Fiscal Effects of Inflation and Inflationary Effects of Fiscal Policy

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The ECB and Its Watchers XXIII, March 22, 2023
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
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

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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

**Figure: Spreads and PEPP**

Sources: Refinitiv and ECB calculations.
Note: The latest observations are for March 2022.

**Figure: Cumulative PEPP purchases**
Fiscal Effects of Inflation

Figure: Model IRF to 6.5% Debt Shock