Inflation risk and the finance-growth nexus

Alexandre Corhay Jincheng Tong*

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This paper shows that the effect of inflation on asset prices and real aggregates depends on the financial intermediation sector. When firms finance using nominal long-term debt issued by financial intermediaries, unexpected changes in inflation lead to a wealth transfer across sectors. Higher inflation decreases firms' real liabilities and default risk, which helps reduce debt overhang. However, it hurts intermediaries' balance sheet, leading to a contraction in credit. We show theoretically that the ultimate effect of inflation depends on the tightness of financing constraints in the intermediation sector. We find strong empirical evidence consistent with these results. We also show that an inflation policy responding to both financial and real variables can help stabilize our economy.

Keywords: Inflation, asset prices, credit risk, debt deflation, financial intermediation, monetary policy, general equilibrium model, recursive preferences.

*Alexandre Corhay (alexandre.corhay@rotman.utoronto.ca) and Jincheng Tong (jincheng.tong@rotman.utoronto.ca) are affiliated with the Rotman School of Management, University of Toronto. We would like to thank Hengjie Ai, Knae Bae, Anmol Bhandari, Frederico Belo, Michele Dathan, Robert Goldstein, Urban Jerman, Raymond Kan, Mariana Khapko, Chay Ornthanalai, Lukas Schmid, and Adrien Verdelhan for helpful comments and suggestions on the paper. We also thank Federica Clerici for her work on an early version of this draft and seminar participants at the University of Toronto, the University of New South Wales and the University of Amsterdam. Alexandre Corhay recognizes the financial support from the Canadian Securities Institute Research Foundation.