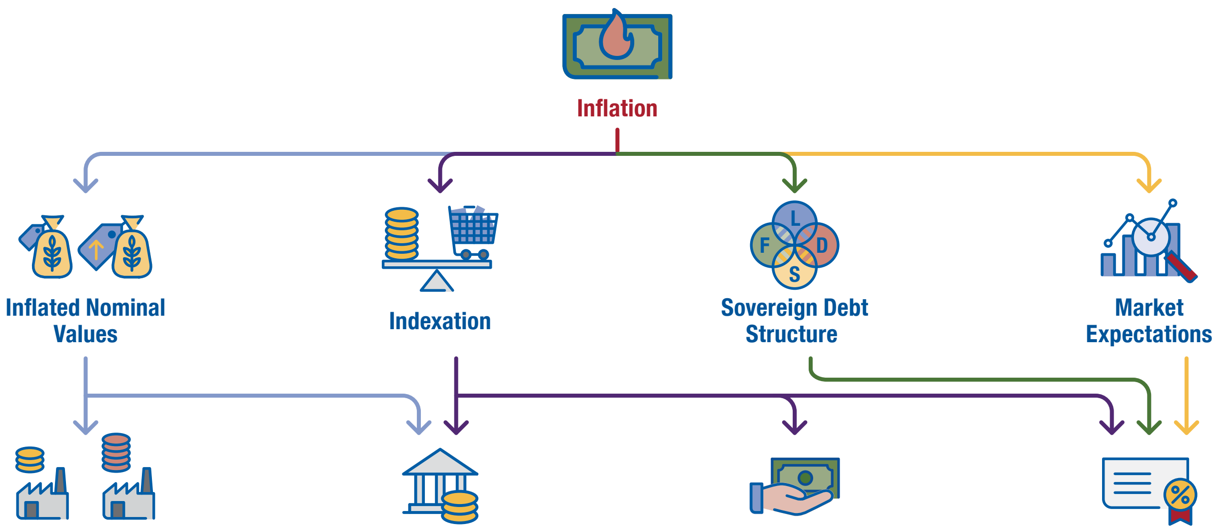
Immediate Impacts of Inflation on Public Finances



GDP Denominator

- Nominal GDP increases with inflation lead to lower fiscal deficits and public debt as a ratio to GDP.

Revenue

- The nominal tax base also grows with inflation (for example, value-added tax and profit tax).
- If income tax brackets are not indexed to inflation, taxpayers may be pushed into higher tax brackets (bracket creep).

Primary Expenditure

- Primary expenditure does not usually move immediately with inflation. However, public expenditure can go up with inflation with a short delay via indexation of public goods and services (for example, public wage, social benefits, subsidies, pension, and medical expenses) to inflation.

Interest Bill and Debt Service

- Interest payments on inflation-indexed bonds go up with inflation.
- Governments with more short-term debt (S) than long-term debt (L) face higher refinancing costs as investors ask for higher returns to compensate for expected inflation. They pay higher interest on foreign-currency-denominated debt (F) than on domestic-currency debt (D) when the currency depreciates due to inflation.

Source: IMF staff analysis.
Note: The infographic depicts channels of inflation's immediate impact on fiscal variables, occurring before a policy response.