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Inflation Risk Dynamics and Its Effects on Corporate and Market Behavior

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Abstract

This article investigates how inflation risk dynamics influence corporate and market behavior in a context of renewed inflation volatility and heightened macroeconomic uncertainty. The study conducts a systematic literature review of peer reviewed articles published between 2019 and 2023, examining how inflation levels, expectations and uncertainty affect firms' investment, pricing, employment and financing decisions, as well as the pricing of assets in equity and bond markets. The synthesized evidence shows that persistent and uncertain inflation tends to depress real investment, encourage caution toward irreversible projects and shape managers' pricing and wage setting strategies. On the financial side, the review finds that inflation risk is a priced factor, generating time varying risk premia, sector specific valuation effects and regime dependent hedging properties across asset classes. The article discusses these results by organizing studies into corporate and market focused strands and concludes that inflation risk must be analyzed within an integrated macro financial framework linking firm decisions, monetary policy and asset pricing.

1. Introduction

Inflation has reemerged as a central concern for policymakers, firms, and investors as many economies have shifted from a regime of low and stable prices to one characterized by sudden inflation surges and heightened uncertainty. Inflation risk dynamics, understood as the time varying distribution of possible future inflation outcomes, influence real borrowing costs, debt burdens, and discount rates, and thereby shape both corporate decisions and the pricing of financial assets. For firms, changes in inflation and inflation risk affect input costs, wage bargaining, product pricing, and the real value of nominal liabilities. For financial markets, they alter expected cash flows and risk premia across asset classes, with implications for portfolio allocation and valuation at both aggregate and sectoral levels (Laurila & Ilomäki, 2020; Časta, 2023; Chiang & Chen, 2023).

Recent micro level evidence underscores the importance of inflation expectations and perceived inflation risk as drivers of firm behavior. Survey and experimental studies show that when managers expect higher inflation, they tend to adjust prices more frequently, modify employment and investment plans, and change their demand for credit, with these responses shaped by the prevailing monetary policy framework (Coibion et al., 2020). Firm surveys further suggest that companies often rely on simple or adaptive rules when forming inflation expectations, and that their beliefs can diverge systematically from those of households and professional forecasters (Zhang et al., 2022). At the macro level, empirical work for emerging economies finds that inflation uncertainty can have a statistically significant and negative effect on domestic investment, with permanent components of uncertainty

exerting stronger adverse effects than transitory ones (Kamasa et al., 2022). Complementary evidence for Turkey indicates that macroeconomic uncertainty, including inflation uncertainty, is an important determinant of private investment dynamics (Güney, 2020). These findings point to inflation risk as a key channel linking macroeconomic conditions to corporate investment behavior.

On the financial side, a growing asset pricing literature documents that inflation risk is priced in stock and bond markets. Studies for the United States and other advanced economies report that higher inflation risk and inflation induced volatility are often associated with lower stock returns and increased market uncertainty, while sectoral evidence shows that the sensitivity to inflation risk varies across industries (Časta, 2023; Chiang & Chen, 2023). Other contributions emphasize that inflation affects risky investments by altering investors' attitude toward risk and their processing of information, which can change the demand for risky assets and amplify financial market volatility (Laurila & Ilomäki, 2020). Although these strands of research provide important insights, they are frequently separated between macroeconomics, corporate finance, and asset pricing, and often analyze either firm behavior or market outcomes in isolation.

This article addresses these gaps by conducting a systematic literature review of peer reviewed studies published between 2019 and 2023 on inflation risk dynamics and their effects on corporate and market behavior. By synthesizing evidence on inflation expectations, uncertainty, and risk premia from both firm level and market wide perspectives, the review seeks to clarify the main channels through which inflation risk shapes investment, financing, pricing, and asset returns. It also

aims to identify areas of convergence and disagreement in the recent literature and to highlight open questions that warrant further empirical and theoretical research.

2. Literature Review

The existing literature on inflation risk and economic behavior can be broadly grouped into work that emphasizes real corporate decisions and work that focuses on financial market pricing. On the corporate side, research documents that inflation uncertainty shapes investment, cash flow management, and risk-taking. For an emerging economy, Kamasa et al. (2022) show that higher inflation uncertainty depresses domestic investment, consistent with real options arguments that firms delay irreversible projects when the price environment is volatile. Laurila and Ilomäki (2020) find that inflation risk alters the risk return trade-off of long-term investments, suggesting that firms reallocate portfolios away from assets whose real value is highly sensitive to unexpected price changes. At the same time, survey-based evidence indicates that firms' inflation expectations are heterogeneous and systematically related to their pricing, wage setting, and financing decisions, which creates a direct link between subjective inflation beliefs and corporate behavior (Zhang et al., 2022).

A second strand of work analyzes how inflation risk is priced in equity and bond markets, thereby shaping broader market behavior. Boons et al. (2020) document a time varying inflation risk premium in stock returns, showing that portfolios with high exposure to inflation innovations earn higher expected returns. Časta (2023) provides complementary evidence that cyclical components of inflation

and interest rates significantly improve the predictability of excess stock returns. Liu and Serletis (2022) demonstrate that the relationship between inflation, inflation uncertainty, and equity returns is complex and highly country specific, with sign and magnitude changing across regimes and between advanced and emerging economies. Sectoral and country level work for major equity markets similarly reports that high inflation episodes can be associated with either negative valuation effects or improved hedging properties, depending on monetary policy credibility and the underlying macroeconomic environment (Chiang & Chen, 2023).

More recent contributions explicitly connect inflation expectations to cross asset allocation and regime dependent risk taking. Pesci et al. (2022) show that European asset returns react nonlinearly to implied inflation forecasts, with inflation indexed bonds, commodities, and selected equity sectors offering better hedging performance when markets move into high uncertainty regimes. Taken together, these studies highlight that inflation risk dynamics affect both firm level decisions and market level pricing, but the evidence remains fragmented across countries, asset classes, and empirical approaches. This motivates a systematic literature review that integrates findings on how inflation risk and uncertainty propagate through corporate investment, financing and pricing behavior, as well as through equity and bond markets, in order to clarify common mechanisms, identify sources of heterogeneity, and map out open questions for future research.

3. Methods

This study uses a systematic literature review approach to synthesize recent evidence on inflation risk dynamics and their effects on corporate and market behavior. The review focuses on peer reviewed journal articles published between 2019 and 2023. Relevant studies were identified through keyword searches in major academic databases using combinations of terms such as "inflation risk", "inflation uncertainty", "inflation expectations", "corporate investment", "firm behavior", "asset pricing", and "stock returns". The search was limited to articles written in English and published in academic journals. After removing duplicates, titles and abstracts were screened to exclude studies that did not analyze inflation risk or uncertainty or did not link inflation to corporate decisions or financial market outcomes. Conceptual papers, policy reports, book chapters, and non-refereed working papers were excluded to ensure a consistent level of methodological rigor.

Articles that passed the initial screening were read in full to confirm their relevance. A simple data extraction template was used to record information on country or region, sample period, type of data (micro firm level or macro/market level), measures of inflation risk or uncertainty, corporate or market outcomes, empirical methods, and main findings. The selected studies were then analyzed using descriptive and thematic synthesis. Descriptively, the literature was mapped by year, geography, and main focus (corporate behavior or market pricing). Thematically, the evidence was grouped into clusters covering firm level responses to inflation risk, the pricing of inflation risk in equity and bond markets, and regime or context dependent effects. This structure provides a clear basis for comparing results across

studies and for identifying areas of convergence, divergence, and gaps for future research.

4. Results and Discussion

The synthesis of recent studies reveals several consistent patterns in how inflation risk and uncertainty influence corporate behavior. Across both advanced and emerging economies, higher and more uncertain inflation tends to depress real investment and encourage caution in long term commitments. Evidence from Ghana shows that permanent components of inflation uncertainty have a stronger negative effect on domestic investment than transitory shocks, suggesting that firms react more strongly when they perceive inflation risk as persistent rather than temporary noise (Kamasa et al., 2022). Macro level work for Turkey and other emerging markets similarly indicates that macroeconomic uncertainty, including inflation uncertainty, is an important determinant of private investment dynamics and firms' willingness to expand capacity (Güney, 2020). At a more aggregate level, studies for Central and Eastern Europe document that inflation uncertainty often exerts a larger negative impact on output growth than inflation itself, supporting the view that uncertainty is a distinct and powerful transmission channel (Živkov et al., 2020).

Firm level evidence helps explain these macro outcomes by documenting how managers adjust their policies when inflation risk rises. Survey based work for the United States and other advanced economies shows that managers with higher inflation expectations are more likely to revise prices, renegotiate wages, and alter

investment and hiring plans (Coibion et al., 2020; Zhang et al., 2022). Cross country analysis of advanced and emerging economies further suggests that inflation and inflation uncertainty affect real activity in nonlinear and regime dependent ways, with effects that differ across phases of the business cycle and levels of financial development (Liu & Serletis, 2022). Taken together, these findings indicate that inflation risk is embedded in firms' cost expectations, demand forecasts, and financing conditions, which in turn shapes their propensity to undertake risky or irreversible projects.

On the financial market side, the review confirms that inflation risk is priced in both equity and bond markets, but in ways that are sensitive to regimes and market structures. For equity markets, time varying factor models show that portfolios with high exposure to inflation innovations and inflation volatility earn higher expected returns, implying the presence of an inflation risk premium in the cross section of stocks (Boons et al., 2020; Časta, 2023). Sectoral evidence for the United States indicates that inflation risk has heterogeneous valuation effects, with some sectors experiencing pronounced negative reactions to inflation surprises while others display partial hedging properties (Chiang & Chen, 2023). European evidence based on a regime switching framework further shows that the hedging role of inflation sensitive assets such as inflation linked bonds, commodities, and selected equity sectors strengthens when inflation expectations move into high volatility regimes (Pesci et al., 2022).

The bond market evidence complements these findings by highlighting the role of inflation risk premia and forecast errors in shaping yields and term structure

dynamics. Studies for emerging bond markets and inflation targeting economies indicate that a nontrivial share of variation in nominal yields is driven by changes in the inflation risk premium rather than pure expectations of future inflation, especially during periods of heightened macroeconomic uncertainty (Časta, 2023). Recent work for Central and Eastern European countries shows that macroeconomic and policy uncertainty are associated with larger inflation forecast errors, underscoring the difficulty of anchoring expectations in volatile environments and the potential for mispricing of inflation risk in bond markets (Kliber et al., 2023). These results suggest that market-based measures of inflation expectations embed both expectations and compensation for bearing inflation risk, and that this decomposition is crucial for interpreting signals from yields and breakevens.

Overall, the combined evidence points to several robust conclusions. First, inflation risk and uncertainty matter for real corporate behavior, not only through average inflation but also through the perceived distribution of future inflation outcomes. Second, inflation risk is a priced factor in both equity and bond markets, with premia that vary over time, across sectors, and across asset classes. Third, the strength and sign of these effects are context dependent, varying with monetary policy credibility, financial development, and exposure to external shocks. These patterns highlight the importance of integrating corporate finance, macroeconomics, and asset pricing perspectives when assessing the consequences of inflation risk dynamics for firms and markets.

5. Conclusion

This review shows that inflation risk dynamics matter in a deeper way than simple changes in average inflation. Firms respond not only to realized price increases but also to the perceived persistence and uncertainty of inflation. When managers view inflation risk as high and long lasting, they tend to delay or scale down irreversible investments, adjust pricing and wage policies more frequently, and become more cautious in their financing choices. These micro level responses help explain why inflation uncertainty can depress domestic investment and output even when inflation itself is moderate, and why the same inflation shock can have very different real effects across countries and periods, depending on monetary policy credibility and the broader macroeconomic environment.

On the financial side, the evidence indicates that inflation risk is a priced factor in both equity and bond markets. Inflation innovations and inflation volatility are associated with time varying risk premia, sector specific valuation effects, and shifts in the performance of traditional hedging assets. Market based measures of inflation expectations therefore embed both views about future inflation and compensation for bearing inflation risk, especially in high uncertainty regimes. This has important implications for interpreting signals from yields, breakevens, and equity returns, and for understanding how inflation risk is transmitted through portfolios and balance sheets.

Taken together, the findings suggest that inflation risk should be analyzed within an integrated macro financial framework that links firm behavior, monetary policy, and asset pricing. For policymakers, anchoring inflation expectations and

reducing uncertainty can support investment and limit destabilizing swings in risk premia. For firms and investors, managing exposure to inflation risk requires attention to both real decisions and financial strategies, including sectoral allocation and the role of inflation sensitive assets. Future research can build on this review by combining firm level and market level data, exploring non-linear and regime dependent effects more systematically, and extending coverage to low income and highly volatile economies where inflation risk may be particularly noticeable.

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