Is inflation back, and in which form?

Federico Sturzenegger
Harvard University and Universidad de San Andrés

GGI, September 2022

The Fragility of IT

- For most of you IT is a sturdy, stable regime
- Theory says it is not:
  - Money is endogenous
  - This means there are multiple equilibria
  - Requires the Taylor principle to pin down a unique equilibria
  - But the equilibria is pinned down because it is globally unstable
  - And hinges on strong credibility which we don't model (nor understand)
- For those of us that have had to deal with these issues in volatile contexts we know how unstable this can be

A Tale of Two Countries

- Is it possible to rescue IT once its credibility has been tampered?
- Argentina and Turkey couldn't

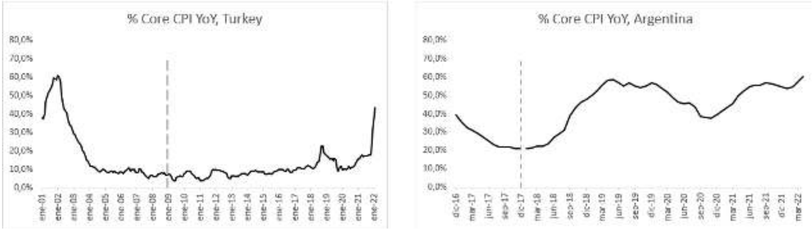


Figura: Turkey and Argentina

- Can Humpty-Dumpty be put together again?

A Tale of Two (Oil) Shocks

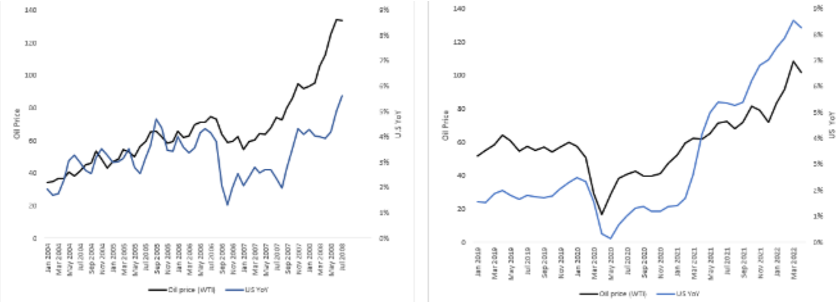


Figura: Two oil shocks, different responses

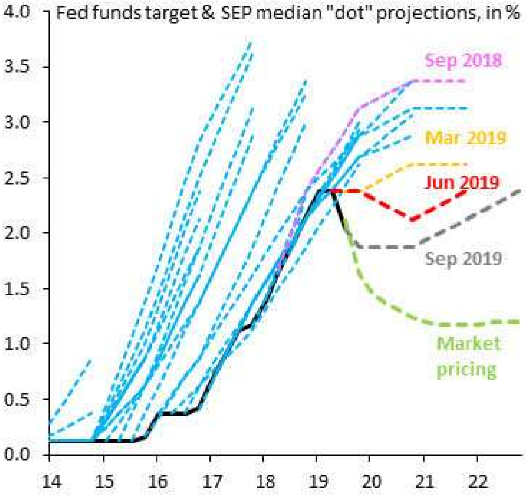
The oversold role of shocks

- Obviously there is a correlation
- But let me argue that these shocks don't create inflation
  - With flexible prices and exogenous monetary policy ...
  - In a NK framework with IR policy, money is endogenous. Inflation increases because the CB reacts so that there is more inflation
  - In short: it is not the shock, it is monetary policy!
  - This is the passthrough debate in EMs

The role of expectations

- Professional vs households expectations
- The role of salient prices in forming expectations (dollar, regulated prices, fuel, stock market): did not find it in Argentina.
- Political support is key

Did it start here...?



How Not to Improve Credibility

- Argentina's inflation theorem: "the number of stories for inflation is proportional to the rate of inflation".
- When you say inflation is transitory...
- or when you say inflation is a supply shock...
- you affect credibility (in a bad way),
- and directly violate the Taylor principle.

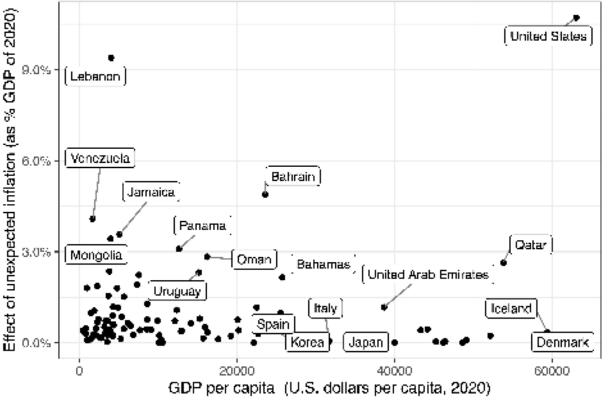
The unpleasant credibility arithmetic

- Once credibility is lost things get nasty
  - Increasing interest rates affects credibility not necessarily the right way
  - Fiscal monetary interactions start to become relevant
  - For the US, money abroad adds to the dilemma
- How to recover credibility? Open research question.

A final remark on the global distributive effects of inflation

- US inflation reduces de value of US nominal assets
- We estimate that loss in 2 Trillion
- 25 % of that is paid by non residents
- There is 1.3 trillion of long term fixed rate debt issued by non-US countries
- Other countries had a windfall of 100 billion

The global distributive effects of inflation



The global distributive effects of inflation