

Long-run inflation and financial panics

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Does long-run inflation matter for financial stability? This paper studies how trend inflation affects the likelihood of banking panics in a New Keynesian DSGE model with endogenous bank runs. The results suggest that higher long-run inflation can raise run probabilities even without unexpected monetary tightening. The mechanism operates through firms' price setting which becomes less responsive to current economic conditions as trend inflation increases. As a consequence, recessions are associated with weaker disinflation and thus higher real short-term rates, lower asset prices, and stronger pressure on bank balance sheets.

Many recent policy debates consider the question of whether a prolonged period of elevated inflation rates might have consequences for financial stability

Structural factors – such as deglobalization, the pursuit of decarbonization, and rising fiscal pressures due to defense spending and industrial policy – might contribute to *persistently* high inflation in the future. Existing policy analyses have so far focused mainly on short-run financial stability risks arising when inflation proves more persistent than anticipated and monetary policy has to tighten by more than expected; with the conclusion that a stronger than expected policy-rate hike by the central bank is necessary to stabilize the economy. The current paper contributes to this discussion with an explicit focus on the impact of long-run inflation on financial stability. We find that higher long-run inflation by itself might be a reason for financial stability concerns, even apart from surprising policy-rate changes. To the best of our knowledge, this is the first paper to study the effect of long-run inflation on financial stability.

The existing theoretical literature mainly points towards detrimental effects of long-run inflation

The higher the latter, the poorer and more volatile the economy. However, the existing studies have so far abstracted from assessing any potential financial stability consequences of trend inflation. This is where our study steps in. We employ a modified version of the theoretical framework proposed by Gertler et al. (2020). It is an otherwise standard New Keynesian DSGE model with nominal frictions in which system-wide bank runs may arise endogenously. Such runs (or banking panics) are the specific form of financial instability inherent in the economy. As in the bulk of the existing macroeconomic literature, our measure of long-run inflation corresponds to the steady-state rate of price change, also called trend inflation. With a higher average inflation, price adjusting firms effectively become more forward looking, thus paying relatively less attention to current macroeconomic conditions. Accordingly, recessionary shocks – such as banking panics – are associated with smaller declines in the aggregate price level.

We find that trend inflation has substantial effects on the probability of bank runs

This probability more than doubles when annual trend inflation rises from 0 % to 6 % p.a. The

intuition behind this result is the following. A higher trend inflation makes firms' price-setting more forward looking. Accordingly, while the temporary recession induced by a bank run is associated with a decline in the current price level and inflation, this decline is relatively smaller. The weaker drop in inflation magnifies the fall in run-equilibrium asset prices, thus putting a relatively heavier drag on banks' balance sheets. Higher trend inflation deepens the drop in asset prices mainly via two channels. First, according to its Taylor rule, the central bank engineers a smaller decrease in the policy rate. Accordingly, the expected real interest rate falls by less, so future earnings on assets are discounted more heavily than in a lower-trend-inflation environment. Second, the weaker drop in inflation weakens aggregate demand which, in turn, strengthens the downward pressure on the expected future earnings on assets.

The transition path to a lower long-run inflation target also matters for financial stability

We further find that, in the model, disinflations - i.e. transitions to a lower long-run inflation target engineered by the central bank - are associated with higher likelihood of banking panics in the short run. This is especially the case when a sharp "cold turkey" disinflation is pursued. By contrast, the increase in bank-run probability is more muted if the transition is announced in advance. The model results underscore the importance of credible communication.

The implications of the zero lower bound on financial stability depend on the level of long-run inflation

The model also implies that the presence of an occasionally binding zero lower bound on the nominal interest rate (ZLB) increases the likelihood of bank runs, but only for relatively low levels of long-run inflation, i.e. below about 1 % per annum.

We further investigate how monetary and macroprudential policy parameters shape bank-run risk

Finally, we show in a purely positive analysis that the run probability is hump-shaped in the central bank's responsiveness to inflation. Furthermore, the model suggests that, in a higher trend-inflation environment, reducing bank-run risk through tighter macroprudential policy may entail larger long-run output costs.

Literature

Gertler, M., N. Kiyotaki, and A. Prestipino (2020). Credit booms, financial crises, and macroprudential policy. *Review of Economic Dynamics* 37, S8-S33.

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