EXECUTIVE SUMMARY

Chapter 2: Inflation and Disinflation: What Role for Fiscal Policy?

The upsurge in inflation since 2021—the sharpest in more than three decades—has called on policymakers to respond. Government policies need to be informed by an understanding of how inflation affects various groups in society through uneven impacts on the budgets of different households. This chapter examines the multifaceted impact of inflation on fiscal variables (see infographic) and the distribution of well-being, and it explores how fiscal policy can do its part to curb inflation while supporting the vulnerable.

Governments influence how the costs of inflation are distributed not only through discretionary intervention but also through automatic indexation of pensions, transfers to poorer households via social safety nets, wages of civil servants, and tax thresholds. A survey of current international practices shows that indexation varies considerably across countries. Pensions are the most commonly indexed—in nearly all advanced economies and about 40 percent of emerging market and developing economies—followed by cash transfers to vulnerable groups and public wages.

The impact of inflation on the fiscal accounts also depends on redistribution—in this case, between the public sector and the private sector. Unexpected inflation erodes the real (inflation-adjusted) value of government debt, with bondholders taking the brunt of the hit. For countries with debt exceeding 50 percent of GDP, each 1 percentage point surprise increase in inflation is estimated to reduce public debt by 0.6 percentage point of GDP, with the effect lasting over the medium term. These effects are smaller or negligible for countries with a large share of debt denominated in foreign currency. When inflation is expected, it is not associated with a decline in debt ratios, highlighting that inflating debt away is neither a desirable nor a sustainable strategy. Likewise, deficit-to-GDP ratios initially decline as the nominal (current monetary) values of the economy's output increase and, consequently, the tax base rises, generating more tax revenue, while spending fails to keep up. But such effects dissipate over time.

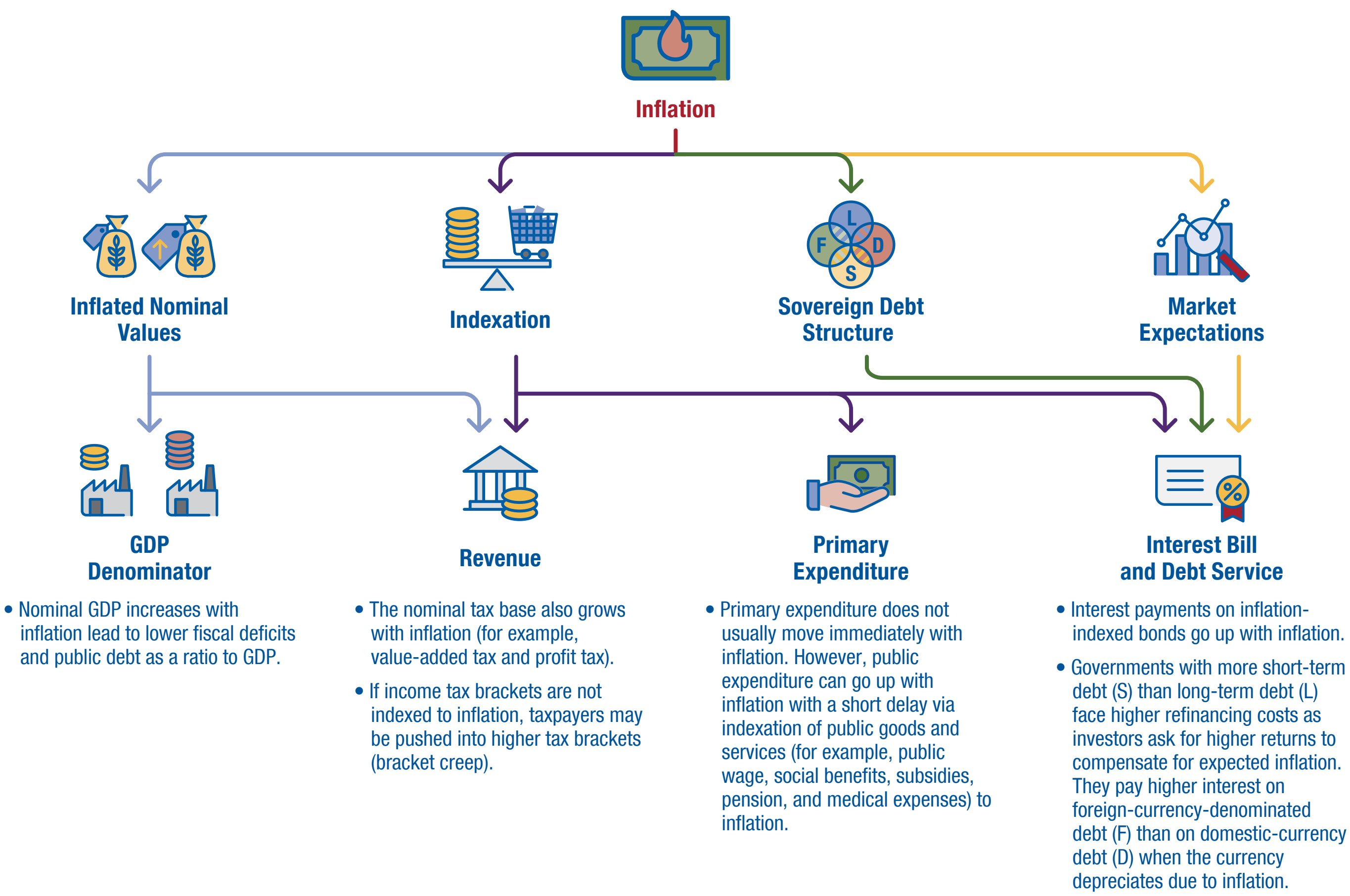
In addition, the chapter shows that redistributive effects of inflation on households are more complex than usually thought. Based on surveys of thousands of households in *Colombia*, *Finland*, *France*, *Kenya*, *Mexico*, and *Senegal*, estimates are provided for the price acceleration from the second quarter of 2021 to the second quarter of 2022 for three channels (see Chapter 1 for more recent developments on the relationship between inflation and public finances): (1) real incomes (wages and pensions), (2) losses in net nominal assets, and (3) faster-than-average price rises for the main goods and services consumed by a given group (such as food prices, which hurt the poor during the period studied). Results show that changes in real income were the most important and differed the most across countries but less so across income groups. Losses on net nominal assets were larger for older groups than for young adults (who often have outstanding mortgage debt) in countries with sizable household credit markets. During the period considered, the estimated impact of inflation on the poverty rate (prior to new policy measures in response) is about 1 percentage point in three countries in the sample (*France*, *Mexico*, *Senegal*).

Fiscal policy also influences aggregate demand and inflation, with its ultimate impact depending on the monetary authorities' response. Estimates indicate that an increase in public spending of 1 percentage point of GDP led to an increase in inflation of 0.8 percentage point in the 1950–85 period and of 0.5 percentage point thereafter. The difference arguably stems from a more forceful response by central banks to rising inflationary pressure in the post-1985 era. Analysis using a model that embeds inequality in incomes, consumption, and asset holdings shows that a reduction in the fiscal deficit leads to a similar level of disinflation but requires a smaller increase in interest rates than when central banks act alone. The analysis also shows that deficit reduction combined with transfers to the poorest yields a smaller drop in total private consumption and a consumption path associated with less inequality across households. These effects are even more important when public debt is high because fiscal restraint limits the rise in the cost of borrowing and reduces debt vulnerabilities.

The chapter offers several lessons for policymakers at the current juncture:

- Although surprise inflation may occasionally offer some breathing room for debt ratios, attempts to keep surprising bondholders have historically proved futile or harmful.
- When reviewing automatic or discretionary indexation, policymakers need to decide which programs and groups to protect from income erosion while avoiding excessive indexation or other policies that make inflation more persistent. The impact of decisions about public wages (including choices regarding indexation) on private wage setting should also be carefully assessed.
- When considering new measures or reforms against the backdrop of significant inflation, policymakers should consider that different groups of households may already be experiencing sizable distributive effects.
- Fiscal policy—involving tough policy choices on what budget items to cut and which to protect or expand—can support monetary policy in the effort to bring down inflation while protecting those most affected by the cost-of-living crisis.

Immediate Impacts of Inflation on Public Finances



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