

Fiscal Effects of Inflation and Inflationary Effects of Fiscal Policy

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Background

- Large increase in debt-to-GDP ratios from 2019Q4 to 2021Q1
- Countercyclical fiscal policy and government response to the pandemic
- General Escape Clause under the Stability and Growth Pact (SGP) was activated three years ago

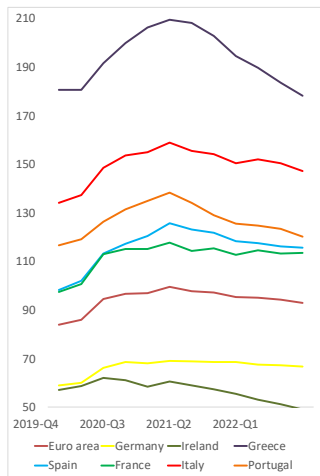


Figure: Debt-to-GDP

Dynamics since the Pandemic

- EA economic growth has rebounded in 2021
- Inflation has picked up
- The fiscal stance has tightened
- Geo-political events and international business cycle have slowed growth down in the EA

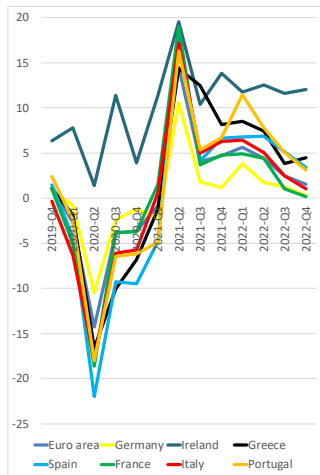


Figure: Real GDP Growth

Dynamics since the Pandemic

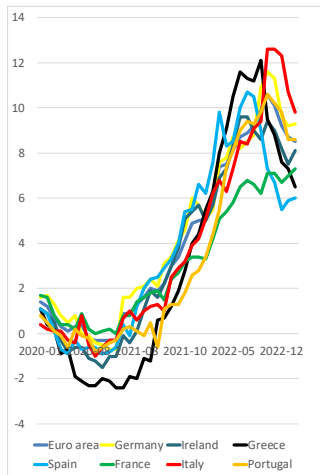


Figure: Inflation

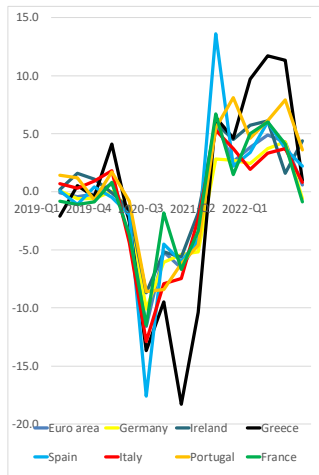


Figure: Fiscal Stance

Fiscal Effects of Inflation

Several fiscal effects of inflation

- Inflation erodes the real value of outstanding debt
- It is less contractionary than standard fiscal tools
- It raises government borrowing costs
- The snowball effect, $i - g$, is positive and growing for some EA members
- The ECB's actions and credibility will impact for how long borrowing costs will stay high

Fiscal Effects of Inflation

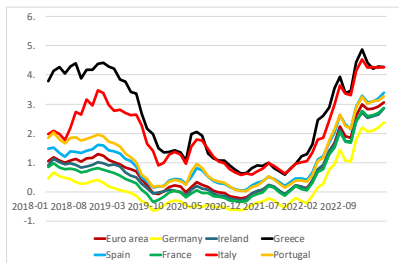


Figure: Long-term Rates

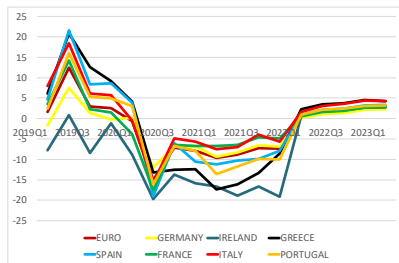


Figure: Snowball

Inflationary Effects of Fiscal Policy

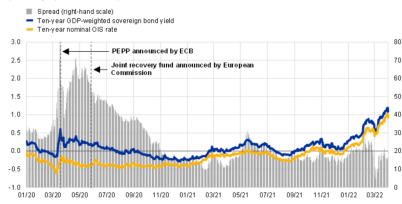
Fiscal policy always has inflationary effects

- Growth is slowing down in the EA
- Fiscal stance is positive

Fiscal Effects of Inflation in the EA

- Spread on 10Y government bonds are currently 180-200 bps
- PEPP played a fundamental role in keeping spreads under control until March 2022

(percentages per annum, basis points)



Sources: Refinitiv and ECB calculations.

Note: The latest observations are for March 2022.

Figure: Spreads and PEPP

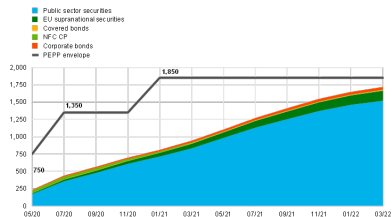


Figure: Cumulative PEPP purchases

Fiscal Effects of Inflation

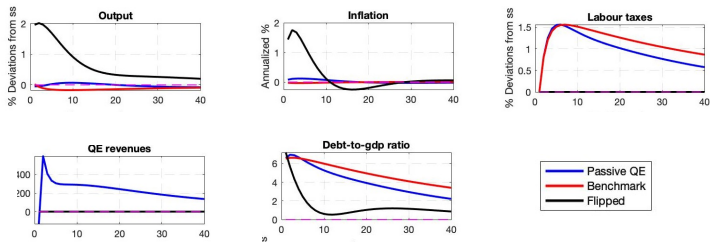


Figure: Model IRF to 6.5% Debt Shock