Discussion of “Inflation after the Iran war”

by Ricardo Reis

Francesco Bianchi

Johns Hopkins University
NBER & CEPR

Summary

Excellent paper combining state-of-the-art methods to address a timely policy question

- An unexpected energy price shock following the Iran-Israel-US conflict
  $\Rightarrow$ Initial direct impact on inflation has already materialized

  1. Will the inflation shock compound into larger, persistent inflation?
  2. Should central banks tighten to control inflation?

- The paper examines inflation outlook for 2026 and beyond in the Euro Area (EA), United Kingdom (UK), and United States (US)

- **Key Finding:** Inflation will likely run higher than initial estimates and persist into 2027, but will be far smaller and more short-lived than the 2021–24 episode

Four Transmission Channels

Four channels through which energy shocks can translate in persistent inflation:

1. Sticky Prices
2. Expectations
3. Fiscal Policy $\Rightarrow$ fiscal inflation
4. Transmission to Long-Run Anchor

Main comments

I will focus on the third channel (fiscal inflation):

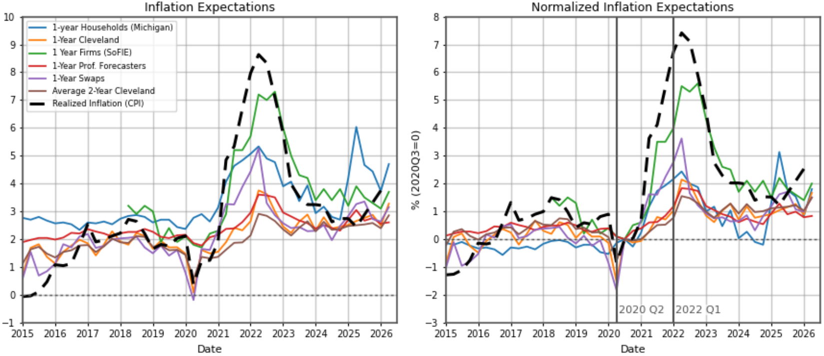
1. Why were many surprised by the recent inflation surge?
2. Is the Iran shock different? Why?

In a nutshell: Ukraine shock occurred in the aftermath of the pandemic and this matters to understand its inflationary effects. Current policy environment different (so far).

Risk: What if the Iran shock is a **further** signal of a new world order?

Inflation surprise?

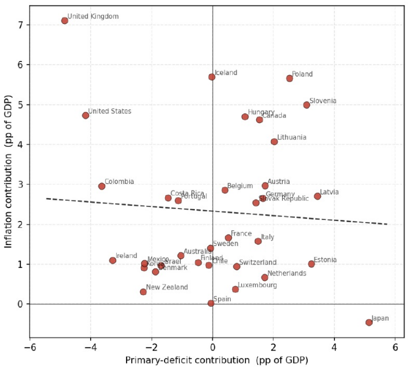
Why did professional forecasters miss the rise in inflation?



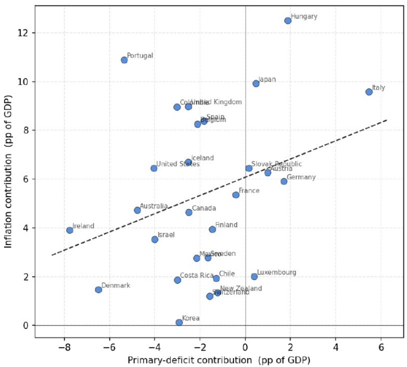
Notes: The figure displays different measures of inflation expectations. In the right panel, inflation expectations are normalized in a way that they coincide in 2020:Q3. We thank Joe Hazell for sharing the data.

Why did the IMF miss the link between inflation and deficits?

(c) Predicted deficits vs. inflation

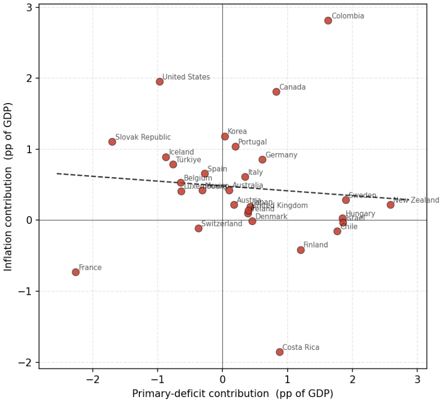


(d) Actual deficits vs. inflation



Notes: The figure displays the revision in forecasts for deficits and inflation from the IMF WEO and the realized values for the same variables in the aftermath of the Ukraine shock. Source: Reis (2026).

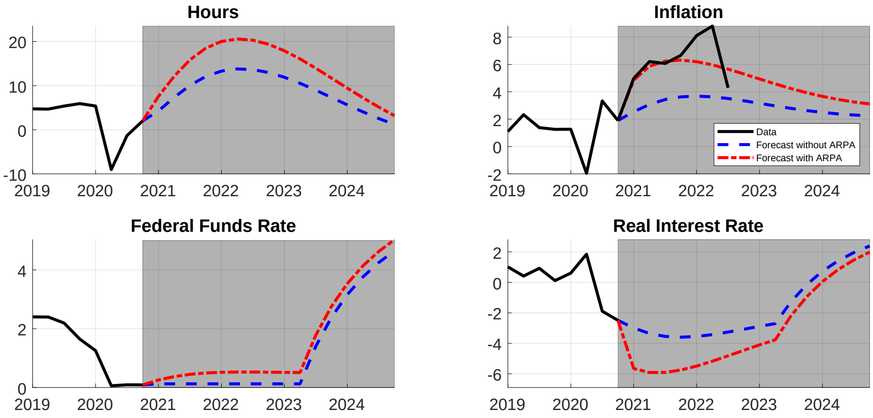
Why does the link seem absent after the Iran shock (so far)?



Notes: The figure displays the revision in forecasts for deficits and inflation from the IMF WEO in the aftermath of the Iran shock. Source: Reis (2026).

Unfunded fiscal shock in the US (Bianchi, Faccini, Melosi, QJE 2023)

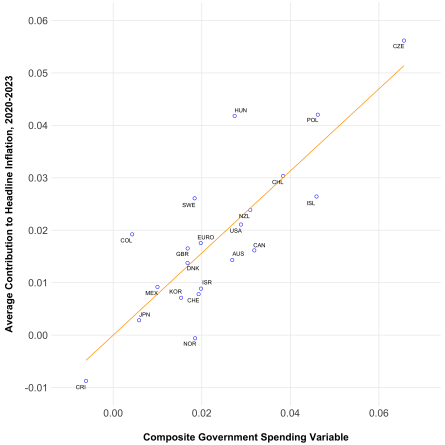
Ukraine shock hit while economies still dealing with the COVID pandemic



Notes: The figure displays forecasts for hours, inflation, FFR, and real interest rate in the United States based on real time information as 2020:Q4. Source: Bianchi, Faccini, and Melosi (2023)

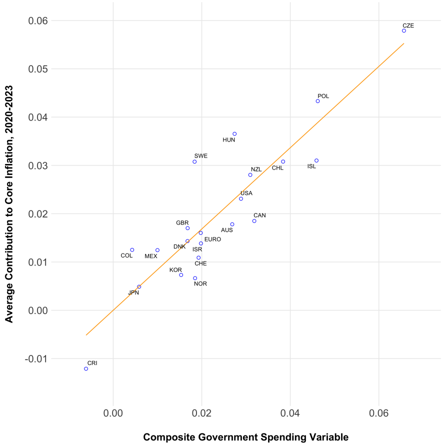
Unfunded fiscal shock in OECD countries (Barro-Bianchi, EJ 2026)

Headline CPI inflation versus composite govt-spending variable



Unfunded fiscal shock in OECD countries (Barro-Bianchi, EJ 2026)

Core CPI inflation rate versus composite govt-spending variable

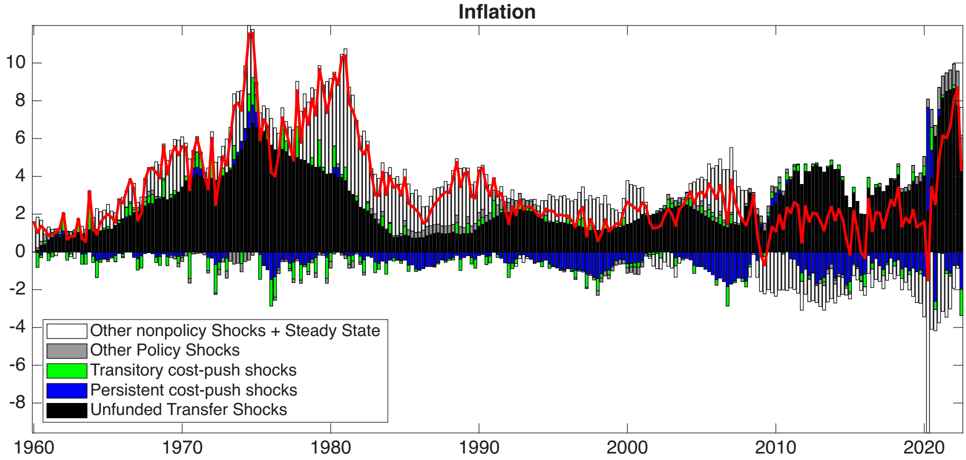


What is different?

- Iran shock hit while economies had already largely reabsorbed the post pandemic inflation increase
- Central banks have already changed their stance and little appetite for more inflation
- Euro Area (EA) more exposed to energy shocks than the UK and US **+** below 2% $\Rightarrow$ markets might have anticipated more tolerance for inflation increase
- Does this mean that we are in the clear?
  I see one major risk that markets do not seem to appreciate

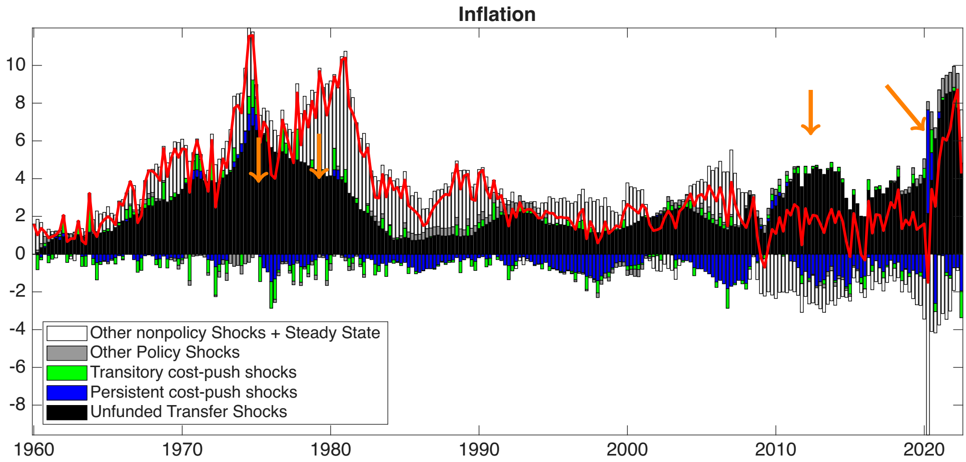
Is the future one of less economic integration?

- Bianchi, Faccini, Melosi (QJE, 2023) decompose evolution of US inflation since 1960



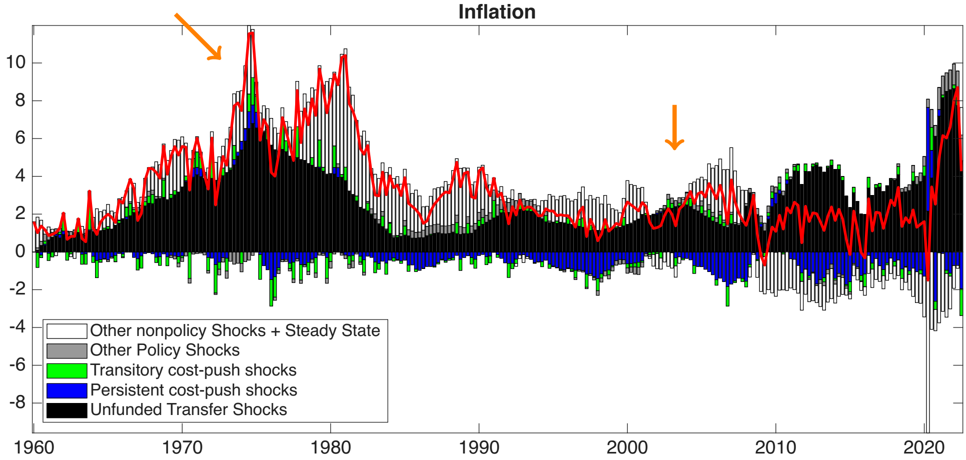
Is the future one of less economic integration?

- Fiscal inflation accounts for persistent inflation fluctuations, including post-pandemic



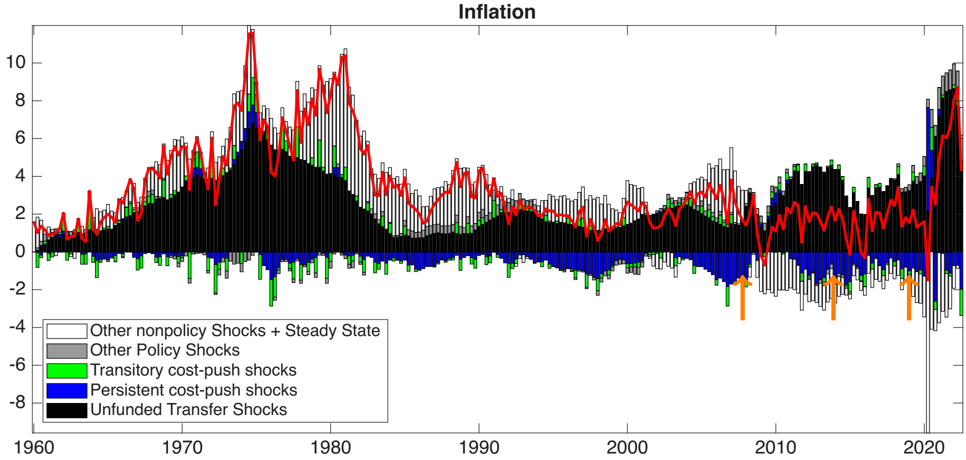
Is the future one of less economic integration?

- Temporary cost-push shocks accounts for spikes of inflation



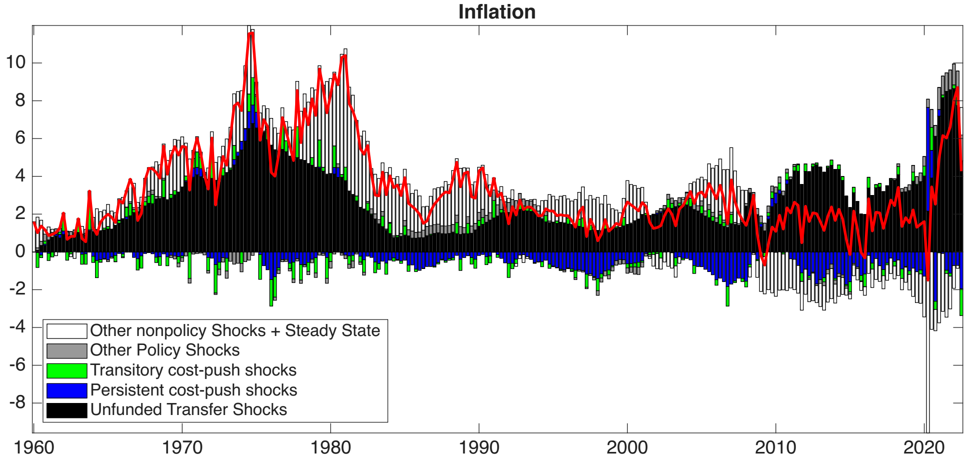
Is the future one of less economic integration?

- Persistent cost-push shocks counteract fiscal inflation in the post-Millennial period



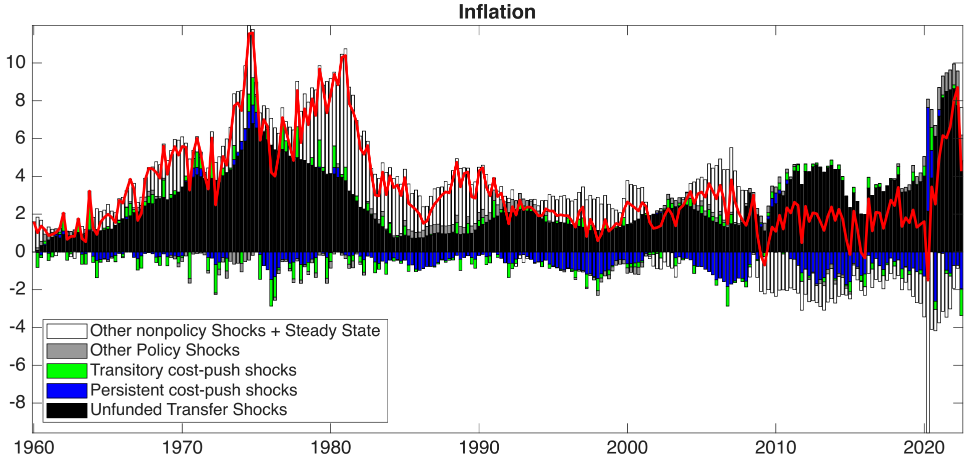
Is the future one of less economic integration?

- What if Iran shock, like tariffs, is a signal of the world moving toward less integration?



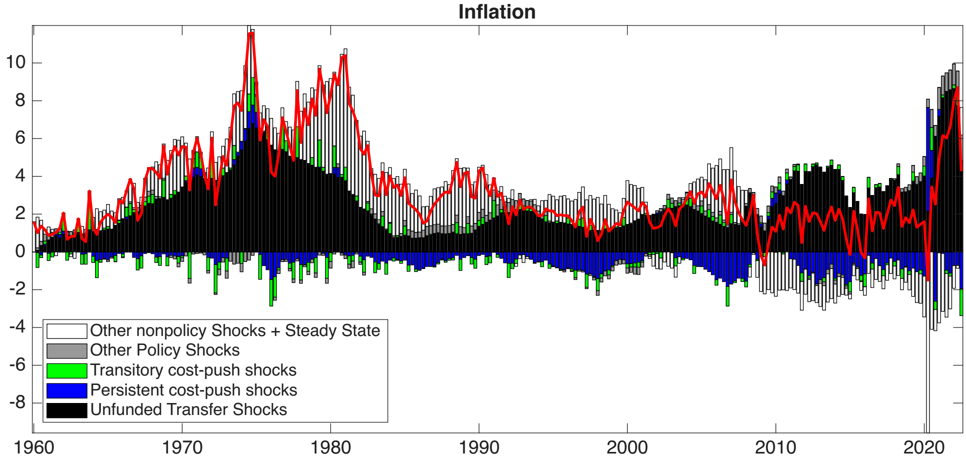
Is the future one of less economic integration?

- Arguably current fiscal situation becomes much more precarious



Is the future one of less economic integration?

- Interest rate increases could backfire if not backed by fiscal adjustments



Conclusions

- Masterful paper that addresses a key policy question: Is there a risk of a persistent inflationary episode? What should central banks do?
- Stakes are high, given the recent inflationary episode
- At the moment, some signs of fragility, but overall situation appears stable
- So far, the Iran shock has not triggered fiscal inflation
  $\Rightarrow$ Difference is due to the policy response to the pandemic
- Risk ahead: Iran shock further signal of fragmented world economy
  1. Reversal of deflationary forces that have characterized the past two decades
  2. In a fragile fiscal situation rate hikes can backfire
     $\Rightarrow$ debt accumulation $\Rightarrow$ more fiscal inflation