

Sticky Inflation: Monetary Policy when Debt Drags Inflation Expectations

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The views expressed are those of the authors and should under no circumstances be interpreted as reflecting those of the Banque de France or the Eurosystem.

Brief overview

Study an economy with fiscal imbalance (war, pandemic)

- Key tension: rate hike (MP contract.) increases cost of debt, worsen fiscal outlook
- Agents expect a future policy shift: CB temp. tolerates higher π to reduce public debt
- Link between public debt and inflation expectations \Rightarrow inflation pressure today

Optimal MP when agents anticipate the possibility that CB temp. inflates away debt

- Deviation from standard Taylor principle: underreaction is optimal

Motivated by post-COVID inflation surge: CBs held rates low despite early warnings

Important contribution

- Not a fiscal dominance story
- Inflationary finance affects:
 - Households through the Euler equation
 - Firms through the Phillips Curve

⇒ **Heterogeneity in inflation expectations (households/firms)**

Agents are forward-looking

Expectation of the possibility of the CB accommodating π in the future brings π today up

Growing empirical literature on household and firm inflation expectations:

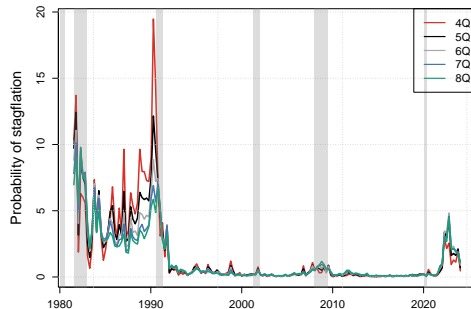
- infl. exp. have a strong backward-looking component (e.g. exp. formation: adaptive)
- inflation expectations depend on perceived or experienced inflation
- Andrade et al. 2025: Debt-inflation link depends on household's view about fiscal space
- Savignac et al. 2024:
 - positive link between firms' exp. about own prices and exp. about aggregate π .
 - firms perceive little link between price and wage inflation

Particularity of paper: effects on price setting behaviour of firms (elaborate further)

Dedola et al. (2023): freq. of price changes correlates more with π when π is high (Calvo?)

Objectives of the central bank I

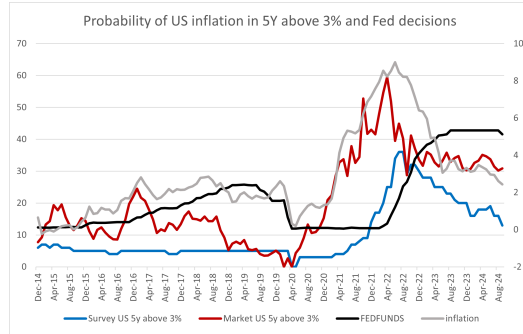
Policy trade-offs



- Mouabbi, Renne, Tschopp: risks of stagflation are back (policy trade-offs)
- Hawk-Dove: reflect dual mandate in the Taylor Rule

Objectives of the central bank II

Average inflation targeting



- Central bank cares about the entire path of inflation
- Was the Fed behind the curve? (policy objective: average inflation targeting)

Debt stabilisation

What about the fiscal authority?

This paper: MP has a debt stabilisation motive

- under nominal valuation: inflation surprises matter to inflate away debt

But debt structure also affects debt dynamics

- Renne (2024): macro-finance framework to evaluate public debt management strategies
- Exploit maturity and debt indexation (inflation/real GDP)
- Demand- vs. supply-driven economy: correlation between inflation and growth
- If adverse demand (supply) shock, long-term nominal bonds are (least) favourable

Central bank credibility and independence

This paper: coordination (not fiscal dominance)

- Communication is crucial
- ... and complicated
- What about CB commitment allowing for anchored inflation expectations
- Here, we assume that inflation corrects the fiscal imbalance
- What if the fiscal authority continues its fiscal expansion?

Overall, great contribution!

- Optimal MP in a high debt environment
- Interesting mechanisms (debt/inflation expectations; sticky inflation; exp. heterogeneity)
- I highly recommend you all to read it!