

Discussion of:

# Fiscal deficits and inflation risks: the role of fiscal and monetary regimes

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Joint NBP-NBU ARC, 22-23 January 2023

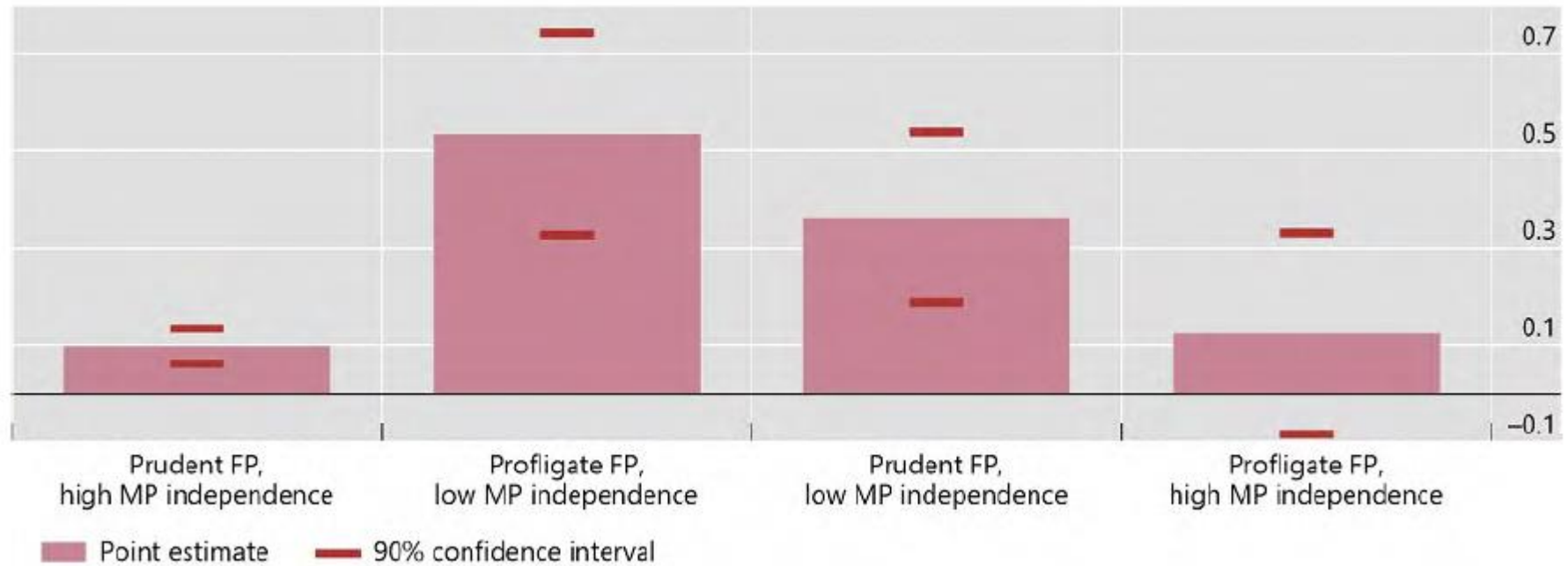
# How does fiscal policy affect inflation?

- Ongoing debates on the effects of a massive wave of fiscal stimulus during COVID-19
- A long lasting discussion in the literature
  - Strong evidence of positive effects on output (fiscal multipliers: Ramey, 2019; Sheremirov & Spirovskaya, 2022; Auerbach & Gorodnichenko, 2012)
  - **No conclusive answer for inflation** (Reinhart & Sbrancia, 2015)
  - What is the role of fiscal and monetary policy mix?
- **The paper:**
  - Classifies “fiscally-led” vs. “monetary-led” regimes
  - Estimates the effect of fiscal deficits on inflation in a panel of 21 AE over 1972-2011 under different policy regimes
  - Finds that higher deficits lead to higher inflation especially under “fiscally-led” regime
    - **Prudent monetary policy is crucial to accommodate inflationary effects of fiscal shocks**

# Challenges

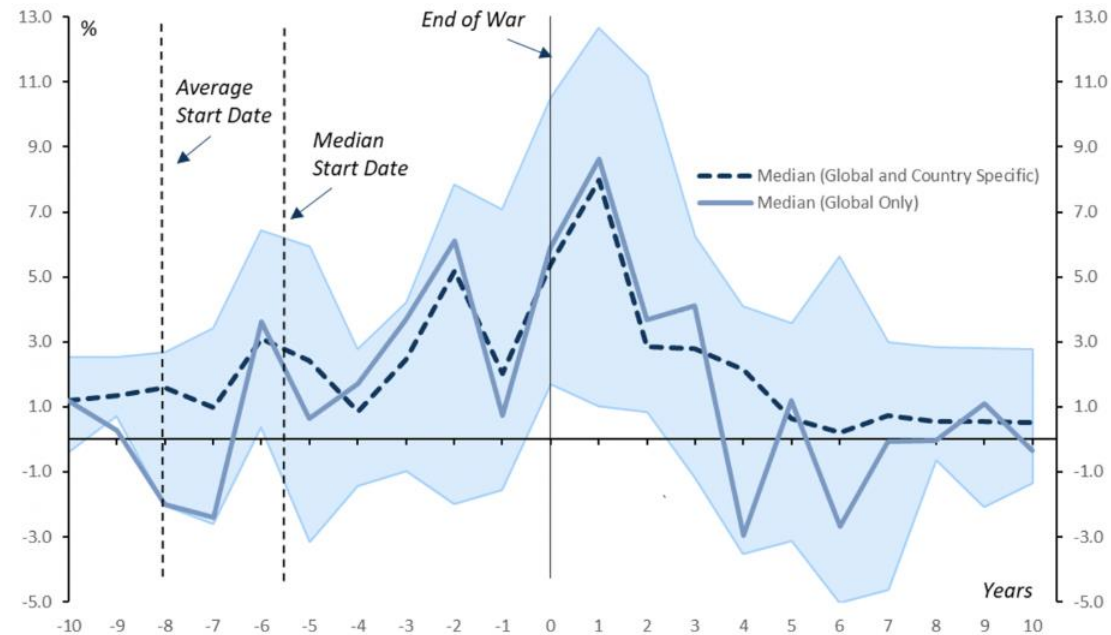
- **Regime classification:** *de jure* vs. *de facto* monetary and fiscal regimes?
  - MP: “legal” independence to identify regimes
  - FP: fiscal reaction functions of primary balance to stabilize debt
  - Alternative classifications for robustness
- **Estimation and shock identification:** Endogeneity, nonlinearity, asymmetry, low-inflation period
  - Quantile regressions for panel data to estimate inflation-at-risk from higher fiscal deficits
  - Forecast performance to validate the inclusion of fiscal deficits to Philips curve
  - Robustness checks for asymmetries, low-inflation period, alternative shock identification

# Results



# Lessons and new challenges for Ukraine

- Full-scale russia's aggression
  - Wars are associated with high and long-lasting inflation (usually due to fiscal expansion)
  - **Prudent MP and independent CB during and after the war**

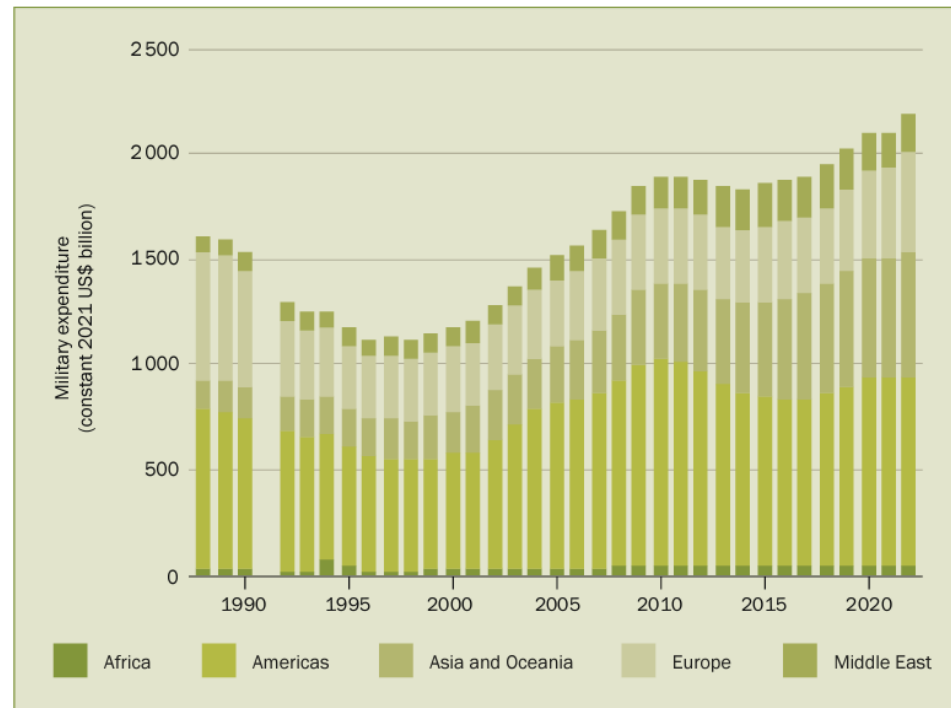


Notes: CPI Inflation (% year-on-year) around wars, median and interquartile range.

Source: Daly & Chankova (2021)

# Lessons and new challenges for the world

- Global geopolitical tensions due to the war in Ukraine and the rift between the Western-style democracies and China triggered the expansion of defense spending
  - Stimulative short-term effect on output (see Chebanova et al. 2023)
  - **Prudent MP and independent CB to accommodate inflationary effect of fiscal expansion**



**Figure 1.** World military expenditure, by region, 1988–2022

Source: SIPRI Fact Sheet. Trends in World Military Expenditure, 2022 (2023)

# Summary

- Very interesting and timely paper!
- Robust results
- The importance of the topic goes far beyond the scope in the paper (especially in the context of NBP-NBU ARC 2023)
- Suggestions for future work:
  - Military spending for shock identification (SIPRI dataset)
  - Quantile regressions combined with IV approach (see, for example, Harding & Lamarche, 2009)

# Literature

- Daly, K and R Chankova (2021). “Inflation in the Aftermath of Wars and Pandemics”, Goldman Sachs Global Economics Analyst, 25 March
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- Reinhart, C. and Sbrancia, M. (2015). “The liquidation of government debt”, *Economic Policy*, Vol. 30, No 82, April 2015, pp. 291-333
- Ramey, V. A. (2019). Ten Years after the Financial Crisis: What Have We Learned from the Renaissance in Fiscal Research?" *Journal of Economic Perspectives*, 33, 89-114.
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- SIPRI Fact Sheet. Trends in World Military Expenditure, 2022 (2023)