Inflation after the Iran war

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LSE

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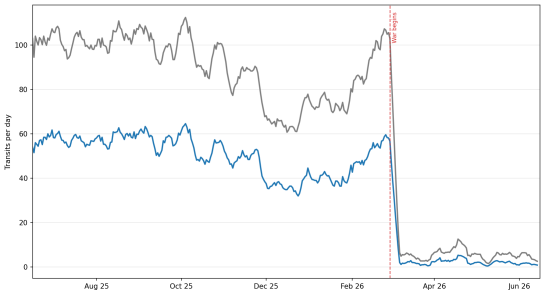
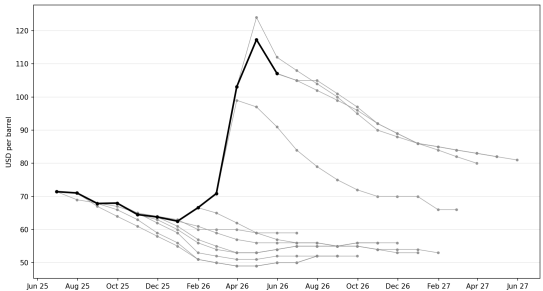
A NEW SUPPLY SHOCK: HOW MUCH INFLATION?

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

  Inflation = Share of adjusters times Mean adjustment

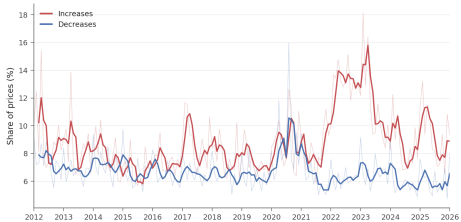
- Inaction models: price gap between actual price and the ideal reset price has to be large enough to form a new plan.

- Inflation pressure: when gaps are piling near the left barrier of the price gap distribution

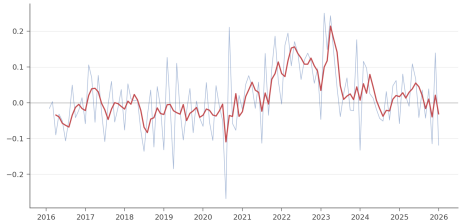
- Inflation realization: in inflationary periods, many similar price rises.

TRANSMISSION TO PRICES: 2021–24

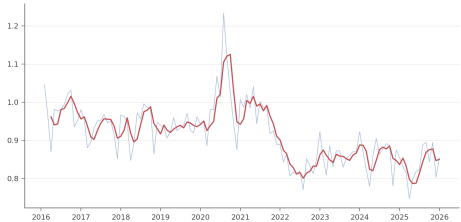
Frequency changing



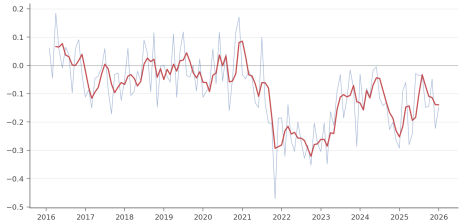
Mean change



Standard deviation

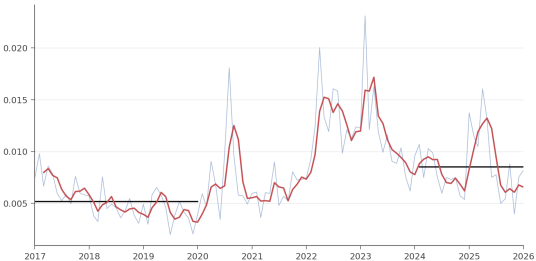


Skewness



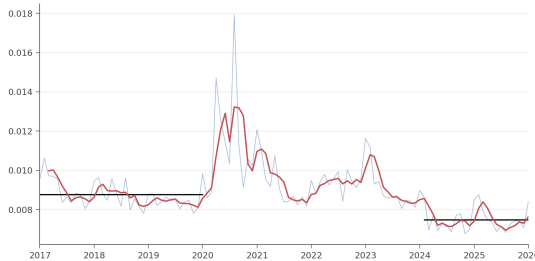
HAS THE PHILLIPS CURVE STEEPENED?

Frequency-based measure



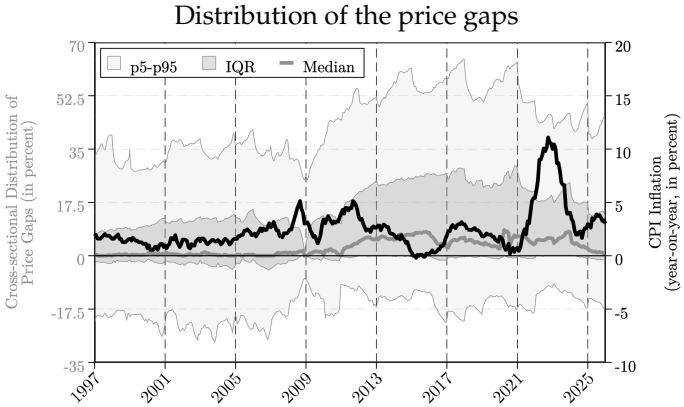
- Slope $\propto 1/[\sum_j w_j(1/f_j)^2]$
- Slightly *higher* than pre-20
- Scars from the past?

Adjusted for distribution



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

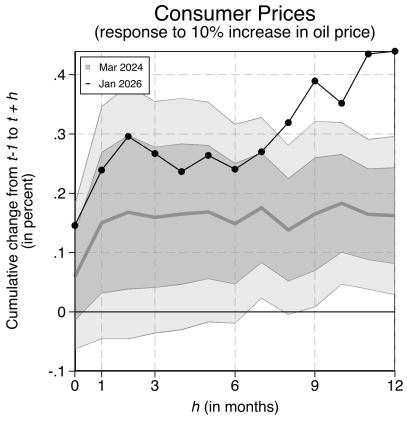
The distribution of price gaps, not price changes

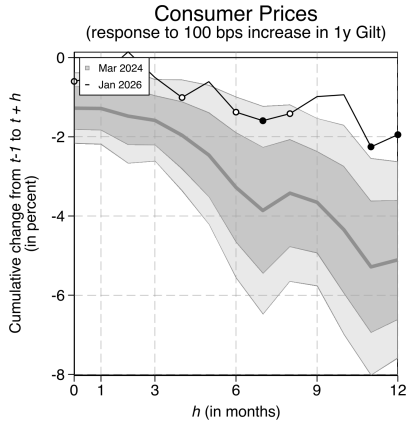


Problems with slope: (i) the Iran shock is smaller than 2021–22, (ii) slope is about demand, not supply, shock.

- 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





35–50% shock → ≈1pp on impact, 1.4% by 2027 (lower bound, given size of shock)

Monetary policy is weaker

2. Transmission to expectations

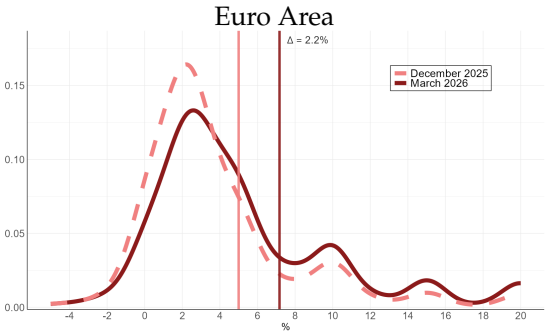
- For persistence: second round effects from inflation, to expectations, to future prices, wages, and demand

- 2021-24 experience: expectations data were invaluable.

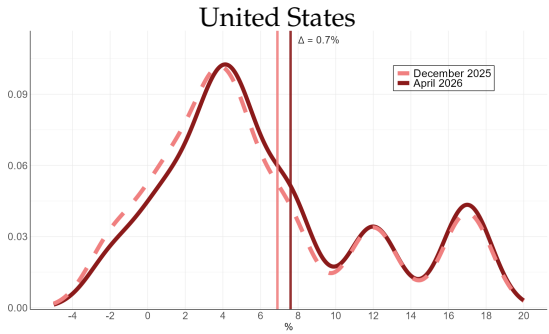
- Which expectations? Households and firms. Distribution led the mean, through second and third moments.

- Starting point in 2025: inflation expectations were anchored, but not as deeply rooted in the ground as in the 2010s.

HOUSEHOLD DATA

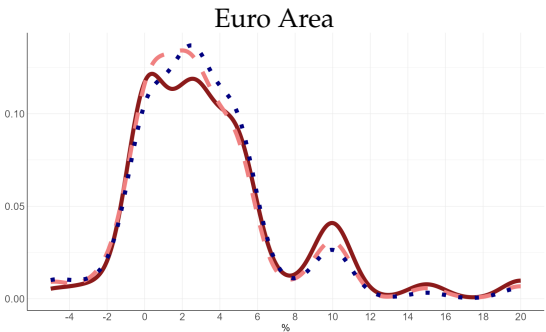


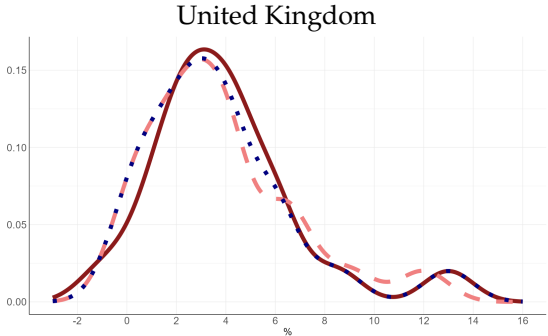
Median up 1.2%, thickening of the tail



No visible change

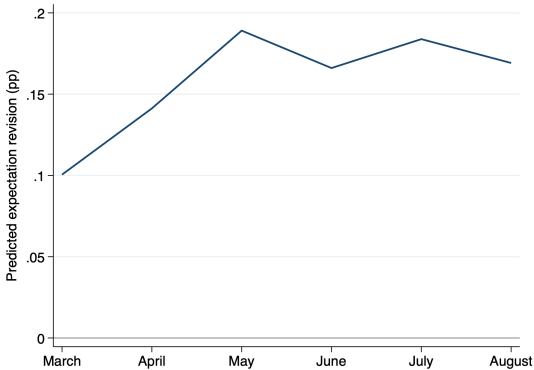
SAME WITH FIRMS, WHERE UK∼US



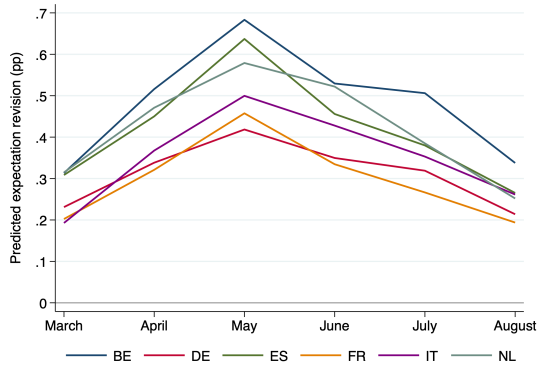


But how much is due to the energy shock?

With full electricity passthrough



With country-specific energy passthrough



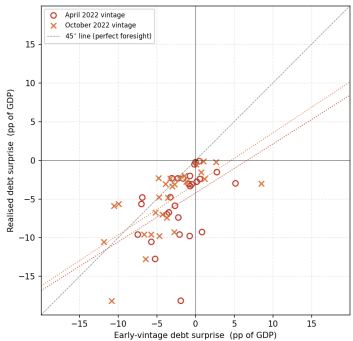
- In 2021-23, expected inflation increased 4.4x more than justified by energy shock
- In 2026: similar ratio 0.5 $\rightarrow$ 2.2

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.

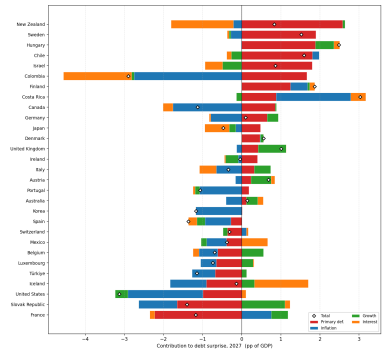
DEBT: WEO FORECAST REVISIONS

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

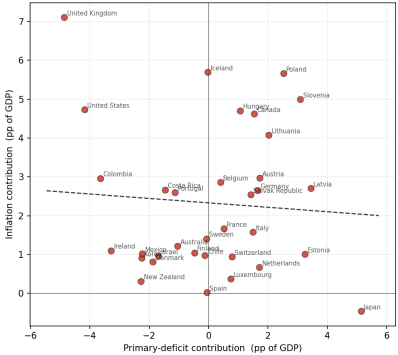
The present: Iran and the April revision



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

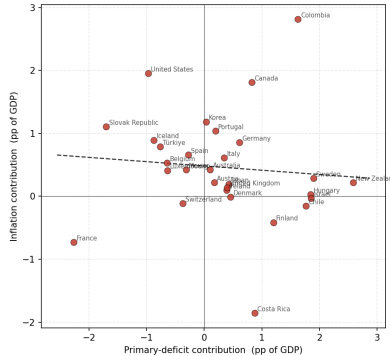
DEFICITS: WEO FORECAST REVISIONS IN 2022

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



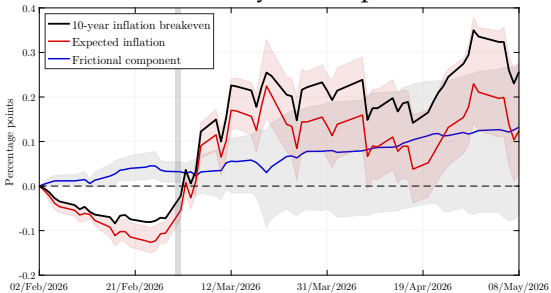
- Right now, the deficit and inflation surprises are *uncorrelated*, as in 2022
- Inconclusive link from fiscal→ inflation transmission. Yet?

4. Transmission to the anchor

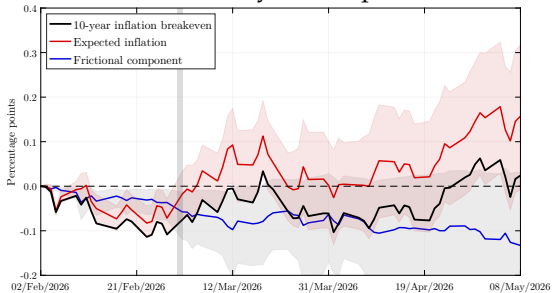
- Prolonged elevated inflation: loss of the inflation anchor.
- Credibility: belief that inflation will be 2% in the long run.
- Judging them: insurance prices in financial markets.
- In 2021-24: clear and persistent rise in tail events.

10-YEAR SWAP PRICES: RAW AND FUNDAMENTAL

EA 10-year swap



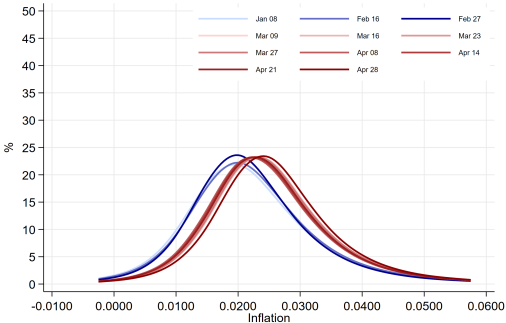
US 10-year swap



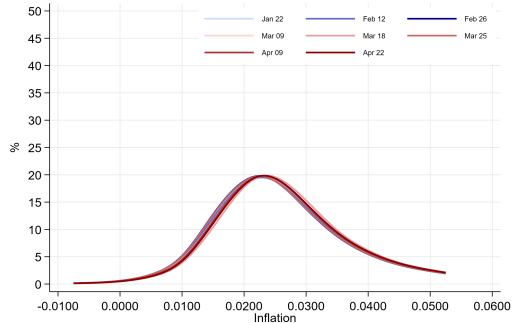
- Raw 10y rise per annum: EA $+0.25$, UK $+0.15$–0.20, US ≈ 0.
- Net of frictions, fundamental $\approx$0.15–0.2pp *everywhere*.
- Years 2–10 only $+0.16$pp. Some persistence into 2027–28, but anchor intact.

SWAPTIONS: WHAT IS HIDDEN IN THE TAILS?

Euro Area



United States



- Only EA shifts. But concerns about noise/fundamental same. Ignore.
- For both, distribution shifts right, but horizontally
- No thickening of tails, no evidence of fear of a regime change.

Conclusion

- This paper assessed transmission of energy shock to inflation via:

  1) Prices: UK inflation rises sharply and persist to 2027, 2pp. Monetary policy is weaker.
  2) Expectations: EA stands out as amp;ification. Beyond direct effect, in line with 2022.
  3) Fiscal policy: guarded grounds for some optimism. But early.
  4) Anchor: no signs of danger. Confirms persistence into 2027.

- 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 impact, 2pp, into 2027.
  3) On the other hand: no evidence of 2022 type aggressiveness.