The distribution-inflation nexus

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Abstract:

This paper studies the effect of inflation on poverty in a large cross-country panel dataset of 155 countries observed from 1970 to 2024. We estimate two-way fixed effects models that control for economic growth and estimate the sensitivity of the poverty headcount ratio (measured using different poverty lines) to the inflation rate. Our results point to a statistically significant impact of inflation on poverty, but only when relatively high poverty lines are used. Heterogeneity analysis reveals that the size of this effect is positively associated with country income level, while a substantial statistically significant effect is also found among low-income countries when lower poverty lines are used. Furthermore, unconditional quantile regressions show that the effect is actually largest in the third quartile of the poverty distribution, which suggests the link is particularly strong for upper-middle income countries. These results contribute to the relevant ongoing debate on the consequences of inflation and suggest a rationale for the political popularity boost usually associated with successful disinflations.

JEL Classification: E31, I32, O11

1. Introduction

A little inflation has been claimed to be beneficial for a healthy economy, as it may boost aggregate demand, investment, and employment. However, as inflation rises, it becomes harmful for economic functioning, destroying credit, long-term planning, and even nominal contracts. This contradiction gave rise to a branch of literature examining the effects of inflation on growth and vice versa. Although the debate is not closed, most scholars today agree that there is a non-linear relationship, shifted by one or several thresholds. In its simplest form, it can be said that inflation has different consequences depending on whether it is below or above certain values.

Inflation also drives economic policy, as the latter is responsive to the movements of the former. Most central banks follow some kind of Taylor Rule, which states they must tighten the economy to battle accelerations upfront, especially those driven by demand surges.

Since inflation shapes both economic outcomes and policies, it is trivial to say that it also plays a role in determining income distribution. However, there is scarce evidence on this relationship. In this paper, we explore this nexus, searching whether higher or lower inflation leads to a more egalitarian income distribution. We do so by analyzing the poverty rate distribution across different inflation values, *ceteris paribus* income, given the close negative relation between GDP and poverty. Therefore, our focus is set on how that income is distributed and how that distribution reacts to changes in the inflation rate.

This analysis is relevant for several reasons. Firstly, due to the renewed interest in inflationary processes spurred by recent world shocks such as the COVID-19 pandemic and Ukraine's invasion. Secondly, since Argentina is one of the countries with higher inflation levels in the world in the last decade, understanding its potential effects on social variables is of particular interest for our country. Finally, the evidence provided in this line of research could represent a substantial contribution to other related fields, such as political economy. In particular, we aim to address the question of why disinflations are typically associated with very high political popularity, suggesting that this is mainly because such processes foster growth and reduce income inequality, lowering poverty.

The rest of the paper is structured as follows. Section 2 briefly reviews the relevant literature. Section 3 describes the data used in our exercises. Section 4 provides evidence on the inflation-poverty nexus, both through descriptive statistics and linear regression models. Finally, section 5 offers some concluding remarks.

2. Literature review

In his famous 1958 seminal paper, William Phillips finds a downward slope in the relation between wage variation rates and unemployment in the United Kingdom, which he interprets as a positive relation between labor demand and workforce price growth. Thinking about inflation as equal to the growth rate of wages (costs) minus the productivity growth rate, the finding implied a negative relationship between the unemployment rate and inflation, something that Samuelson and Solow (1960) labeled as the Phillips Curve -PC- (Gordon, 2008). This finding opened a debate that lives up to the present, and raised the question of whether the trade-off could be exploited to boost GDP growth at the cost of increasing inflation.

In the late sixties, the stagflationary environment led Friedman (1968) and Phelps (1967, 1968) to conclude that, although the PC is observable in the short run, it cannot be exploited in the long run, when the unemployment rate converges to its exogenous 'natural' value. When inflationary surprises were incorporated into expectations, shifting the PC, surges in inflation could no longer boost activity.

However, in the nineties, several scholars as Fisher (1993), Barro (1995), Bruno and Easterly (1998), Judson and Orphanides (1996), Sarel (1996) and Ghosh and Phillips (1998) make an even greater departure, stating that the PC is reversed at high levels of inflation, where growth is reduced by inflation. This relationship is non-linear, making some inflation values much more pervasive to economic performance than others. The costs become apparent when inflation surpasses a certain threshold, which is estimated using various methods and samples. The first empirical papers of this kind used static panels. Within this tradition, Sarel (1996) finds a 8% threshold; Khan and Senhadji (2001) pin it down to 1–3% for industrial countries and 11–12% for developing nations; Drukker, Gomis-Porqueras and Hernandez-Verme (2005) identify two thresholds in industrialized countries, 2.6% and 12.6%, and one of 19.2% in non-industrialized economies; and Pollin and Zhu (2006) report a threshold between 15%-19% in the full sample, in the range 14-16% for middle-income countries and between 15-23% for low-income countries.

Kremer, Bick and Nautz (2013) introduce the use of dynamic panel threshold models to estimate the inflation costs on growth and find a threshold of 2.5% for industrial countries and 17.2% for developing countries. Using a smooth transition regression model, López-Villavicencio and Mignon (2011) find an inflation threshold of 2.7% for industrialized countries and 17.5% for non-industrialized countries; while Ibarra and Trupkin (2016) estimate thresholds of 4.5% for developed countries and 19.1% for developing economies. A complete review of threshold values can be found in Yusifzada, Comert and Parmaksiz (2024).

All these articles linking growth and inflation are very close to our study for two reasons. In the first place, because income distribution and, more specifically, poverty rates are related to economic growth, although we intend to separate the growth-driven movements from the other channels through which inflation can affect distribution. On the other hand, because we resort to similar econometric methodologies.

There is less written on the direct relation between inflation and income distribution. However, there is some relevant work on the subject. Romer and Romer (1998) find that expansionary monetary policy improves conditions for the poor in the short run, but lower inflation enhances the well-being of the poor in the long run, as higher inflation diminishes growth and increases inequality. Ahumada et al (1993) estimate the inflation tax by income group in Argentina, finding that higher inflation has a regressive effect. Li and Zou (2002), Albanesi (2007) and Thalassinos, Ugurlu and Muratoglu (2012) find, using cross-country panel data, that inflation worsens income distribution. Bulír (2001) and Galli and van Der Hoeven (2001) argue that the effects of inflation on inequality depend on the initial rate of inflation, showing a U-shaped pattern: inequality decreases as inflation moves from very low to low rates, and increases from these values to higher ones. Berisha, Sewak Dubey and Gharehgozli (2023) suggest that this relationship is also dependent on initial distribution, as the contemporaneous negative effect of inflation on inequality increases with higher initial income inequality. This effect reverses with time, becoming positive one year ahead.

Powers (1995) summarizes several papers studying directly the link between inflation and poverty in the United States, which concludes that most action in the poverty rate happens when the unemployment rate moves, while the estimated effect of inflation is small and highly sensitive to the specification. On the contrary, she finds that, using an alternative measure (a consumption-oriented poverty rate, instead of income poverty), inflation positively affected poverty in the United States in 1959-1992. Cardoso (1992) delves into this link in developing countries (Latin America), and argues that inflation increases the number of poor people, by affecting more than proportionately the middle class (they would pay more inflation tax than other groups). Agenor (1998) shows, estimating cross-country ordinary least squares (OLS) regressions for developing countries, that inflation is positively related to the poverty rate. Easterly and Fischer (2001) regress the change in poverty rate against the inflation tax in a pool of 42 transitioning and developing countries between 1981 and 1993 and find a positive and significative, although not robust, relation. Talukdar (2012) also reports a positive relation between inflation and poverty, using static and dynamic panels in developing economies between 1981 and 2008.

Lastly, the research question of this paper is particularly valuable in times of renewed academic interest in inflation. The COVID-19 pandemic and Ukraine’s invasion caused worldwide shocks, triggering global inflation and pushing many economies into chronic inflation processes. Some papers that highlight this renewed interest are Bernanke and Blanchard (2025), Borio, Lombardi, Yetman, and Zakrajšek (2023), Reis (2022), and Yusifzada, Comert and Parmaksiz (2024), among others. Studying how this acceleration may harm the poor can provide valuable insights into the renewed debate on inflation, thereby contributing to a deeper understanding of its broader economic and social consequences. Moreover, clarifying its specific impacts during disinflation episodes can help identify the channels and mechanisms most relevant for contemporary policy design in Argentina, a country that suffered from high inflation in the last decade.

3. Data description

We construct a comprehensive unbalanced panel by integrating five variables obtained from different sources, for the largest country sample possible. Population estimates are taken from the United Nations 2024 Revision of World Population Prospects, spanning from 1960. Inflation data comes from the Ha, Kose, and Ohnsorge (2023) database, covering the period 1970-2024, with average annual variation in headline CPI expressed in percentage points (p.p.) serving as our inflation measure.

Poverty measurements are sourced from the World Bank's Poverty and Inequality Platform, which provides data starting in 1963 (initially for the United States). We use standardized poverty headcount ratios calculated at internationally comparable thresholds of 2, 5, 10, and 15 purchasing power parity (PPP)-adjusted United States dollars (USD) per day. These ratios represent the percentage of population living below each poverty line at 2021 international prices. Additionally, we utilize gross domestic product (GDP) per capita data in PPP terms (constant 2017 international dollars) available from 1990, derived from the International Comparison Program price surveys.

This approach yields an unbalanced panel encompassing 195 countries, with substantial heterogeneity in development levels and economic structures, for the 1970-2024 time window. As inflation may have different dynamics in small countries, we restrict our sample to nations that reach a population of one million inhabitants at some time in the panel, in the same fashion as Ari, Mulas-Granados, Mylonas, Ratnovski and Zhao (2023). Thus, our estimation sample includes 155 countries.

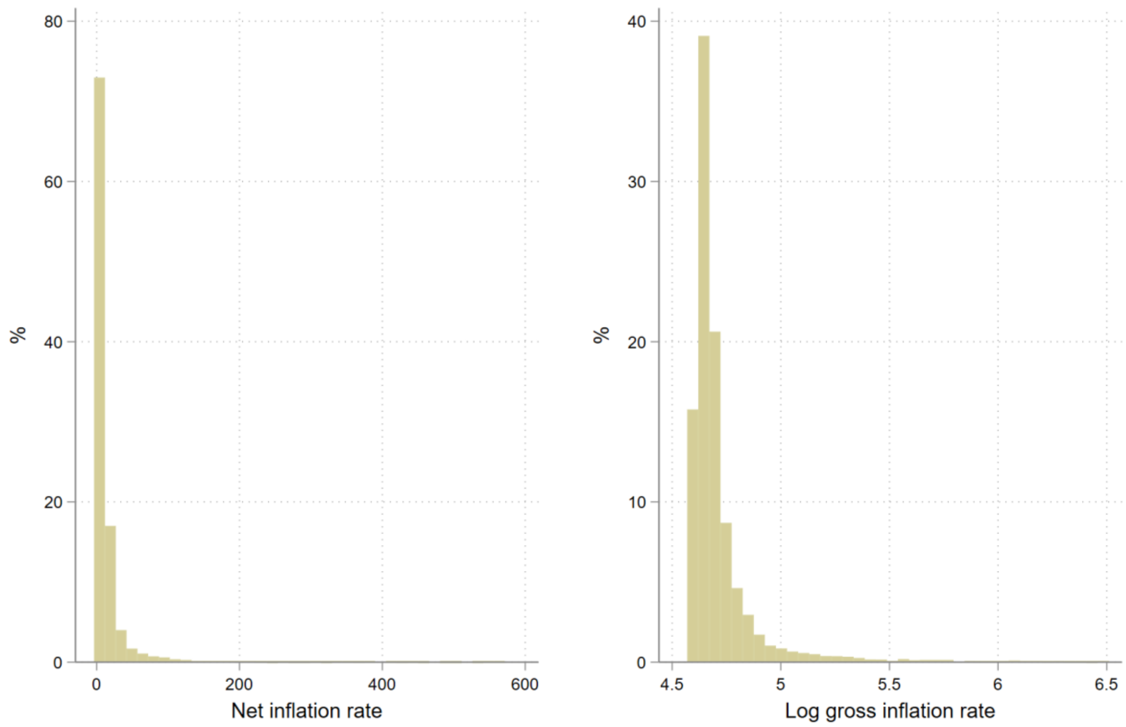
To ensure consistent analysis across different development levels throughout our sample period, we also use the World Bank's income classification, available since 1987, which divides countries in four groups: low, lower-middle, upper-middle and high income.[1] This classification approach allows us to examine how the inflation-poverty relationship varies across countries at different stages of economic development.

The period of analysis has seen a non-negligible number of hyperinflation or very high-inflation processes. This implies that the inflation data features outliers that might distort both visual inspections and econometric estimations.[2] We have made two methodological choices to deal with this issue. The first is to trim the top 1% of the inflation rate distribution. The second is to work with a standard transformation: the natural logarithm of the gross inflation rate. As figure 1 shows, this transformation still yields a distribution with high positive skewness.

[1] For previous years, we deflate the 1987 thresholds (using the United States inflation rate) and compare them to the Gross National Income (GNI) per capita of each country, using the Atlas Method. For a remaining group, with no GNI available, we impute the classification from the nearest year available.

[2] From 7,965 total inflation observations, 249 feature an inflation rate higher than 100%, 54 feature one larger than 1,000% and 7 feature one larger than 10,000%.

Figure 1. Distribution of inflation rates, before and after transformation



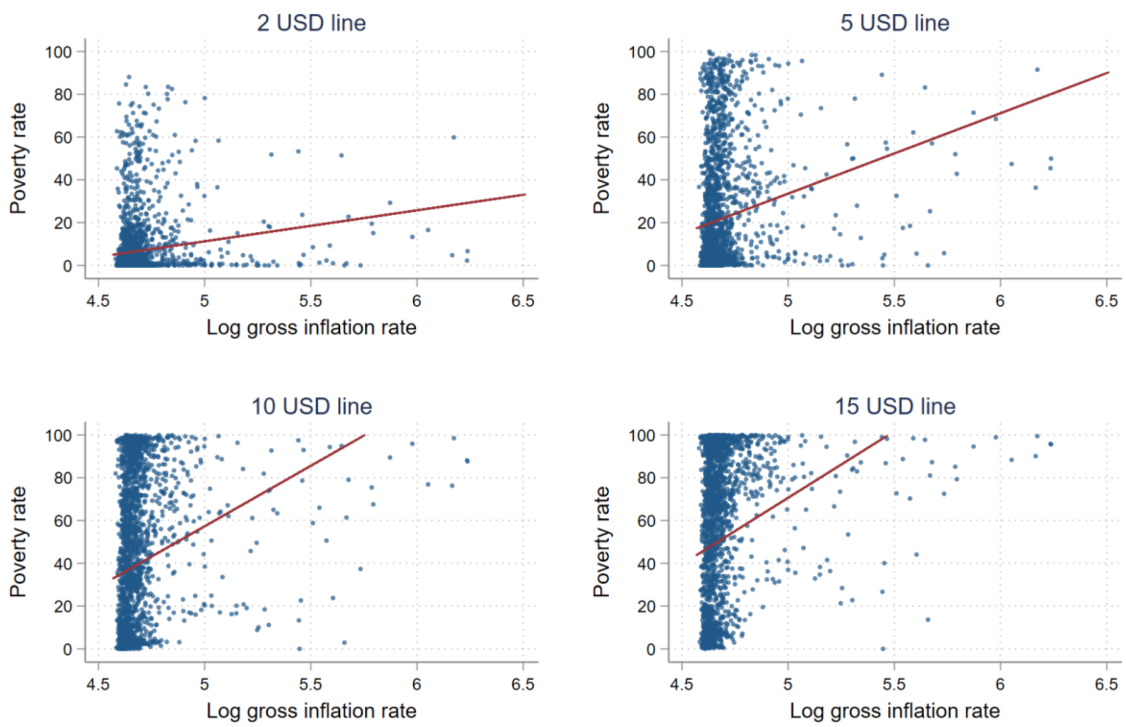
Data Ha, Kose, and Ohnsorge (2023). The figure shows the distribution of the net inflation rate and the log of the gross inflation rate (both expressed in percentage points), after trimming of the top 1% of the distribution.

4. The inflation-poverty nexus

a. Some descriptive evidence

A merely visual inspection provides a first approximation to the inflation-poverty nexus. Using four different harmonized poverty lines, Figure 2 shows that the poverty headcount ratio seems to be positively correlated with inflation. The slope ranges from 14.5 to 62.2, depending on the poverty line specification, implying that the poverty rate increases by between 1.5 and 6.2 percentage points for every 10% increase in inflation.

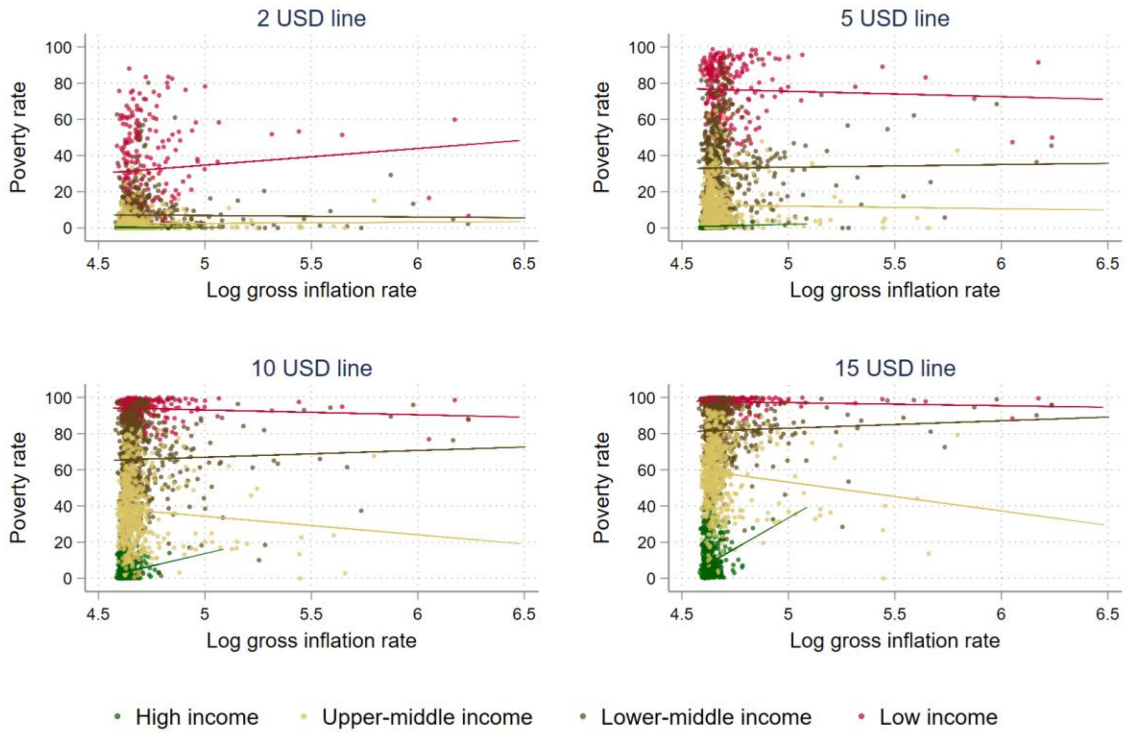
Figure 2. Inflation and poverty rate, cross-country 1970-2024



Data from World Bank and Ha, Kose, and Ohnsorge (2023). The figure shows the correlation between the poverty headcount ratio, calculated using different daily PPP USD poverty lines, and the log gross inflation rate. Regression lines are estimated through ordinary least squares.

However, when the relationship is examined within each income group, the positive correlation generally disappears, as shown in Figure 3, where most regression lines have flat slopes (and even some appear downward-sloping). This occurs because both poverty and inflation are positively correlated with income level—the lower the GDP per capita, the higher the poverty rate, regardless of the inflation rate. Likewise, lower GDP per capita is associated with higher inflation.

Figure 3. Inflation and poverty rate, cross-country 1970-2024, by income level group



Data from World Bank and Ha, Kose, and Ohnsorge (2023). The figure shows the correlation between the poverty headcount ratio, calculated using different daily PPP USD poverty lines, and the log gross inflation rate, by income level group, defined according to World Bank. Regression lines are estimated through ordinary least squares.

This results indicate income level may be a confounding factor between the two variables of interest, thus indicating that controlling for income level (measured through GDP per capita) is necessary to achieve meaningful results. That is what we do in the following subsection.

b. An econometric approach

We estimate different versions of the following two-way fixed effects model:

$$Pov_{ct}^{l} = \alpha + \beta \ln \pi_{ct} + \gamma \ln GDPPC_{ct} + \mu_c + \delta_t + u_{ct} \quad (1)$$

Where Pov_{ct}^{l} is the poverty headcount ratio of country c in year t, when the poverty line is set at l daily PPP-adjusted USD per equivalent adult. π_{ct} is the gross inflation rate and $GDPPC_{ct}$ is the gross domestic product per capita of country c in year t, while μ_c and δ_t are, respectively, country and year fixed effects. u_{ct} is a traditional error term that may feature heteroskedasticity, which we deal with by calculating robust standard errors.

The models are estimated using the traditional within-group estimator, including time dummies. We present different versions of the results imposing alternative restrictions, setting either γ, μ_c or δ_t to zero. When country effects are not included, the estimation strategy is simply OLS.

Given that higher income naturally translates into lower poverty, γ is expected to be negative and statistically significant.[3] β represents how inflation shapes the distribution of that income, generating a larger or smaller proportion of people under certain poverty lines. The sign and size of this parameter are less evident, as descriptive evidence suggests that controlling for income or country-idiosyncratic characteristics might weaken the correlation between inflation and poverty. The goal of these exercises is to obtain the best possible estimation of this parameter.

Table 1 shows the results, which reveal several findings. In the first place, $\hat{\gamma}$ is always negative and statistically significant at a 99% confidence level across all specification, regardless of the poverty line used or the inclusion of fixed effects. This is in line with both previous evidence and general intuition—more average income makes more people surpass a certain income threshold. The magnitude is also economically relevant: each p.p. of increase in average per capita income is associated to a decrease that ranges from 0.1 to 0.33 p.p. in the poverty headcount ratio. Taking the highest value in the range, a sustained annual growth rate of 3.5% is expected to take a little over 1% of the population out of poverty per year.

[3] This statement makes a fundamental assumption: more income translates into less poverty, *ceteris paribus* distribution. This is non-trivial and may not be a correct assumption. Extensive literature has however studied the growth-poverty nexus and provided convincing evidence on it. For instance, for Latin America, the issue is analyzed in Gasparini, Gutierrez and Tornarolli (2007).

Table 1. The effect of inflation on poverty

				2 USD poverty line				
Log gross inflation rate	14.51***	8.51***	8.18***	0.22	-2.37	-6.07***	-0.79	-1.74
Log GDPPC					-9.84***	-9.57***	-13.02***	-9.74**
N	2173	2173	2173	2173	1979	1979	1979	1979
Country fixed effects			Yes	Yes			Yes	Yes
Time fixed effects		Yes		Yes		Yes		Yes
				5 USD poverty line				
Log gross inflation rate	37.59***	28.81***	23.14***	11.83***	0.87	-1.77	4.36	6.65‡
Log GDPPC					-24.34***	-23.94***	-30.19***	-29.30***
N	2173	2173	2173	2173	1979	1979	1979	1979
Country fixed effects			Yes	Yes			Yes	Yes
Time fixed effects		Yes		Yes		Yes		Yes
				10 USD poverty line				
Log gross inflation rate	56.58***	52.21***	27.77***	17.21***	14.82***	17.40***	8.22*	12.13***
Log GDPPC					-31.28***	-31.12***	-33.34***	-31.80***
N	2173	2173	2173	2173	1979	1979	1979	1979
Country fixed effects			Yes	Yes			Yes	Yes
Time fixed effects		Yes		Yes		Yes		Yes
				15 USD poverty line				
Log gross inflation rate	62.21***	61.38***	23.12***	12.49***	21.77***	27.72***	4.72	7.87**
Log GDPPC					-31.88***	-31.99***	-29.89***	-27.17***
N	2173	2173	2173	2173	1979	1979	1979	1979
Country fixed effects			Yes	Yes			Yes	Yes
Time fixed effects		Yes		Yes		Yes		Yes

Data from World Bank and Ha, Kose, and Ohnsorge (2023). The table 1 shows the results of regressions of the poverty headcount ratio (measured using different daily PPP USD poverty lines) on inflation and GDP per capita. ‡ p<0.15, * p<0.1, ** p<0.05, *** p<0.01. Robust standard errors are used in all estimations.

However, the interpretation of $\hat{\beta}$ estimates are less straightforward. On the one hand, higher inflation always increases the amount of people under the 10 and 15 poverty lines, at highly statistical significance levels.[4] In those cases, the coefficient values range from +8 through +28, implying that each 5% of additional inflation increases poverty in a number between 0.4 p.p. and 1.4 p.p. It is important to emphasize that this 5% increase does not correspond to 5 p.p., but rather to a relative increase in inflation. This arises from the monotonic transformation applied—to prevent results from being distorted by extreme values of inflation, we applied a logarithmic transformation that ensures that a certain relative increase in inflation has a constant quantitative effect on poverty. For example, raising inflation from 10% to 11% (a 10% relative increase) produces the same impact on poverty as raising it from 60% to 66% (also a 10% relative increase).[5]

Nevertheless, these estimates drop both in size and statistical significance for the lower poverty lines (2 and 5 USD a day). They even change signs in some cases, suggesting that a reduction in inflation may be associated to rising poverty. This result might be interpreted in different ways. It might be the case that the inflation-poverty link is weak at low levels of the poverty line precisely because such low lines work only for the least developed countries, as the vast majority of the population is above those levels of income in countries that have reached an average economic development level. However, an enticing alternative is the presence of heterogeneities, which we explore in the following subsection.

c. Heterogeneity

In a modified version of the main model, we include an interaction term between inflation and income level, capturing how different income levels affect the effect of inflation on different poverty headcount ratios. The estimated equation now becomes:

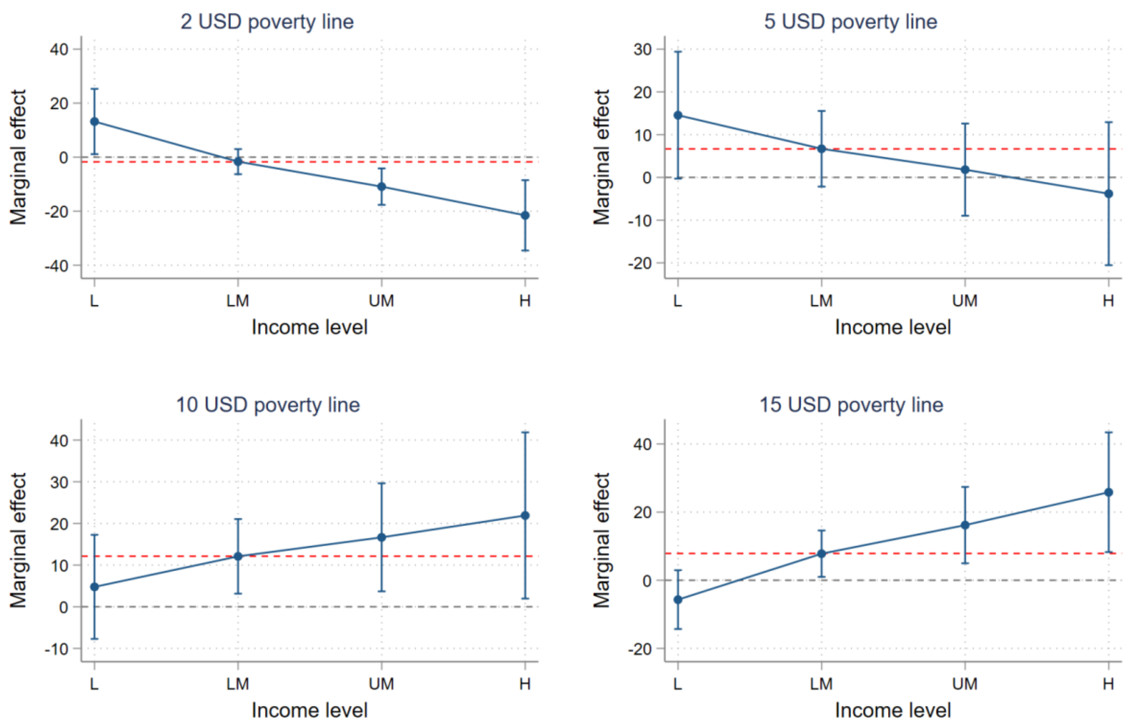
$$Pov^l_{ct} = \alpha + \beta \ln \pi_{ct} + \gamma \ln GDPPC_{ct} + \theta \ln \pi_{ct} \cdot \ln GDPPC_{ct} + \mu_c + \delta_t + u_{ct} \quad (2)$$

This model allows the marginal effect of inflation on poverty to vary across GDP per capita levels. For expositional clarity, we will estimate average marginal effects using the World Bank classification of countries in income level categories.

[4] A minor exception is that of the model with inflation, income and country but not time fixed effects, where the effect is not statistically different from zero in the highest poverty line specification. This is most likely attributable to sampling error.

[5] This type of interpretation might be unintuitive for low inflation regimes but it proves necessary when dealing with high inflation processes, as a one p.p. increase in inflation is nearly negligible in contexts where the annual inflation rate is, say, over 100%.

Figure 4. Heterogeneous effect of inflation



Data from World Bank and Ha, Kose, and Ohnsorge (2023). The figure shows the marginal effect of inflation on the poverty headcount ratio (measured using different daily PPP USD poverty lines) by country income level, controlling for GDP per capita, country and time fixed effects. Estimations are obtained from a model that includes an interaction term between inflation and GDP per capita. Dashed red lines represent the estimated effects from a model without interaction. Robust standard errors are used in all estimations.

Figure 4 provides a valuable insight of the drivers of previous results. As we include another term depending on inflation, β is no longer equal to the marginal effect of inflation on poverty. Now, this effect becomes equal to $\beta + \theta \cdot \ln GDPPC_{ct}$ (thus varying between countries and time). The 2 bottom quadrants show these effects on 10 and 15 USD poverty lines. These are high thresholds for low-income countries, potentially accounting for the non-significance of the point estimates. For middle and high-income countries, estimations retain positive sign and statistical significance, and the size is positively associated to income level, implying that the negative distributional effects of inflation are larger in more developed economies.

The upper panels require a more detailed analysis. They both show a positive and statistically significant impact of inflation on poverty for low-income countries, for which the lines are better suited. Nonetheless, the association between the size of the effect and the income level appears reversed in sign, as effects become smaller—and, in fact, negative—as income level rises.

The fact that, under the 2 USD line, inflation is shown to have negative effects on poverty in upper-middle and high income countries can, once again, be put down to the fact that such line is not well suited for these nations. In fact, the median ratio is under 1% of people under this line in the two groups. Therefore, this is certainly not a very informative distributional measure in that context.

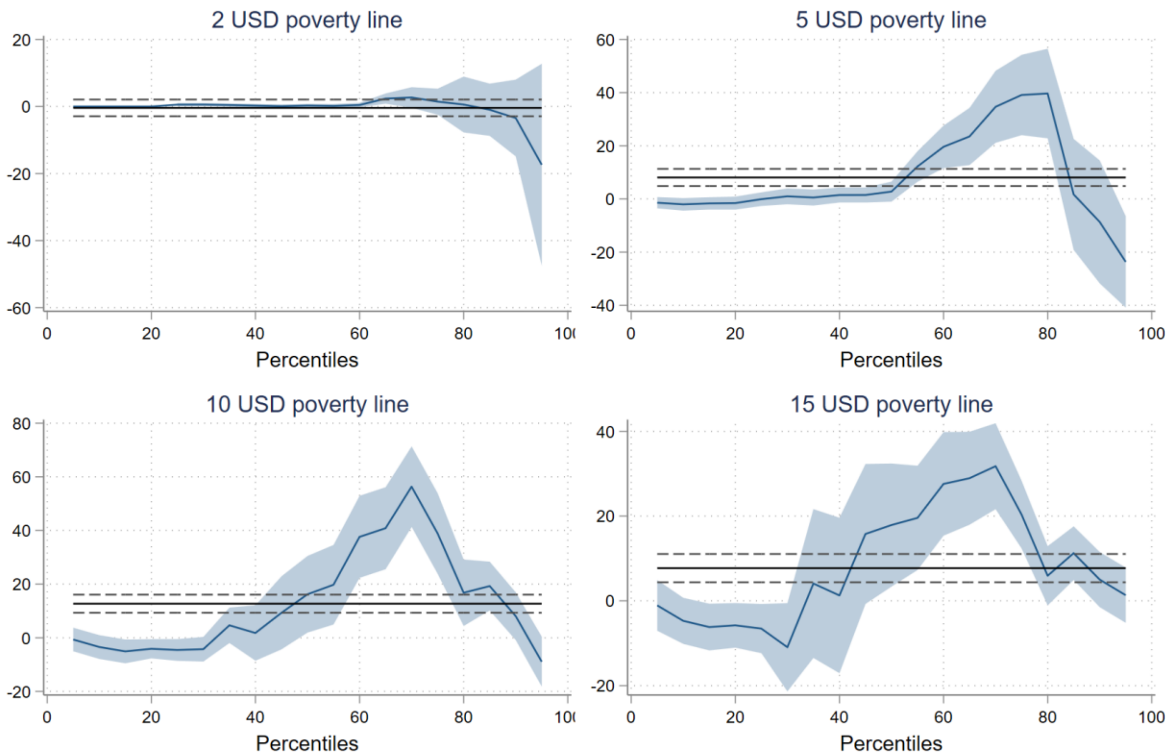
d. A quantile approach

Finally, we move on to a quantile regression version of the exercise. In particular, we implement an unconditional quantile regression methodology that has become popular in recent applied literature. This approach consists of estimating the following version of the model:

$$RIF(Pov_{ct}^{l}, Q_{\tau}|x_{ct}) = \alpha(\tau) + \beta(\tau)\ln \pi_{ct} + \gamma(\tau)\ln GDPPC_{ct} + \mu_c(\tau) + \delta_t(\tau) \quad (3)$$

In this new specification, Q_τ represents the τ percentile of a distribution, with $\tau \in (0, 100)$. Equation (3) regresses the Recentered Influence Function (RIF) of the percentile τ of the unconditional distribution of Pov_{ct}^{l} on the set of regressors we have worked with so far (including all fixed effects), so that $\beta(\tau)$ can be interpreted as the unconditional quantile effect of the inflation rate on the poverty rate—it measures how much the percentile of interest shifts when inflation is marginally increased.

Figure 5. Quantile effects of inflation



Data from World Bank and Ha, Kose, and Ohnsorge (2023). The figure shows the unconditional quantile effect of the inflation rate on the poverty headcount ratio (measured using different daily

PPP USD poverty lines), controlling for GDP per capita, country and time fixed effects, for each percentile of the distribution of poverty. Estimations are obtained from a RIF regression. Blue regions represent 95% confidence intervals. Black solid lines represent OLS effects, black dashed lines represent the respective 95% confidence intervals.

These results complement those in the previous section with some revealing findings. The quantile curves in the bottom panels show a very interesting pattern—they are close to zero in the left tail (and, in fact, are not statistically different from zero up to percentile 40), rise rapidly after the median and finally drop heavily in the right tail. The curves peak around percentile 70, where they reach a value that more than triples the OLS estimate, implying that the effect of inflation on poverty is disproportionately large in this section of the distribution. Since this corresponds to poverty levels usually observed in upper-middle income countries, we might conclude that the distributional harm caused by inflation is exceedingly high in countries similar to Argentina.

This pattern is approximately replicated by the quantile curve for the 5 USD poverty line, although here the right tail reaches large negative values, which are not always statistically different from zero. Finally, no relevant pattern emerges for the 2 USD line, where the quantile curve generally moves within the OLS confidence interval, with very high variability in the estimation in the right tail.

5. Concluding remarks

This article addresses an important yet underexplored question: what is the effect of inflation on income distribution, particularly regarding the poverty rate? The evidence presented shows a robust positive relationship between inflation and poverty. However, the impact varies depending on the poverty line used, the income level, and the poverty rate itself.

Inflation increases poverty when relatively high poverty lines (10-15 USD) are considered, whereas the effect is diluted at lower ones (2-5 USD). Additionally, the size of inflation's impact on poverty increases with GDP, suggesting that the negative distributional effects of inflation are more significant in more developed economies. In contrast, in low-income countries, the direct effect is only observed for lower poverty lines. Furthermore, the effect of inflation on poverty varies by quantile of poverty. It increases after the median, peaks around the 70th percentile, and then decreases as the distribution approaches the upper tail. This indicates that the impact of inflation on poverty is disproportionately larger in this section of the distribution, which corresponds to poverty levels observed in upper-middle-income countries, such as Argentina.

These findings contribute to the ongoing debate on the consequences of inflation and disinflation, providing a rationale for the political appeal of stabilization policies. Moreover, given that the statistical effect of inflation on poverty is more pronounced in middle-income countries, and inflation rates tend to be higher in Latin America, these results are crucial for understanding the distributional effects in our region and country. However, the identified heterogeneities underscore the need for further research to examine their underlying mechanisms and causes, as well as the relationship between stabilization policies, economic growth, inequality, and poverty.

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