

INFLATION AFTER THE IRAN WAR

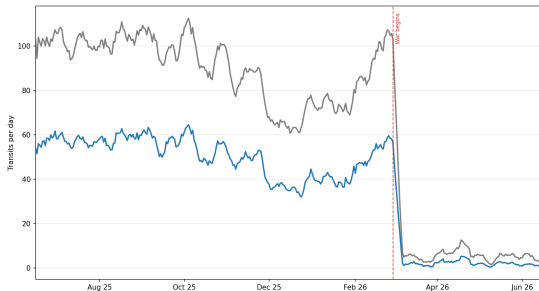
Ricardo Reis

LSE

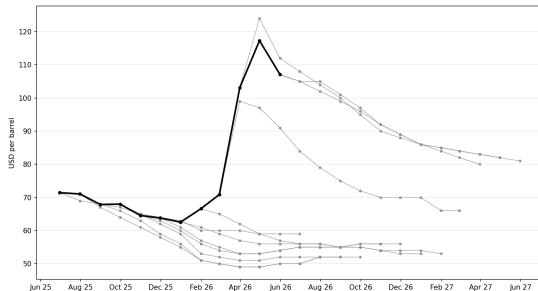
June 2026 (updated July 2026)

A NEW SUPPLY SHOCK: HOW MUCH INFLATION?

Traffic through the Strait of Hormuz



Brent crude: spot and forward curves



By how much will the initial supply shock **transmit to inflation?**

Use **what we learned** from 2022 to assess **transmission and propagation** of this shock **alone**.

TRANSMISSION TO PRICES: MENU COSTS

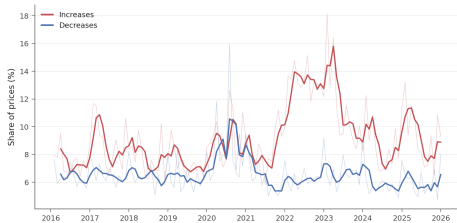
- **Stickiness of prices:** The intensive and extensive margins of inflation

$$\text{Inflation} = \text{Share of adjusters} \times \text{Mean adjustment}$$

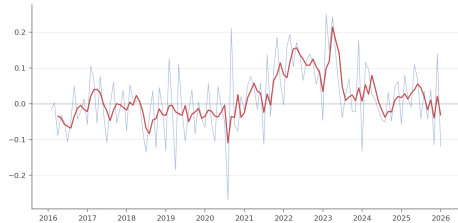
- **Inaction models:** price gap between actual price and the ideal reset price has to be large enough to form a new plan.
- **Inflation pressure:** when gaps are piling near the left barrier of the price gap distribution
- **Inflation realization:** in inflationary periods, many similar price rises.

TRANSMISSION TO PRICES: 2021–24

Frequency changing



Mean change



Standard deviation



Skewness



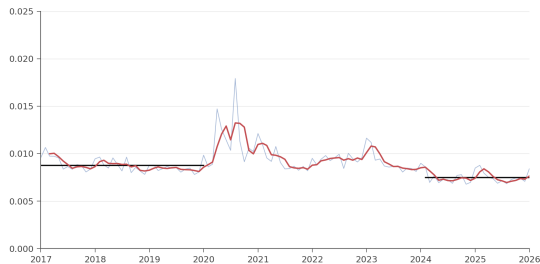
HAS THE PHILLIPS CURVE STEEPENED?

Frequency-based measure



- Slope $\propto 1/[\sum_j w_j (1/f_j)^2]$
- Slightly *higher* than pre-20
- Scars from the past?

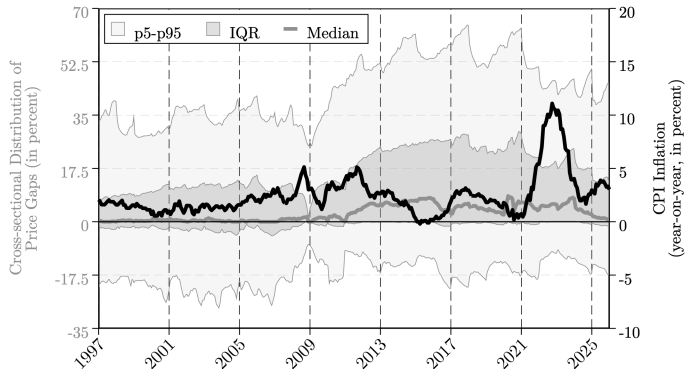
Adjusted for distribution



- Slope $\propto \sum_j w_j f_j / 6k_j$
- Slightly *lower*
- Credibility restored?

THE DISTRIBUTION OF PRICE GAPS, NOT PRICE CHANGES

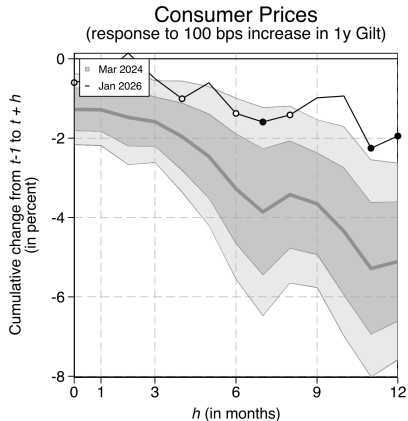
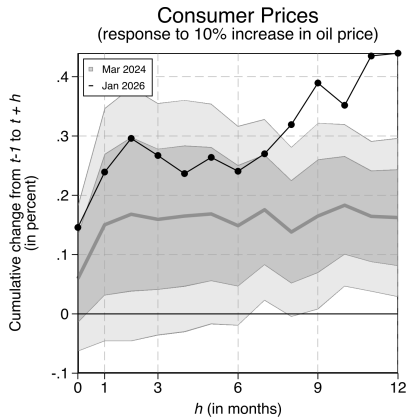
Distribution of the price gaps



Problems with slope: (i) the Iran shock is smaller than 2021–22,
(ii) slope is about demand, not supply, shock.

- Estimated price gaps good-by-good from price histories. *Bandeira, Castillo-Martinez & Wang*
- Apr 2014: more positive gaps → later disinflation,
- Oct 2021: mass on both tails → symmetric response,
- In Jan 2026: mass tilted to the **left tail**, thin right tail
- ⇒ positive shock → fast rise;
- ⇒ negative shock → little.

INFLATION RESPONSE, CONDITIONAL ON JANUARY 2026



Given size of shocks $\rightarrow$ 1.2–1.6pp in 26-27

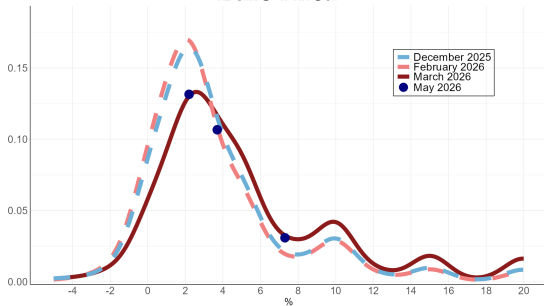
Monetary policy is weaker

2. TRANSMISSION TO EXPECTATIONS

- **For persistence:** second round effects from inflation, to expectations, to future prices, wages, and demand
- **2021-24 experience:** expectations data were invaluable.
- **Which expectations?** Households and firms. Distribution led the mean, through second and third moments.
- **Starting point in 2025:** inflation expectations were anchored, but not as deeply rooted in the ground as in the 2010s.

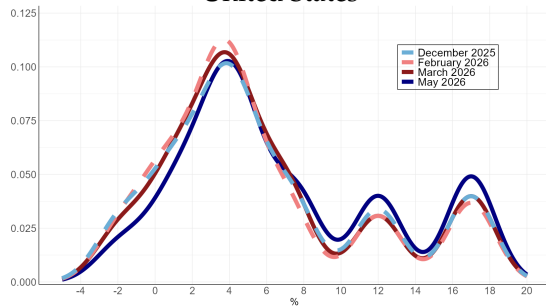
HOUSEHOLD DATA

Euro Area



Median up 0.7%, mean 1.0%, thicker right tail

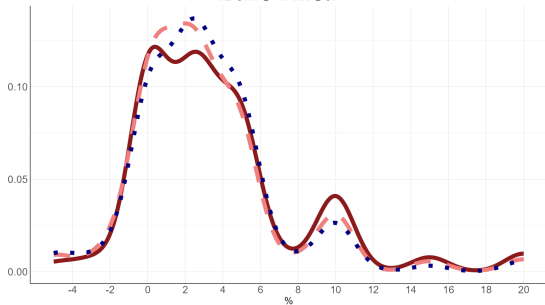
United States



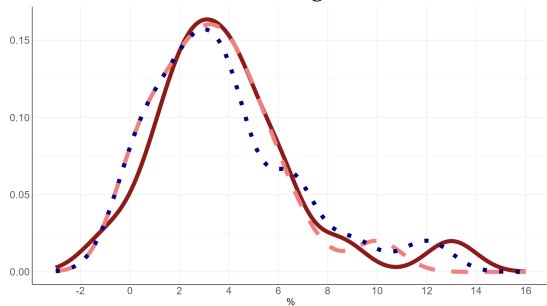
Median up 0.6%, mean 1.4%, similar.

SAME WITH FIRMS, WHERE $UK \sim US$

Euro Area

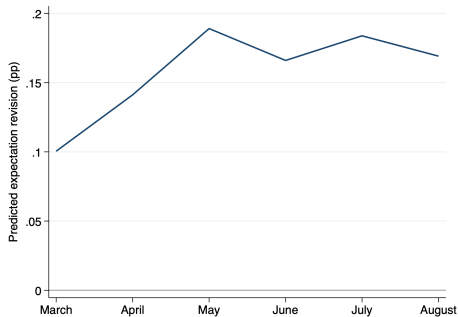


United Kingdom

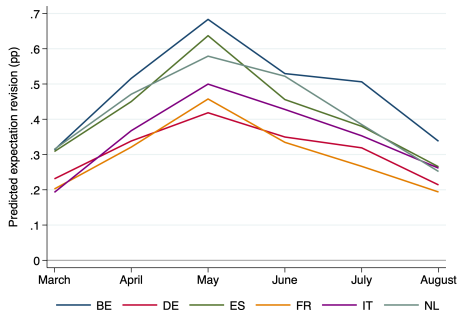


BUT HOW MUCH IS DUE TO THE ENERGY SHOCK?

With full electricity passthrough



With country-specific energy passthrough



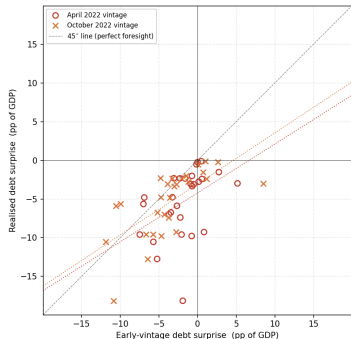
- Same ratio of total to direct as in 2021-23
- 1pp increase in mean expected inflation $\rightarrow$ 0.25pp rise in prices Abberger, Funk, Lamla, Lein & Siegrist
- **Second round effect on inflation: 0.25–0.35pp**

3. TRANSMISSION TO OTHER POLICIES

- **Monetary policy**: ultimately what determines inflation. But what paper is trying to inform.
- **Fiscal policy**: good case for targeted intervention at these times.
- **Impact on inflation**: many, but focus on impact on the deficit and on the debt.
- **In 2021-24**: important role.

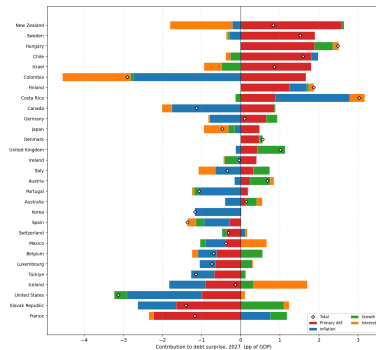
DEBT: WEO FORECAST REVISIONS

The past: 2022 revisions of 2023 outcomes



- Only macro driven components: surplus, interest rates, inflation, economic growth
- Tracks realized, slope 0.64–0.67, R^2 up to 0.45

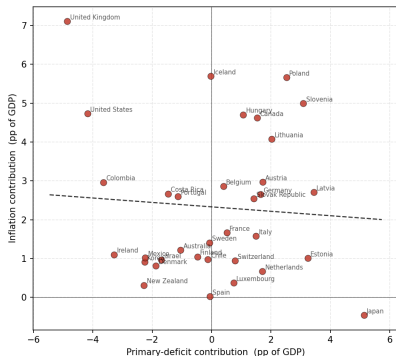
The present: Iran and the April revision



- Debt for 2027 revised **up** in April 2026, but wide dispersion
- Inflation revised up, but modest

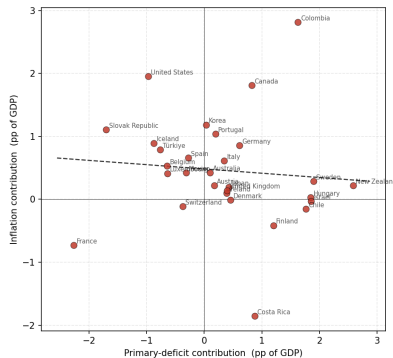
DEFICITS: WEO FORECAST REVISIONS IN 2022

The past: April 22 revisions of 23 outcomes



- No relation between deficit and inflation contributions foreseen at first
- Ex post, the deficit and inflation surprises did co-move (slope 0.37)

The present: Iran and the April 26 revision



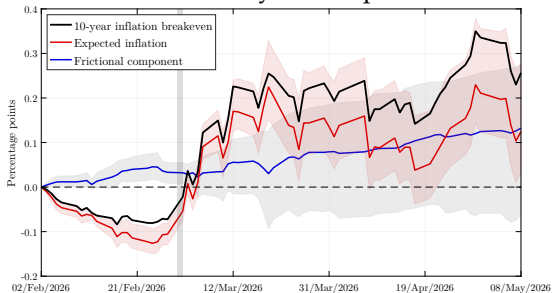
- Right now, the deficit and inflation surprises are *uncorrelated*, as in 2022
- Inconclusive link from fiscal → inflation transmission. **Yet?**

4. TRANSMISSION TO THE ANCHOR

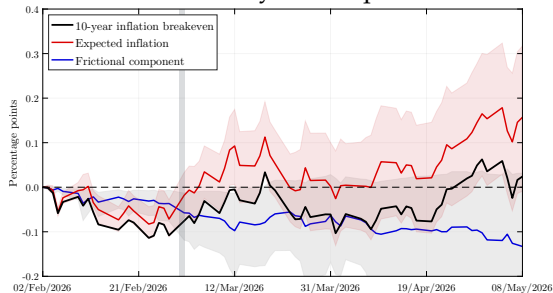
- **Prolonged elevated inflation**: loss of the inflation anchor.
- **Credibility**: belief that inflation will be 2% in the long run.
- **Judging them**: insurance prices in financial markets.
- **In 2021-24**: clear and persistent rise in tail events.

10-YEAR SWAP PRICES: RAW AND FUNDAMENTAL

EA 10-year swap



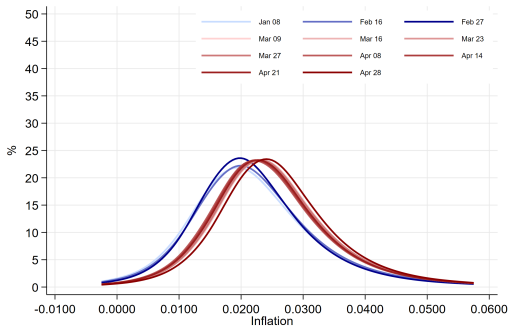
US 10-year swap



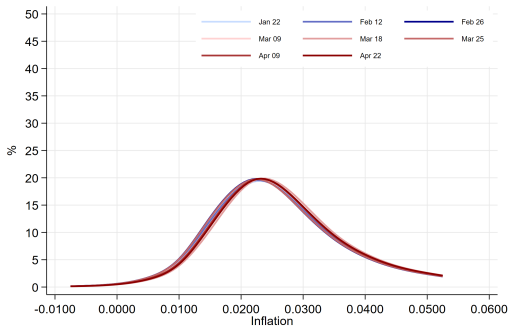
- Raw 10y rise per annum: EA +0.25, UK +0.15–0.20, US ≈ 0 .
- Net of frictions, fundamental ≈ 0.15 –0.2pp *everywhere*.
- Years 2–10 only +0.16pp. Some persistence into 2027–28, but **anchor intact**.

SWAPTIONS: WHAT IS HIDDEN IN THE TAILS?

Euro Area



United States



- If adjust both horizontally by swaps-identified frictions, again very similar.
- For both, no thickening of the tails.
- No evidence of fear of a **regime change**.

CONCLUSION

- This paper assessed transmission of energy shock to inflation via:
 - 1) **Prices**: first-round impact on sticky prices persists to 2027, adds up to 1.2–1.6pp.
 - 2) **Expectations**: second-round impact through expectations adds a further 0.3–0.4pp.
 - 3) **Fiscal policy**: inconclusive, guarded grounds for some optimism.
 - 4) **Anchor**: no signs of danger. Consistent 2-year impact of 1.5–2.0pp.
- Should monetary policy look through or not?
 - 1) **Change in view**: pre-2021 of course, post-2025 act swiftly.
 - 2) **On the one hand**: persistent and significant impact.
 - 3) **On the other hand**: no support for 2022-type aggressiveness.