



Inflation Risk in Turbulent Times

Economic and Policy Regimes Set the Stage

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This presentation was developed with substantial assistance from generative AI tools, including Claude, across the design, analysis, coding, and drafting stages. The author supervised all stages, verified the results, and takes full responsibility for the content.

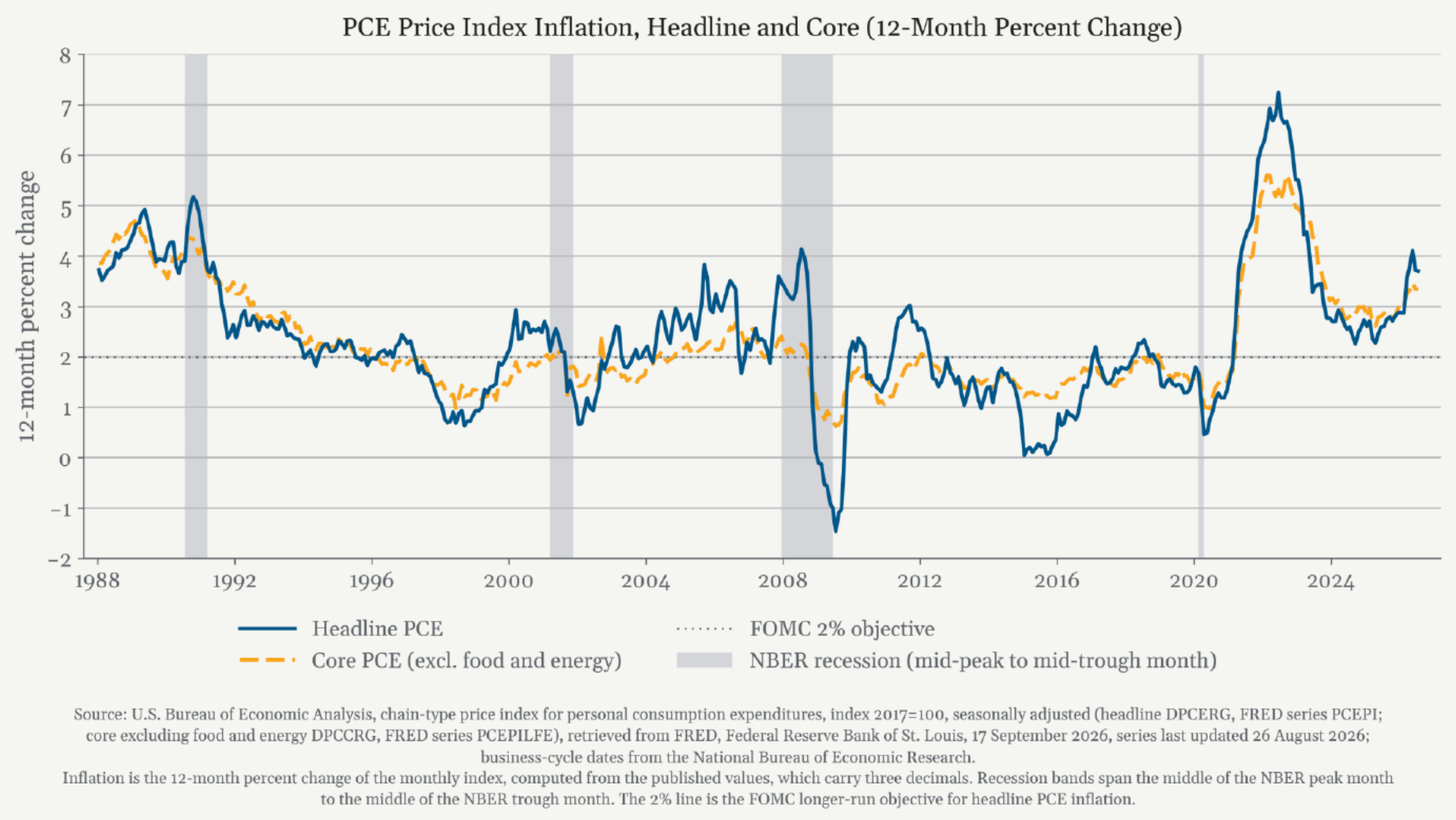
Economic and Policy Regimes Set the Stage

- Taking Stock
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- COVID-19 Pandemic and its Aftermath
- Changing Geopolitical Order and Military Conflict
- Potential AI-related Productivity Boom
- Implications of a Potential Sovereign Debt Crisis



Taking Stock

PCE price index inflation, headline and core





Inflation Targeting

Inflation Targeting: Origins

- New Zealand went first: the Reserve Bank of New Zealand Act 1989 made price stability the Bank's single objective, and the Policy Targets Agreement of 2 March 1990 set a target of 0 to 2 percent by 1992, reached a year early.
- The purpose is to anchor expectations: if the public expects inflation at the target, wage and price setting builds in the target rather than the latest reading.
- Anchored expectations are meant to flatten the Phillips curve, the short-run relation between slack and inflation: employment can swing without pulling inflation off target, and inflation be held at target without large employment losses.

Sources: Reserve Bank of New Zealand Act 1989 and the Policy Targets Agreement of 2 March 1990; Graeme Wheeler, "Reflections on 25 Years of Inflation Targeting," 1 December 2014.

Inflation Targeting: Adoption and the Federal Reserve

- Adoption spread quickly: Canada in 1991, the United Kingdom in 1992, Sweden and Australia in 1993. Every advanced-economy central bank now has an inflation target, whether a point target, a range, or a soft target, and most sit at 2 percent.
- The Federal Reserve came late: its Statement on Longer-Run Goals and Monetary Policy Strategy of 25 January 2012, under Chair Ben Bernanke, first put a 2 percent PCE objective in writing.
- It had aimed at 2 percent implicitly for sixteen years: at the FOMC meeting of 2 and 3 July 1996 the Committee settled on 2 percent after Janet Yellen, then a Governor, argued for it, and Greenspan insisted the figure not leave the room.

Sources: Federal Open Market Committee, "Statement on Longer-Run Goals and Monetary Policy Strategy," 25 January 2012; transcript of the FOMC meeting of 2–3 July 1996; Federal Reserve Bank of Richmond, "The Origins of the 2 Percent Inflation Target," Econ Focus, 2024.

Why the Target Is Not Zero

- Room to ease: spending responds to the real interest rate, the policy rate less expected inflation, and the Federal Reserve has never set its policy rate below zero. At that floor a 2 percent target puts the real rate near minus 2 percent, where a zero target would leave it at zero. The FOMC's framework cites this lower bound as the risk in inflation running persistently below 2 percent.
- A lubricant for the labor market: nominal wages rarely fall, because firms resist cutting them and workers resist accepting cuts. At zero inflation a firm that needs a lower real wage must cut the nominal wage or cut jobs; at 2 percent the real wage falls about 2 percent a year with the nominal wage unchanged. Akerlof, Dickens, and Perry (1996) set out the case.

Sources: Federal Open Market Committee, "Statement on Longer-Run Goals and Monetary Policy Strategy," 25 January 2012, as revised August 2020; Board of Governors of the Federal Reserve System, "Why does the Federal Reserve aim for inflation of 2 percent over the longer run?"; George A. Akerlof, William T. Dickens, and George L. Perry, "The Macroeconomics of Low Inflation," *Brookings Papers on Economic Activity*, 1996.

Why 2 Percent

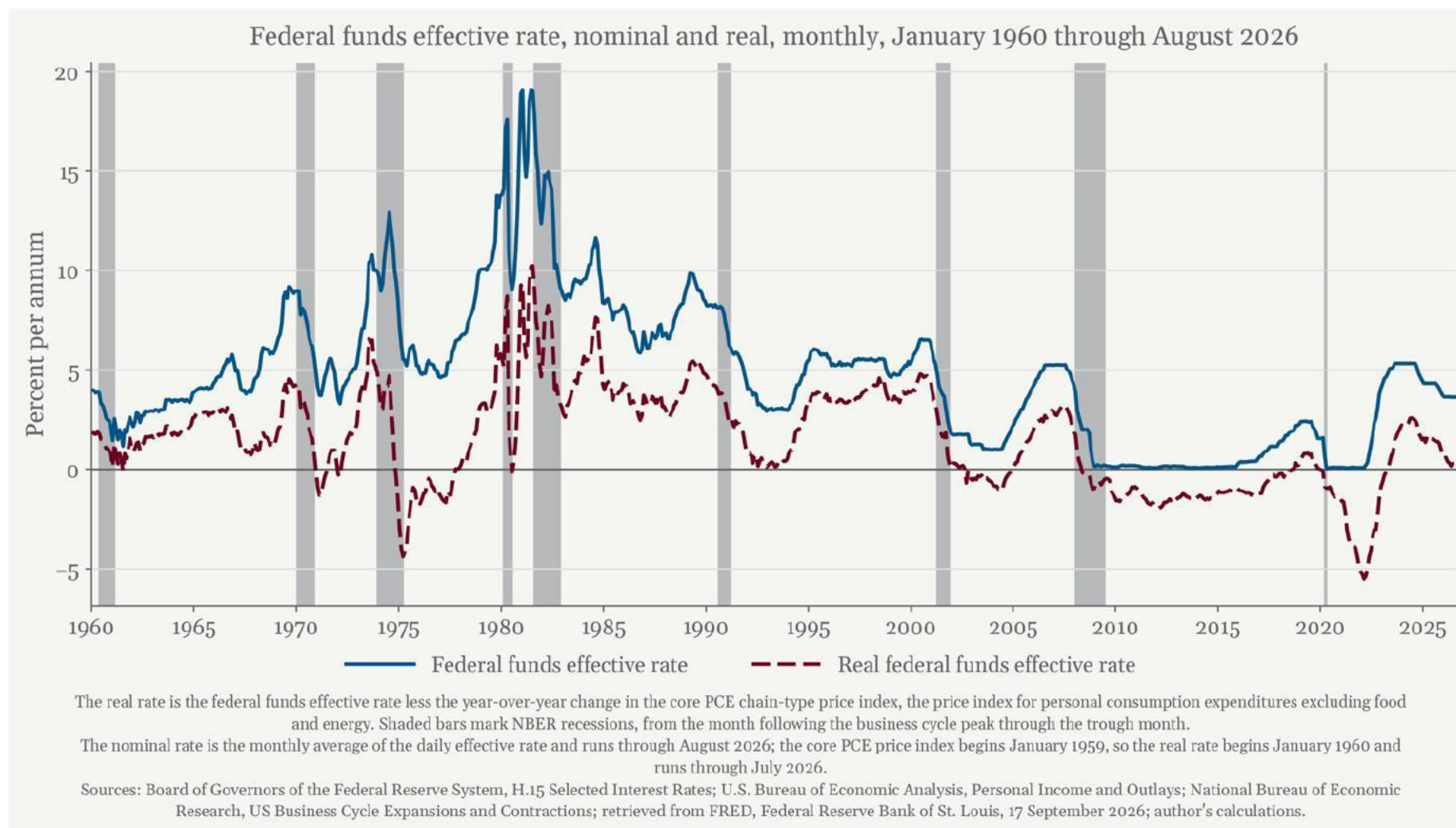
- Why 2 and not another positive number: the target must sit far enough above zero that ordinary fluctuations do not tip the economy into deflation, while the costs of inflation rise with its level. Measured inflation also overstates the rise in the cost of living, so a 2 percent target is nearer 1.5 percent in truth.
- That overstatement is about half as large for PCE, the index the target is written on, as for the CPI: 0.47 against 0.85 percentage points a year on Moulton's 2018 estimates, where the Boskin Commission put the CPI at 1.1 points in 1996. Chain weighting removes most of the fixed-basket substitution bias, and what remains in PCE is unmeasured quality gains and new goods.

Sources: Federal Reserve Bank of St. Louis, "The Fed's Inflation Target: Why 2 Percent?", 16 January 2019; Brent R. Moulton, "The Measurement of Output, Prices, and Productivity: What's Changed Since the Boskin Commission?", Hutchins Center, Brookings Institution, July 2018; Advisory Commission to Study the Consumer Price Index, "Toward a More Accurate Measure of the Cost of Living," December 1996, as reported by the Federal Reserve Bank of Cleveland, "The CPI-PCEPI Inflation Differential," 2020.

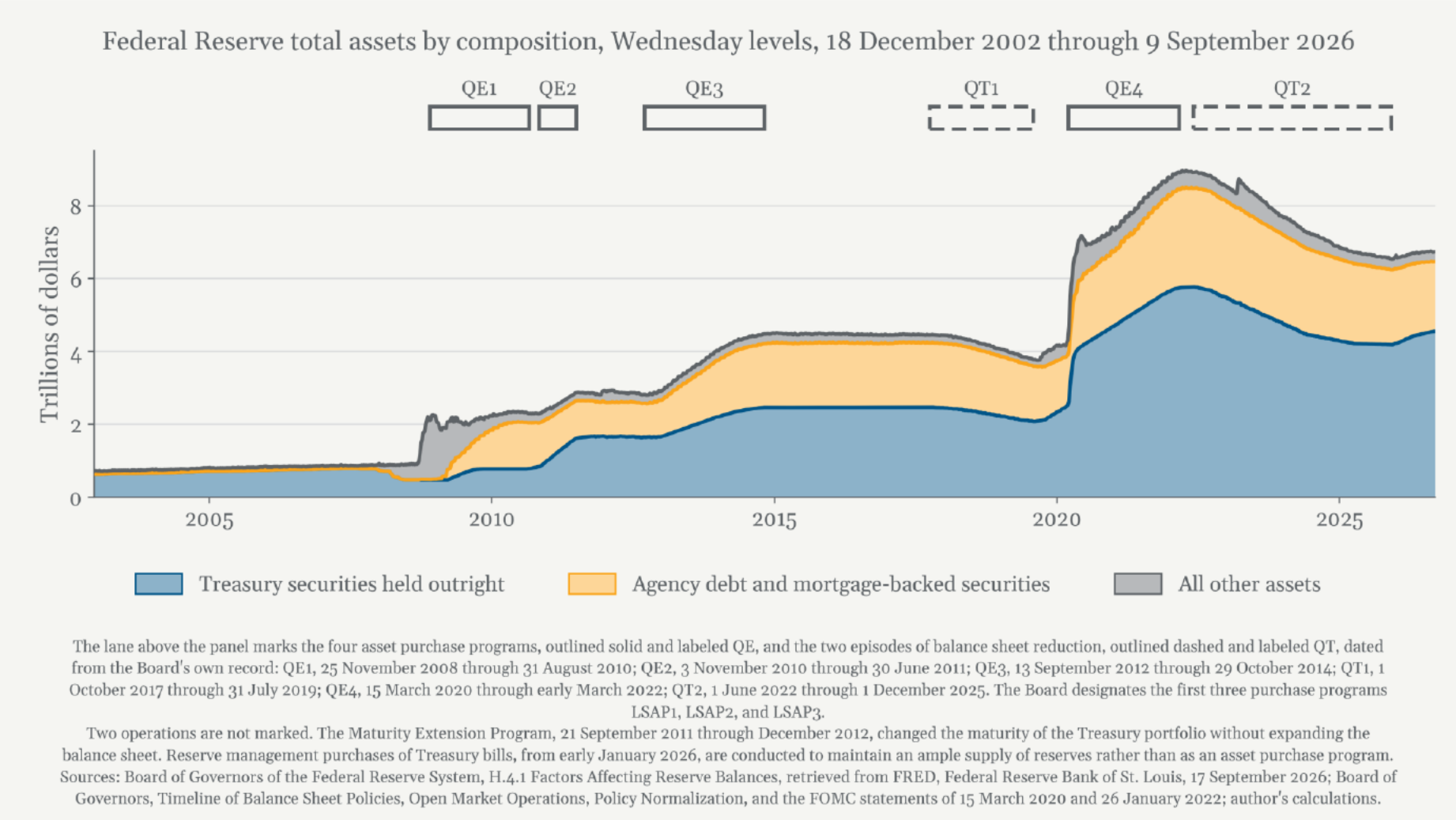


Global Financial Crisis (2007–2009) and its Aftermath

The Federal Funds Rate, Nominal and Real



Quantitative Easing and the Balance Sheet

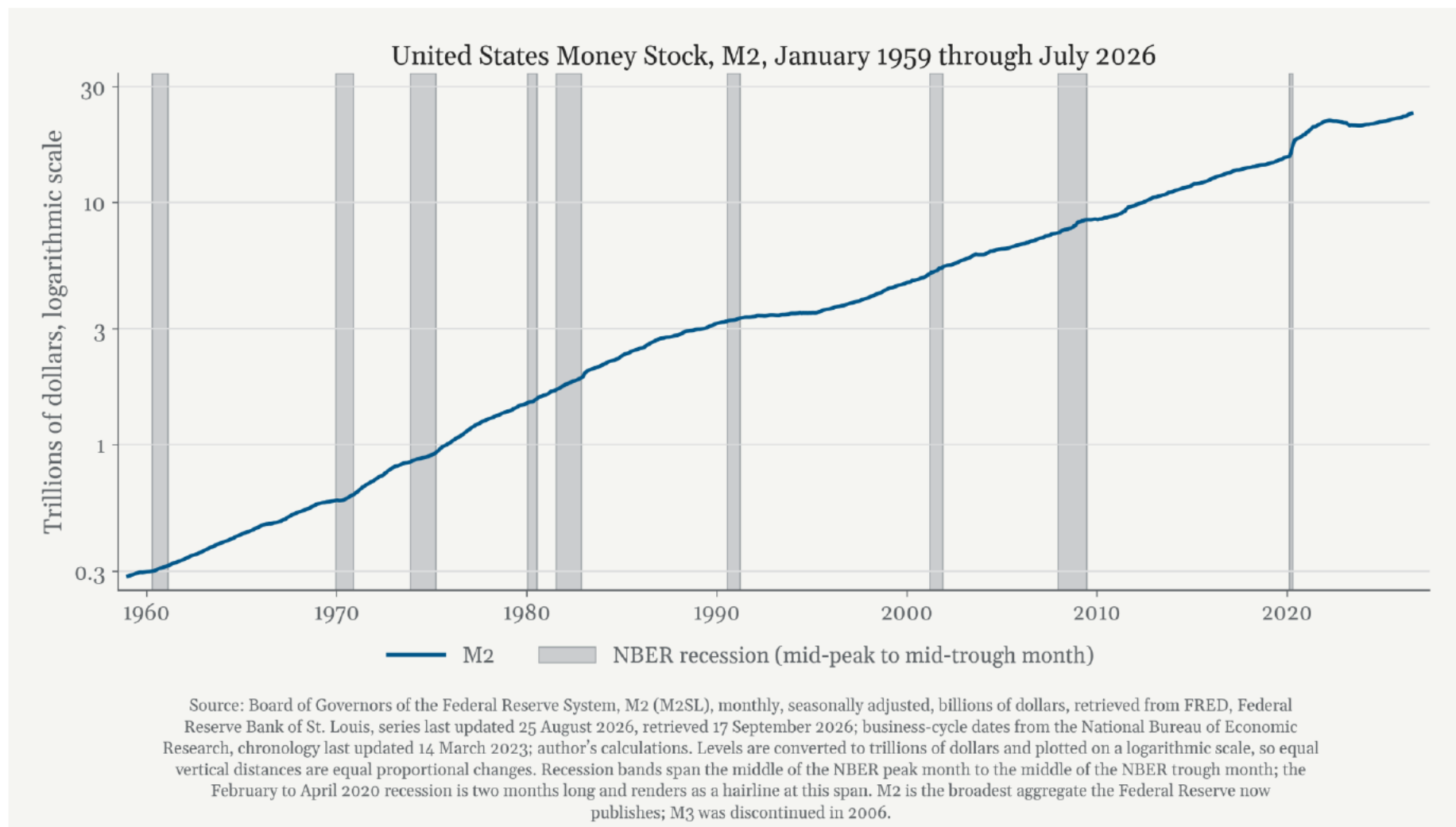


Forward Guidance at the Zero Lower Bound

- The motivation: with the policy rate at its floor, the rate itself has no room left, but the long-term rates that drive borrowing and investment are built from expected future short rates. Guidance about the path is the lever that remains, and it works by lowering those expectations today.
- That requires a commitment to keep rates low well past the point at which a committee weighing only present conditions would raise them, accepting inflation above target later in exchange for easier conditions now. It is the opposite of deciding each meeting on its own merits, and it is time-inconsistent: the promise does the work, and the temptation to break it arrives with the recovery. Eggertsson and Woodford (2003) set out the argument; Krugman (1998) put it as a central bank that must “credibly promise to be irresponsible.”
- The record: “for some time” in December 2008 became “for an extended period” on 18 March 2009, then calendar dates, “at least through mid-2013” on 9 August 2011, late 2014 in January 2012 and mid-2015 in September 2012, and then thresholds on 12 December 2012: rates to stay near zero at least while unemployment exceeded 6.5 percent and projected inflation stayed within half a point of 2 percent.
- The limit: each statement said the Committee anticipated a low rate, not that it promised one, and the members who would have to honour the guidance rotate. As Plosser put it in 2014, the FOMC signalled that it would not act before a threshold was crossed, not what it would do once one was.

Sources: Board of Governors of the Federal Reserve System, “Timelines of Policy Actions and Communications: Forward Guidance about the Federal Funds Rate”; Gaudi B. Eggertsson and Michael Woodford, “The Zero Bound on Interest Rates and Optimal Monetary Policy,” *Brookings Papers on Economic Activity*, 2003; Paul Krugman, “It’s Baaack: Japan’s Slump and the Return of the Liquidity Trap,” *Brookings Papers on Economic Activity*, 1998; Charles I. Plosser, “Communication Challenges,” 28 February 2014.

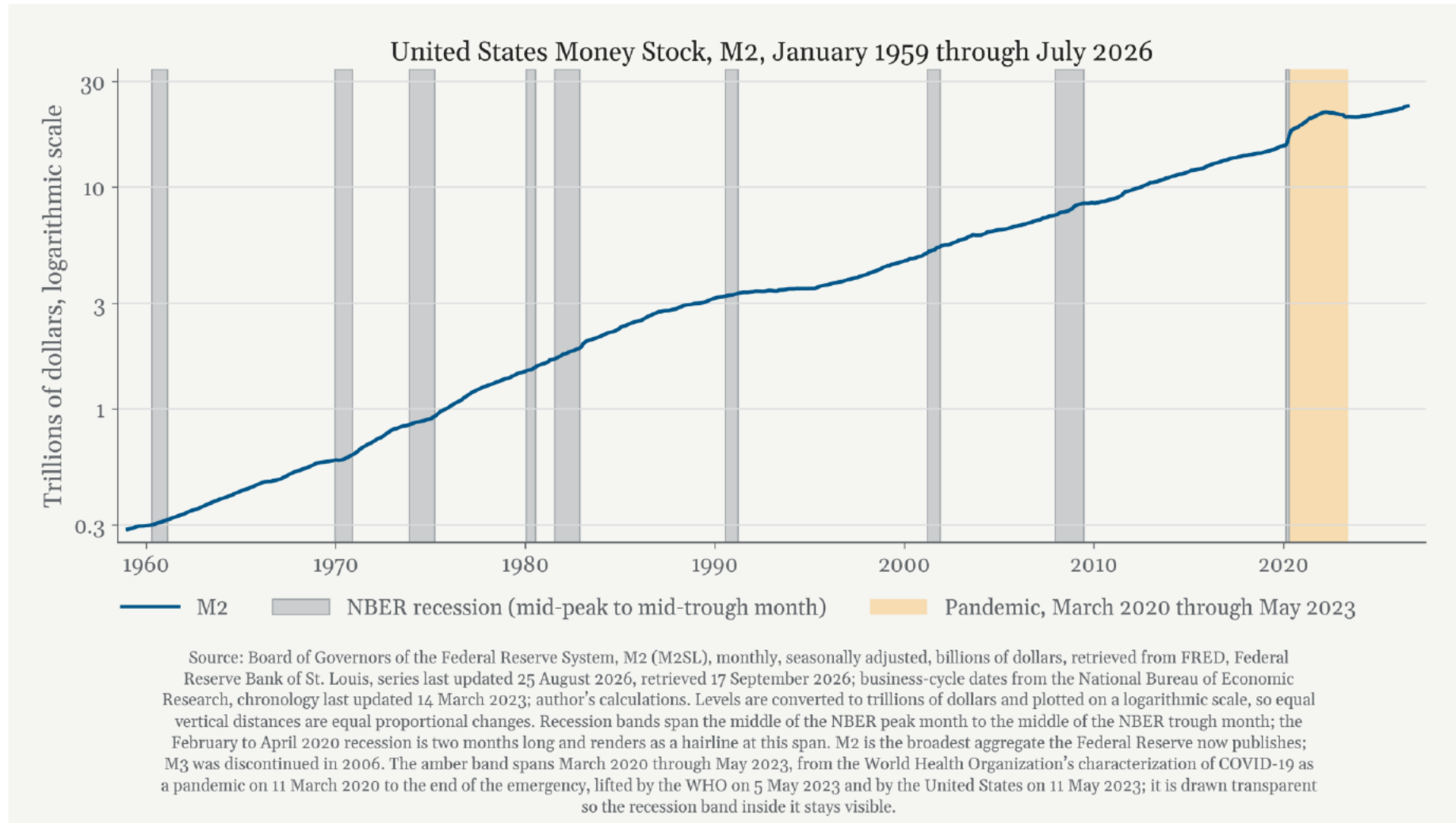
United States money stock, M2





COVID-19 Pandemic and its Aftermath

The Money Stock Through the Pandemic



The \$5.2 Trillion Pandemic Fiscal Expansion

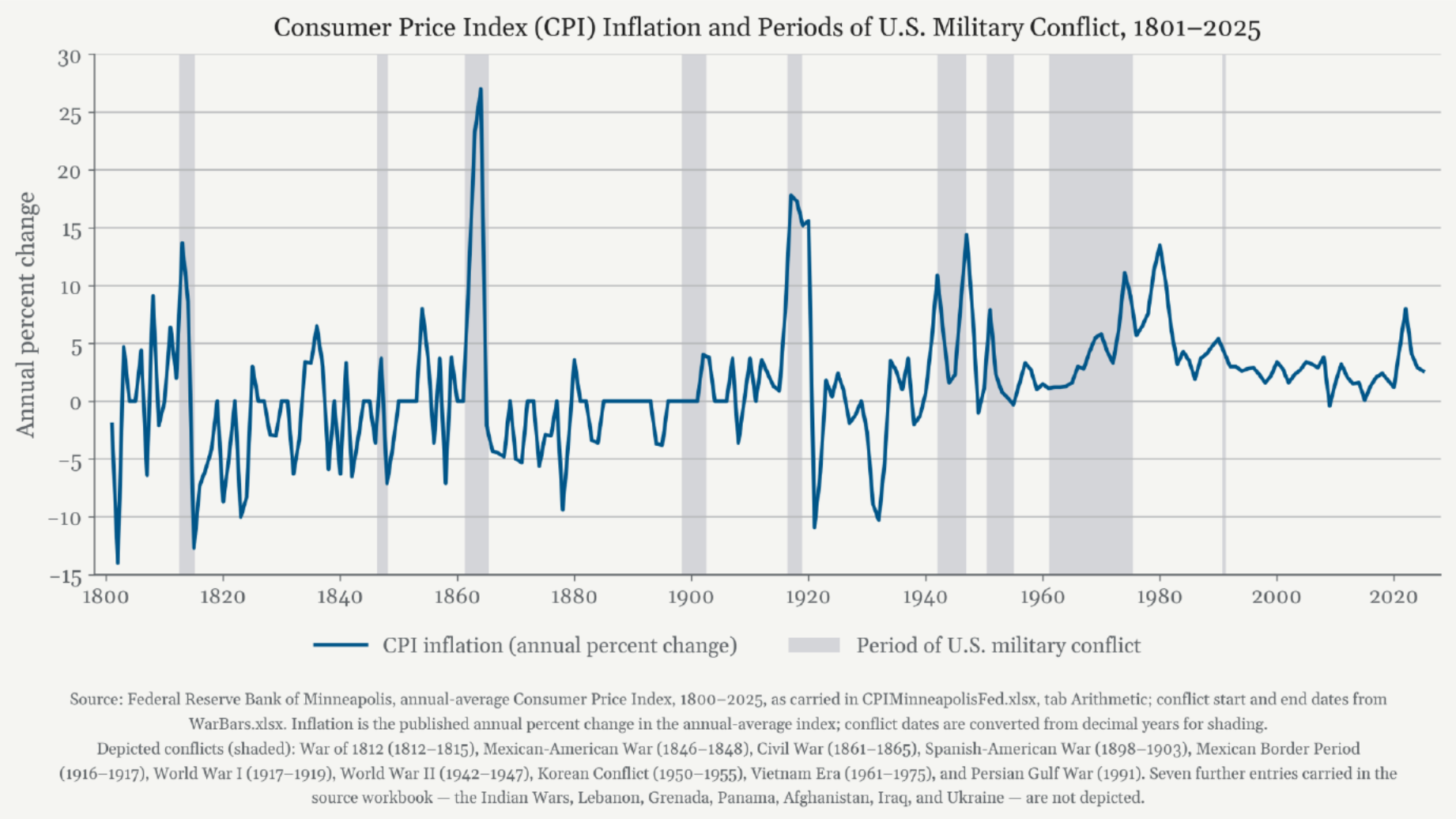
- Romer's verdict on the \$5.2 trillion of deficit impact, spending and tax reductions together: it “runs the gamut from highly useful and appropriate to largely ineffective and wasteful.”
- Suited to a pandemic: \$748 billion of expanded unemployment insurance, \$629 billion of public health spending, \$597 billion of aid to states and localities, each reaching those the pandemic harmed.
- Misguided: \$870 billion of onetime payments, most to households the pandemic had not harmed, and only 15 percent of surveyed recipients mostly spent it.
- Jobs: forgivable loans went only to firms under three hundred employees. Two studies compared firms just inside that cutoff with firms just outside: employment fell less at eligible firms, but by a small margin, putting the cost per job preserved at \$224,000 and \$377,000.
- At those costs the \$808 billion of loans corresponds to 2.1 to 3.6 million jobs, against \$27,000 a job for the 2009 state relief. Whether those jobs outlasted the program was unresolved when Romer wrote.
- The bill: federal debt goes from 79 percent of GDP before the pandemic to 110 percent by the end of fiscal 2023, and Romer's concern is the lost fiscal space deters spending on climate, infrastructure, and poverty.

Source: Christina D. Romer, “The Fiscal Policy Response to the Pandemic,” *Brookings Papers on Economic Activity*, Spring 2021, 89–110, and the Brookings summary of it, 24 March 2021. Cost per job: Chodorow-Reich and others (2012); Autor and others (2020); Chetty and others (2020). Survey share: Coibion, Gorodnichenko, and Weber (2020). Durability: Hubbard and Strain (2020). The count of jobs is this author's arithmetic: outlay divided by each cost-per-job estimate.

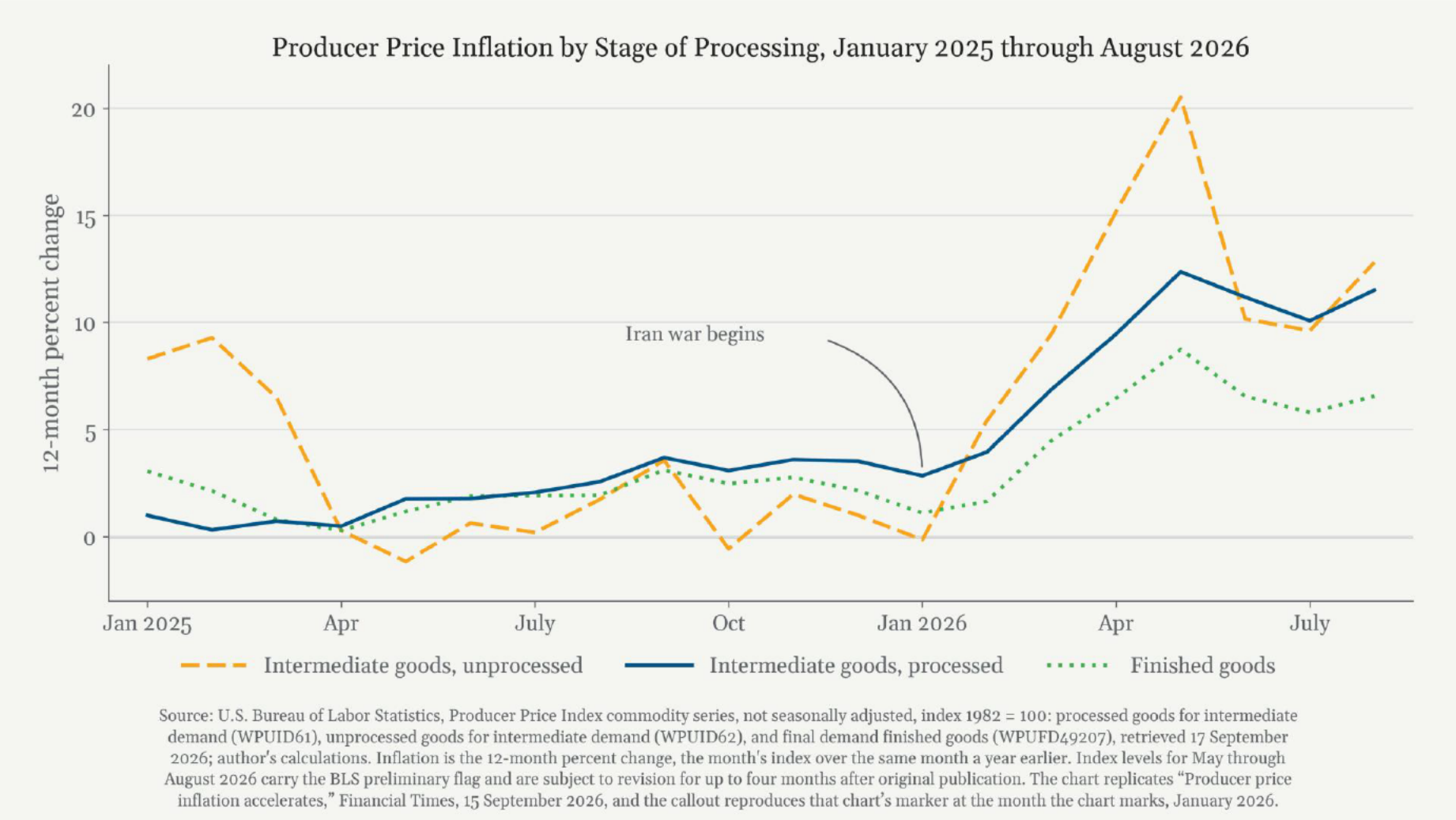


Changing Geopolitical Order and Military Conflict

CPI inflation and periods of U.S. military conflict



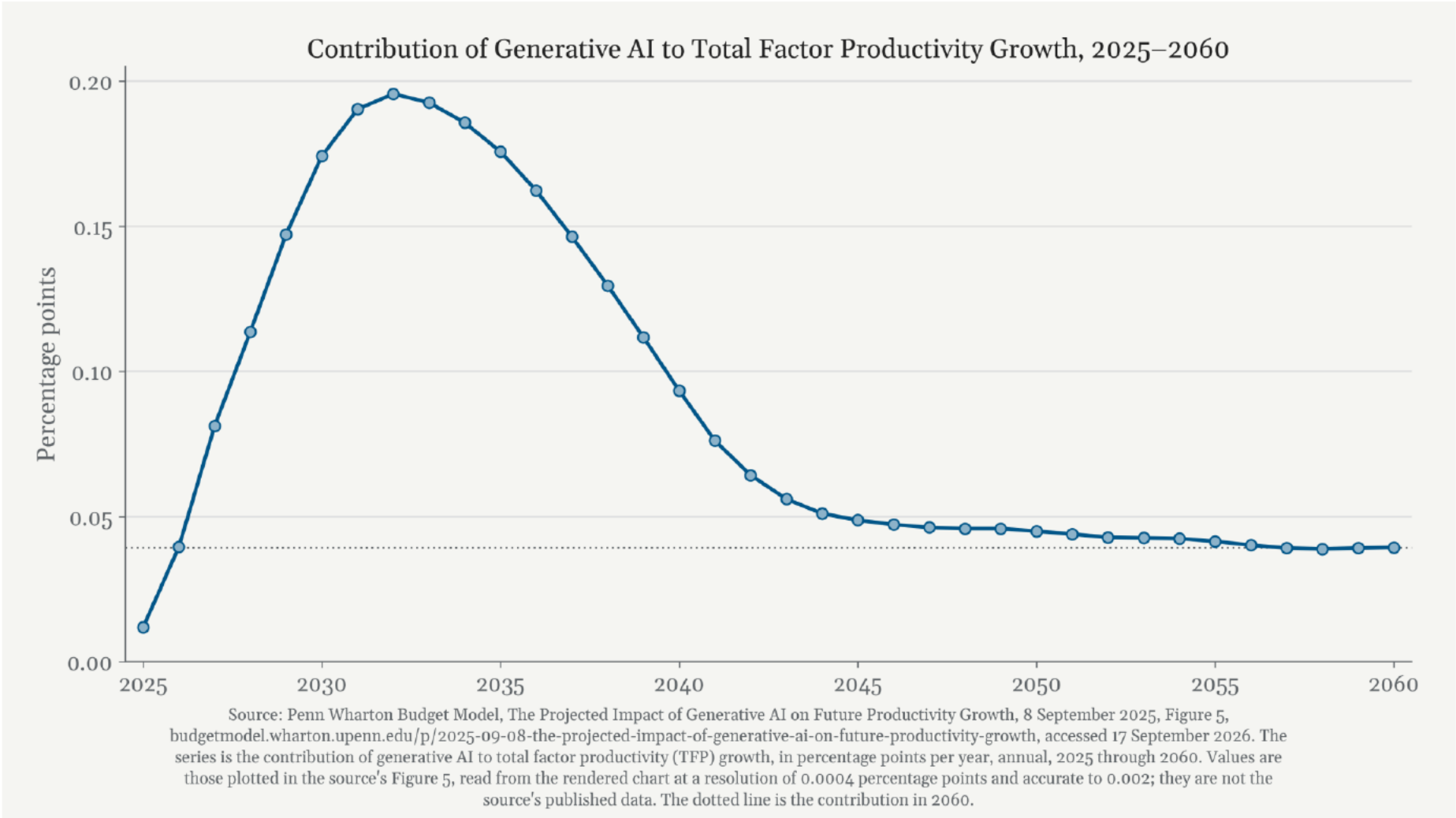
Supply Chain Cost Inflation



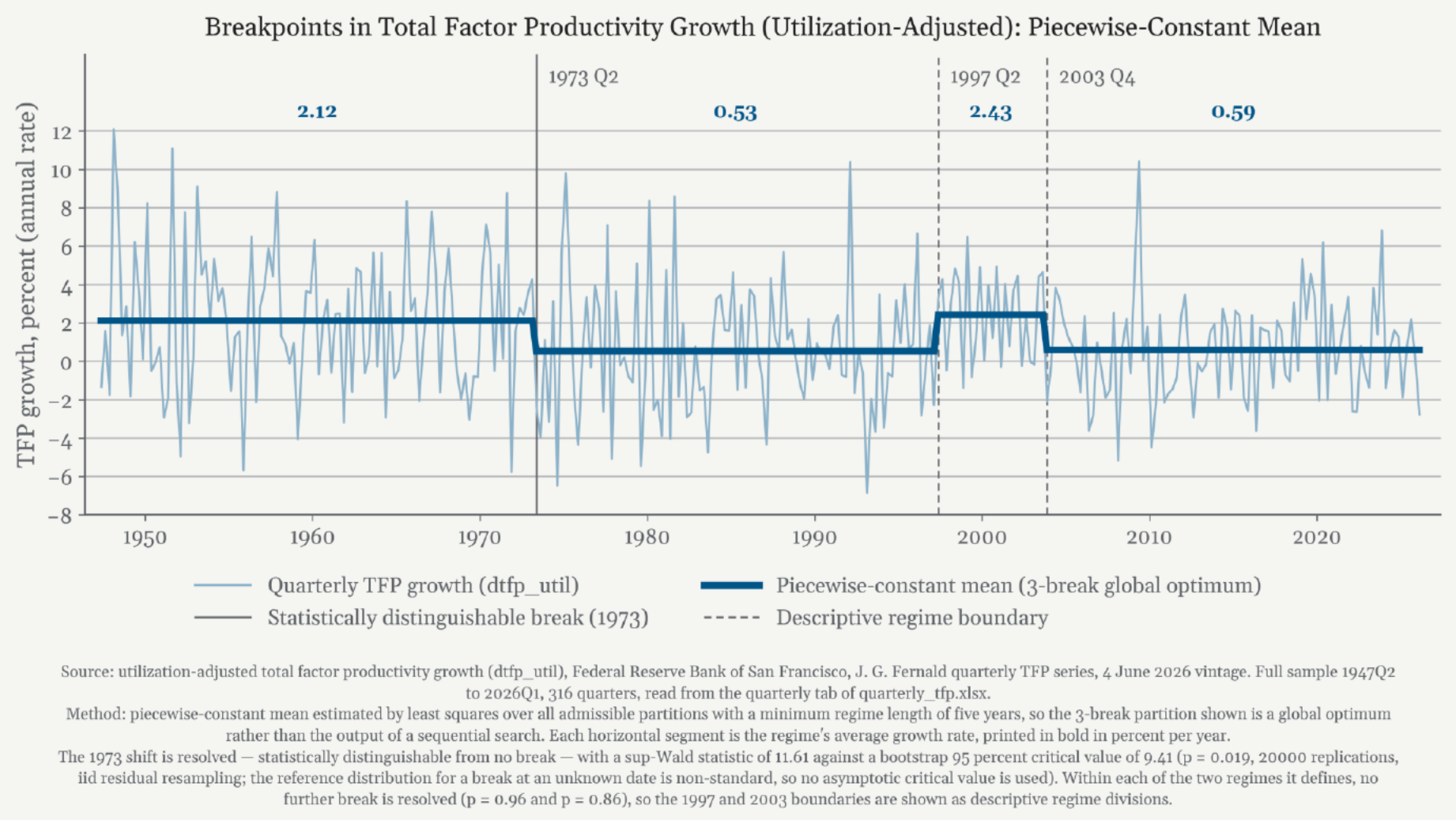


Potential AI-related Productivity Boom

Generative AI and total factor productivity growth



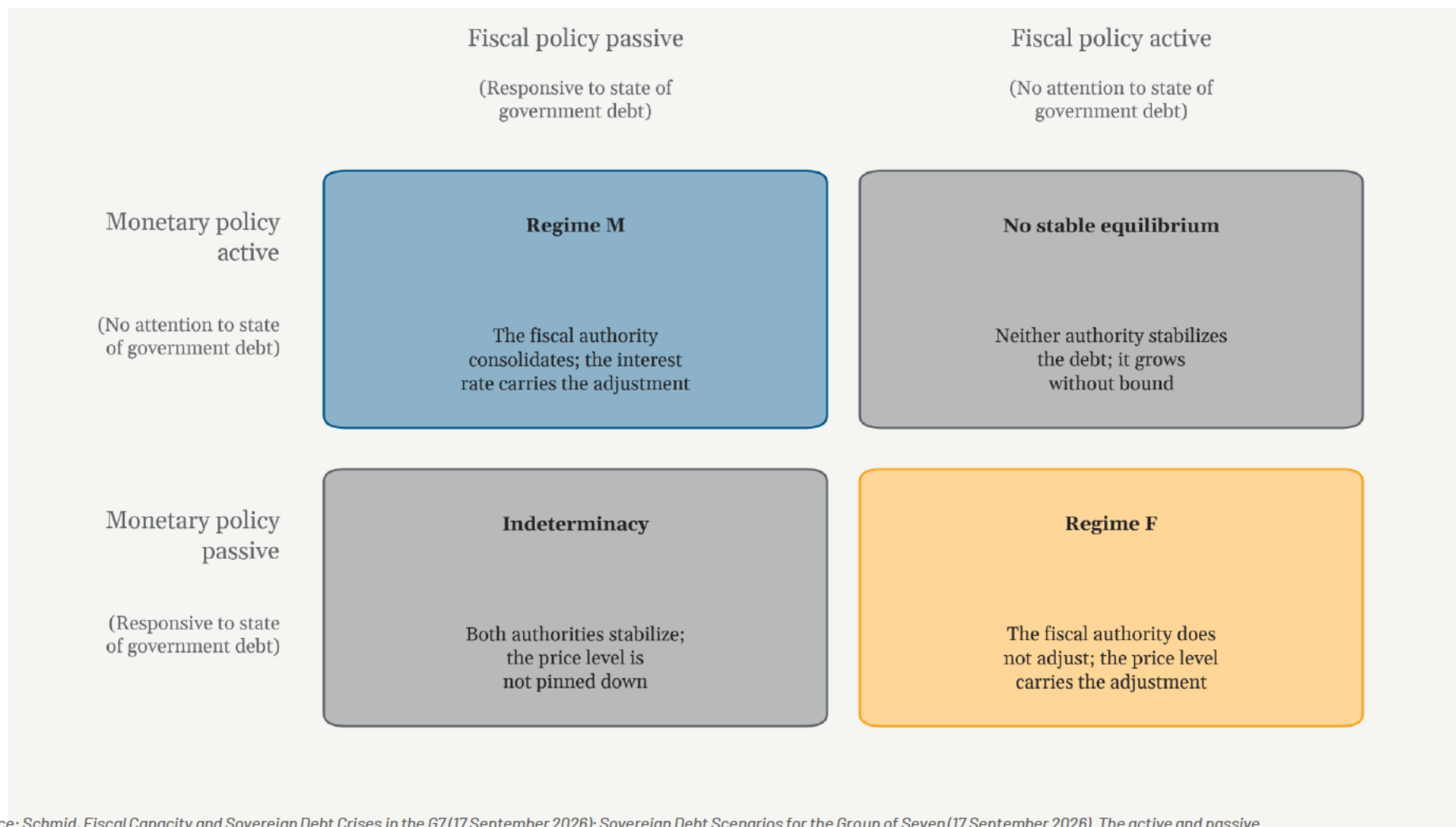
Breakpoints in total factor productivity growth





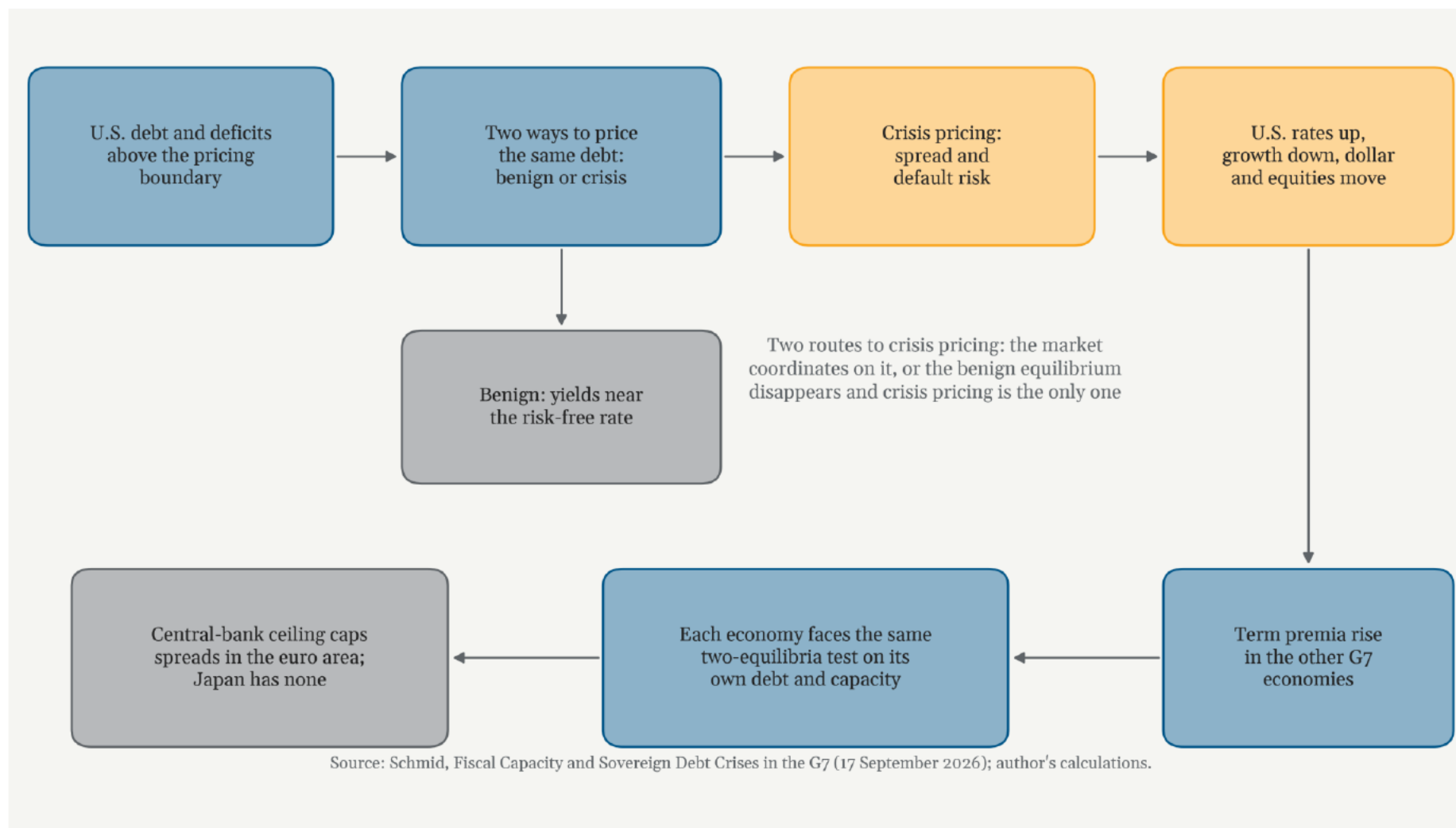
Implications of a Potential Sovereign Debt Crisis

Two crisis regimes: who carries the adjustment



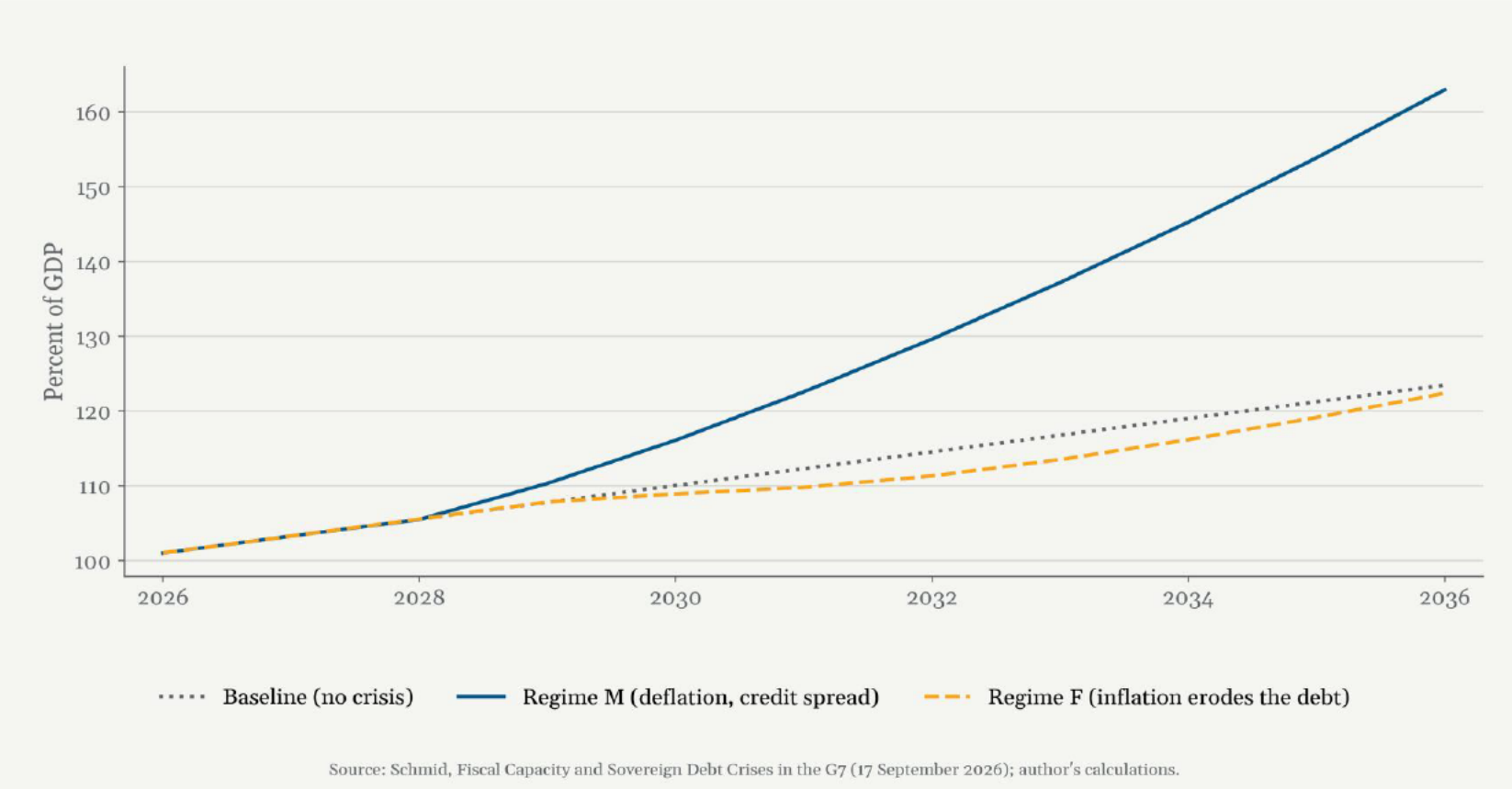
Source: Schmid, *Fiscal Capacity and Sovereign Debt Crises in the G7* (17 September 2026); *Sovereign Debt Scenarios for the Group of Seven* (17 September 2026). The active and passive taxonomy is Eric M. Leeper, "Equilibria under 'Active' and 'Passive' Monetary and Fiscal Policies," *Journal of Monetary Economics* 27 (1991), 129–147, [https://doi.org/10.1016/0304-3932\(91\)90007-B](https://doi.org/10.1016/0304-3932(91)90007-B).

How a sovereign debt crisis works in the G7 scenario set



United States: two regimes, two debt paths

Federal debt held by the public, percent of GDP, 2026 through 2036



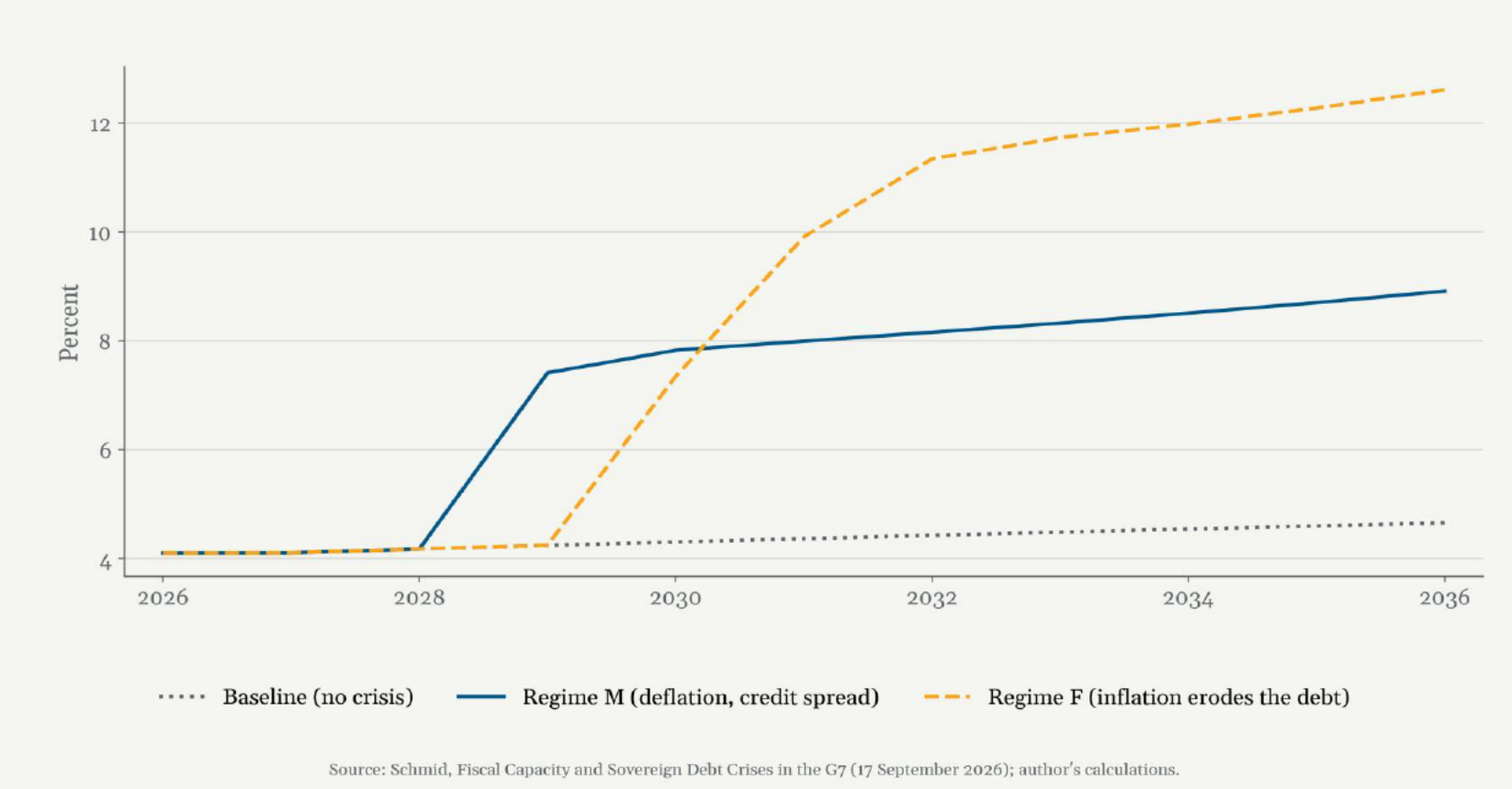
101.0
percent of GDP at the start of the horizon

162.9
percent of GDP in 2036 under regime M, deflation and a credit spread

122.4
percent of GDP in 2036 under regime F, 40.6 points below regime M and just below the no-crisis baseline of 123.4

United States: the 10-year Treasury yield

Percent, 2026 through 2036

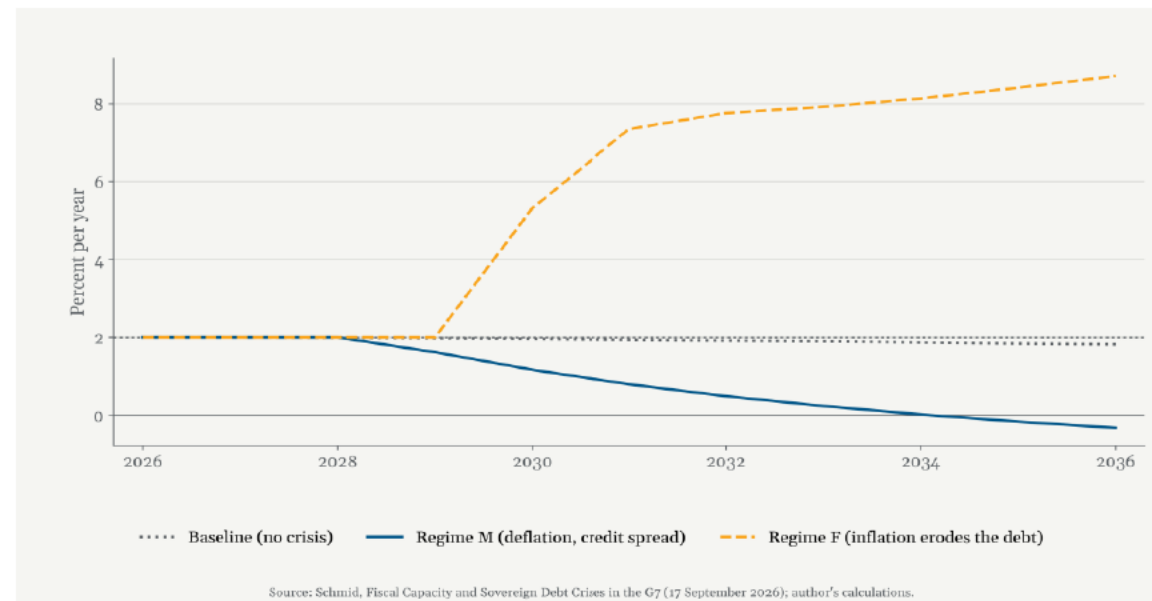
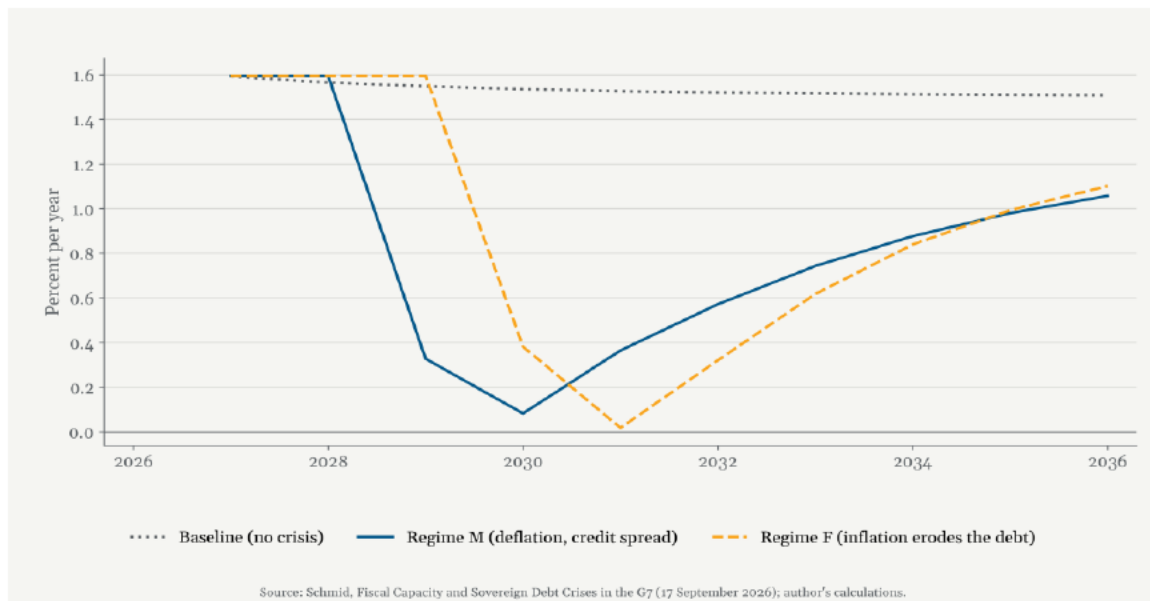


8.9%
in 2036 under regime M, and still rising

12.6%
in 2036 under regime F, as expected inflation enters the yield

2033
the year the policy rate reaches zero under regime M

United States: growth and inflation under each regime



Left, real GDP growth; right, inflation. Under regime M output ends 7.2 percent below its baseline path. Under regime F inflation reaches 8.7 percent, and the equity price level ends 45.4 percent below its no-crisis path, against 49.4 percent under regime M.

What Debt Consolidations Teach

- Eichengreen and Esteves assemble 378 consolidation episodes across 183 countries and 220 years, a consolidation being a durable fall in the debt ratio.
- Moderate inflation helped; high inflation did not, because nominal rates caught up. Most episodes came under low, stable inflation with credible monetary and sound fiscal policy.
- Inflation's contribution was largest from 1945 to 1982, when financial repression and long maturities held rates down, and after 1982, when rates again lagged. It was smallest in the 1920s, when rates responded, the deflationary 1930s, and before 1913.
- Otherwise primary surpluses and growth did the work. The U.S. debt ratio fell 66 points from 1947 to 1956: surpluses about 40 percent of it, growth another 40, the real rate a quarter, inflation 50 percent less 26 for nominal interest.
- Countries in consolidation did not run higher inflation than their peers; outside the interwar years, usually lower.

Source: Barry Eichengreen and Rui Esteves, "Up and away? Inflation and debt consolidation in historical perspective," *Oxford Open Economics* 1 (2022), 1–20. Their panel draws on the IMF's *Public Finances in Modern History* database for 1800 to 1950 and *Global Debt Database* for 1950 to 2019, with other sources where those do not reach; contributions are accounting shares from their decomposition of the debt dynamics, not causal estimates.

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Thank you!



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