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Why US inflation will be higher and more persistent than in most forecasts

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What I said in April at our previous PIIE GEP:
Inflation is coming, whatever the growth rate

Unanchored inflation expectations will be pushed

- Fed policy is already too loose, and inflation is too high, to start
- Fed will be behind the curve – especially if there is a recession
- Fiscal excess will worsen – especially if there is a recession
- Deregulation, M&A and exemptions will increase pricing power and therefore pass-through of tariff pricing increases
- Reversal of usual capital inflows response for USD
- This isn't transitional until deals are made - it is a regime of sustained higher uncertainty

Right call: inflation has been higher, and Fed has cut less than was priced in

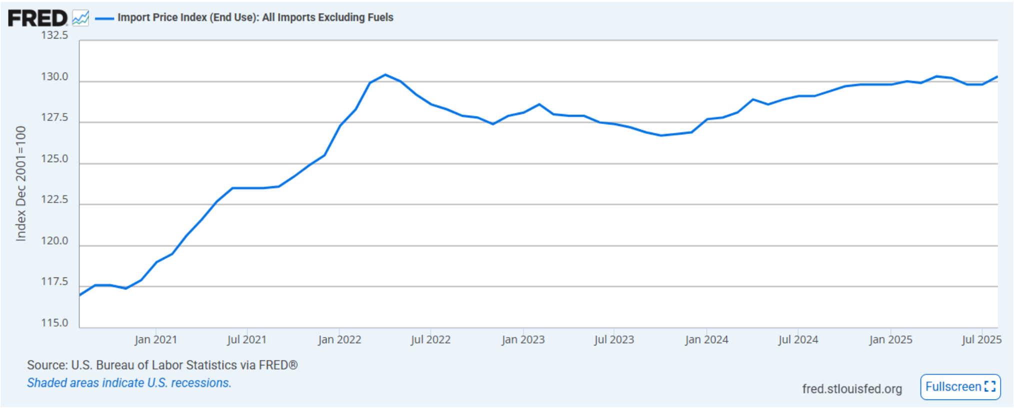
Going forward: dollar and unemployment are lower, growth higher than then

Why US inflation will be higher and more persistent

- Macroeconomic outlook (shocks and cycle) is inflationary
  - Why most inflation from tariffs and deportations is still to come
  - Why the labor market is not only resilient but close to full employment
  - Why fiscal policy in 2026 will be meaningfully looser than in 2025
- Monetary policy is currently much looser than the FOMC seems to think it is
  - Actual financial conditions are more relevant than FFR level
  - Transmission of tightening is lower in this cycle than most past ones
  - The neutral rate r* is meaningfully higher than the FOMC currently says
- Inflation expectations are less well anchored than surveys indicate
  - Recent past experience of higher inflation has a lasting impact
  - Staggered salient price adjustments are coming
  - Federal Reserve independence is being weakened

Why the inflation impact of tariffs has been lagged

Import prices have not risen, so US firms are paying the tariffs so far…



Businesses need time to react to tariffs

- Initially uncertain that they'll stay
- No point in raising prices before inventories (inputs/products) gone
- Direct threats by USG against public companies deter being the first to move
- Decisions about where to source and site production are difficult

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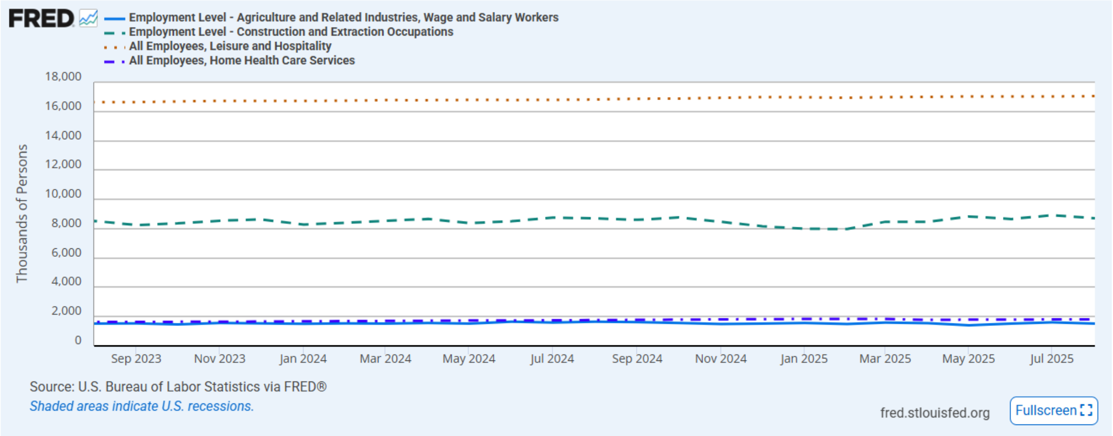
Why the inflation impact of deportation has been lagged

If 1 million+ migrants have left, how has production stayed up?

No increase in native or legal employment in the sectors which are known to be heavy users of migrant labor



What is going on?

- McKibbin, Noland, and Hogan (2024) say impact should be big and stagflationary
- Substitution of K or L not there in the data
- Mismeasurement of net migrant outflows?
- Over-counting/claims of total deported?
- Or workers and families take time to make up their minds on a wrenching decision
  - Not sure that ICE really will come for them
  - Head underground but keep working
  - Employers do not have to pay more or invest – in fact can end up paying less
  - Difficult to decide when to leave

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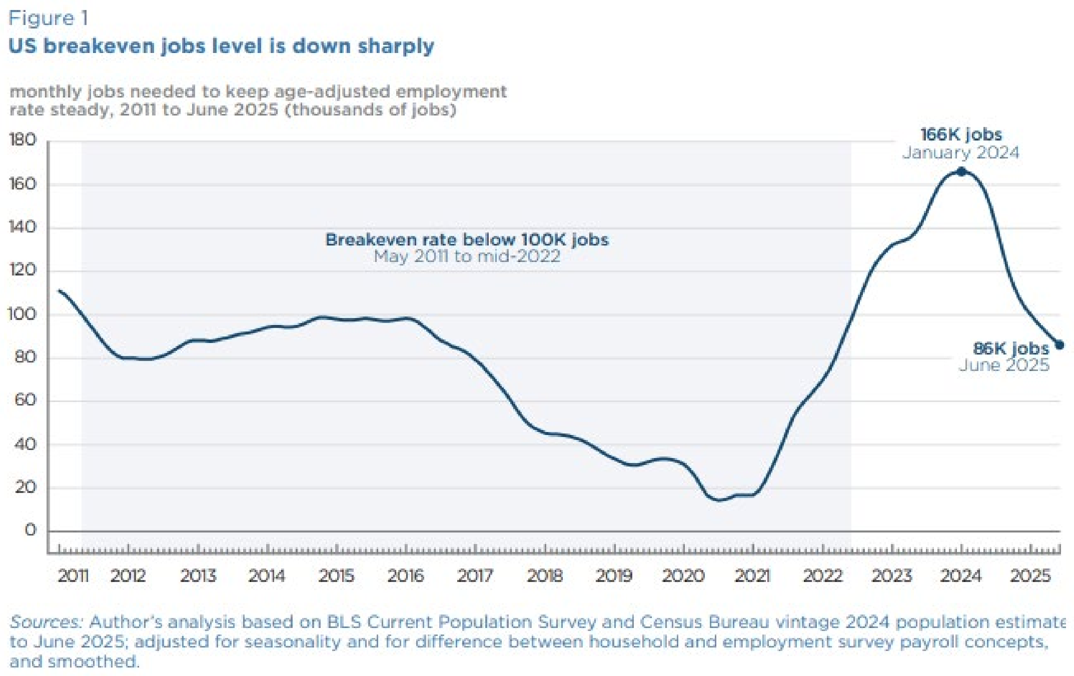
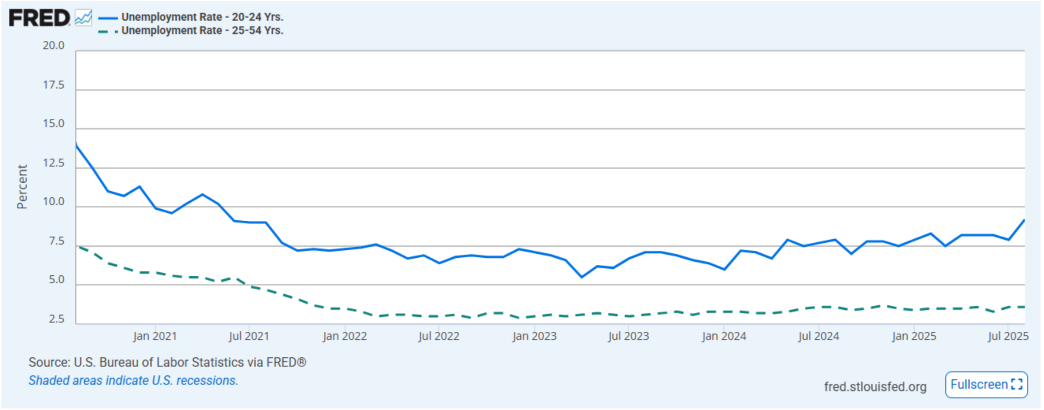
Why the labor market is close to full employment

Absent migration, run rate is much lower (Kolko (2025))



Rising youth unemployment is more likely mismatch/structural than demand



Why fiscal policy will be meaningfully looser in 2026

Tax collection will decline

- Sarin and Summers (2020) argue for a robust large positive correlation between IRS collection budget and tax revenues (larger than CBO)
  - Roughly $20B/year investment in collection generates $100B/year revenue
- IRS budget cut (OBBB + rescissions) is up to $5B, so lose $15-25B
- Likely to be larger revenue loss in a time of changing tax code, lax enforcement of non-wage income taxation, and loss of IRS senior staff

Tariff revenues decline a lot from here

- September tax revenues were $31B, the highest so far this year
- When tariff pass-through hits, some reduction in import consumption
- When companies shift sourcing and production, some reduction
- When USG starts giving out exemptions and offsets (e.g., soy), some reduction
- When Trump and Xi or Modi or Lula make a deal…
- And then comes tariff evasion

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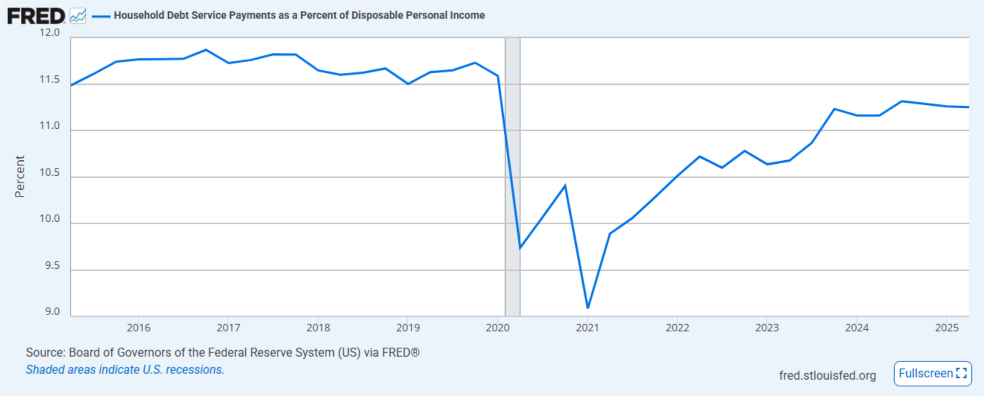
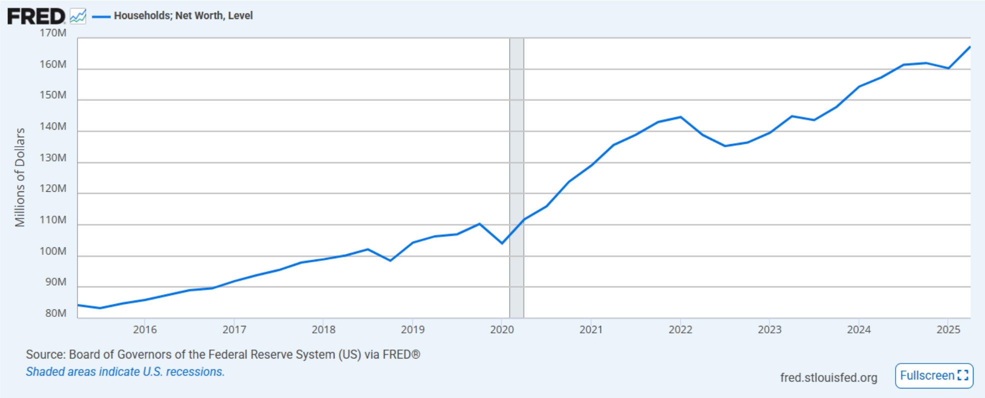
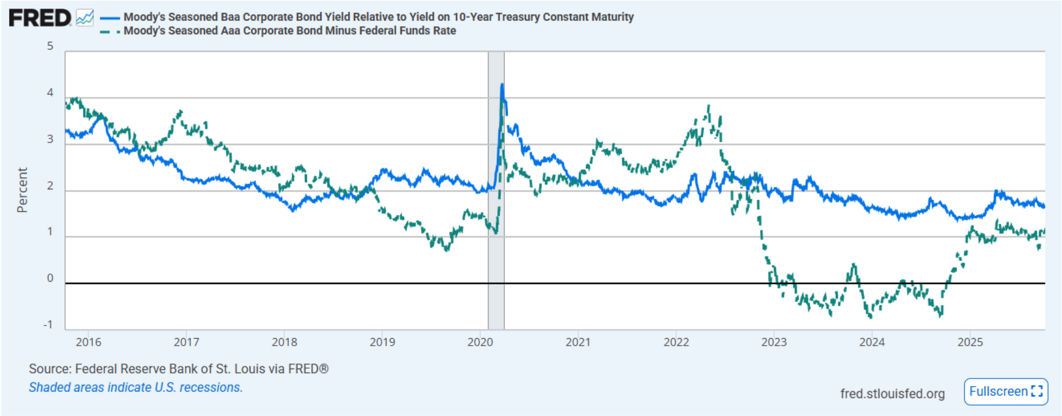
Actual financial conditions are more relevant than FFR

Household balance sheets are still solid





Credit risk spreads remain very low



Monetary policy is looser than FOMC thinks it is

Transmission of monetary tightening is lower in this cycle

- Mag7+ investment is cash financed
- Private credit and private equity are an increasing share of corporate financing
- Financial fragility is low in non-financial corporate sector
- More banks have strong capital and liquidity provisions (for now)
- Equity price increases offset other tightening

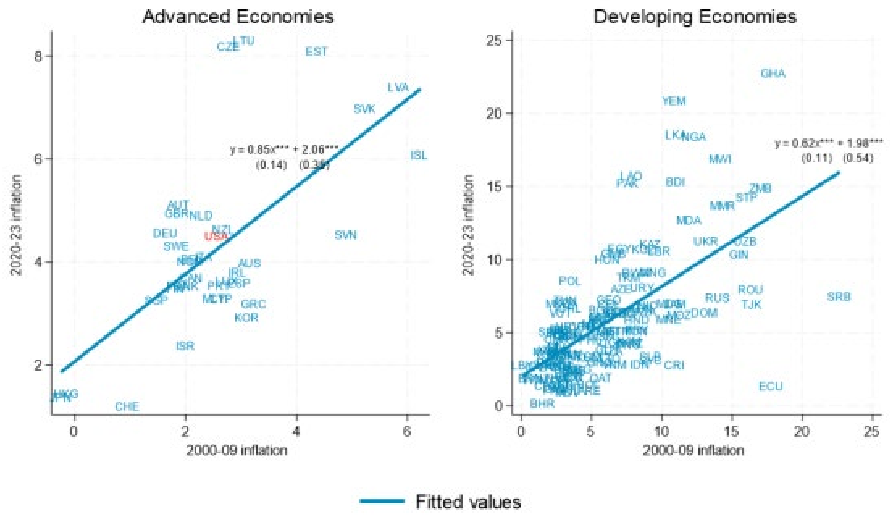
The neutral rate r* is higher in this cycle

- Increased spending on defense/industrial policy will be sustained
- AI and related high-productivity activities raise the cost of capital
- Decoupling of China/Asia from US will reverse savings glut flow
- Need to self-insure against geopolitical risks raises risk aversion

Inflation expectations are less well anchored

Recent past experience of higher inflation has a lasting impact (Gagnon and Kamin 2025)

Figure 1. The correlation of COVID inflation with long past inflation



Staggered salient price hikes are coming

- Think like eggs under Biden
- Beef, certain fruit and veg, musical instruments, toys…
- De minimis imported goods
- Some pharmaceuticals potentially
- Energy depending upon the impact of AI demand
- Durable goods (autos, furniture, construction inputs), though, are less salient for inflation perceptions

Federal Reserve independence is being weakened

- **CBI literature shows two key components matter for inflation**
  - Firing of the governor
  - Forced purchases of debt issues
  - Both are threatened now
- **The FOMC is a committee, and eventually, it will respond to inflation**
  - But a partisan majority on the Board by 28 February can replace any/all Reserve Bank Presidents
- **The impact can be substantial**
  - RBI and CBRT recent examples
  - McKibbin, Hogan, Noland (2024) simulation

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Why US inflation will be higher and more persistent

- Macroeconomic outlook (shocks and cycle) is inflationary
  - Inflation from tariffs and deportations is still to come over next 6-9 months
  - Disinflation from labor market weakening will be minimal or reverse
  - Fiscal policy in 2026 will add 0.5%+ of GDP stimulus vs 2025
- Monetary policy is currently much looser than the FOMC seems to think it is
  - It is difficult to find past instances of recession and disinflation absent financial stress
  - Private credit and Mag7+ do have (hidden) risks, but also low interest-rate sensitivity
  - If the neutral rate is 50-75 bps higher, then inflation increases by about that much
- Inflation expectations are less well anchored than surveys indicate
  - Ultimately, this is a guess, but can expectations really be as anchored now as in 2019?
  - This is as much or more about the impact on inflation persistence as on level, as well as how any delays to tighten are interpreted and reacted to.

➡ **Headline inflation is likely to be 4.5%+ by 2026Q3, and that will at least last into 2027**

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