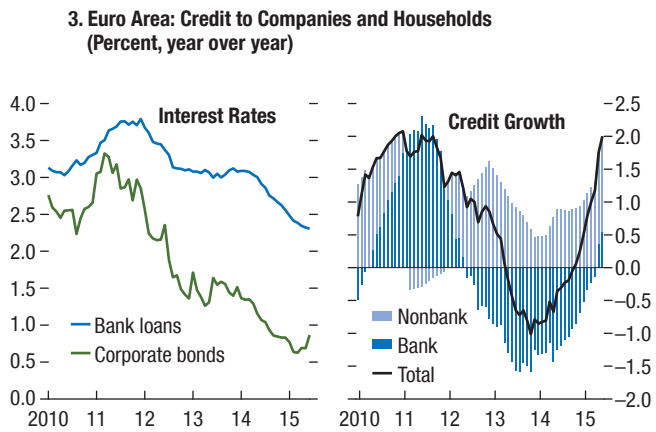
Sources: Bloomberg, L.P.; and IMF staff calculations.
Note: Headline inflation (Japan adjusted for value-added tax).

...and markets have shifted from pessimism to cautious optimism.



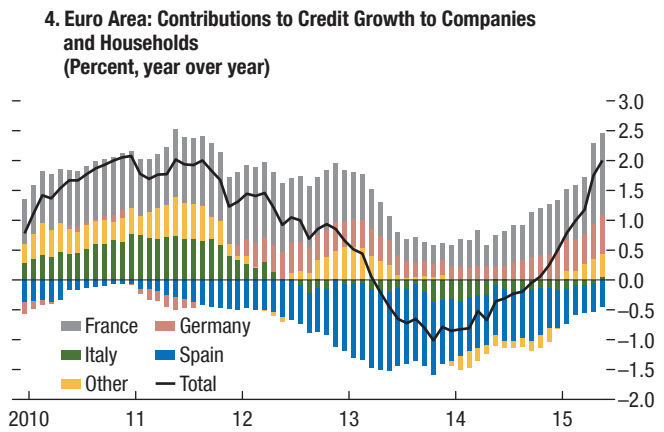
Source: Citigroup.

Euro area credit conditions are easing...



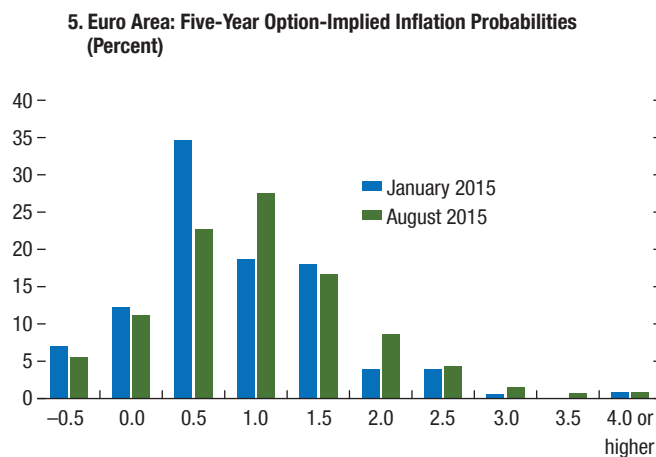
Sources: European Central Bank; Haver Analytics; and IMF staff calculations.

...as quantitative easing and bank reform begin to revive credit.



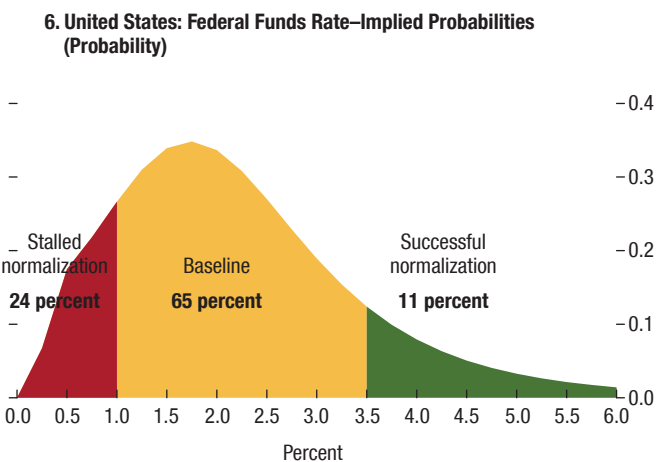
Sources: European Central Bank; Haver Analytics; and IMF staff calculations.

But deflation risks remain in the euro area...



Source: IMF staff calculations.
Note: The probabilities are constructed by creating a "butterfly" portfolio that pays out if inflation takes a specific value or range. The options involved are inflation caps and floors that protect the buyer against high and low inflation, respectively. Each x-axis label refers to midpoint probability.

...and full monetary policy normalization is not guaranteed, even in the United States.



Source: IMF staff calculations.
Note: For this calculation, the market pricing of options expiring in August 2017 on three-month swaps was used to determine the probability that market participants are placing on a stalled normalization. The calculation assumes that the difference between the three-month swap rate and the effective federal funds rate would remain relatively stable, at 15 basis points.