Fiscal Policy and Inflation Expectations

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**Views are my own and do not represent the position of the Banque de France nor the Eurosystem.*

Fiscal theory of the price level and inflation expectations

- In a regime of monetary dominance, primary surpluses are set to satisfy the intertemporal government budget constraint for any given price level. The central bank controls the price level
- In a regime of fiscal dominance, primary balances are set regardless of fiscal solvency, hence the price level adapts to satisfy the budget constraint
- With **fiscal dominance**: **high public debt** should lead to **higher prices** $\rightarrow$ agents anticipate that and their **inflation expectations go up**
- **This paper** tests this hypothesis and investigates the relationships between **budget deficit to GDP and inflation expectations**

Fiscal stance poses challenges for monetary policy's stabilization of expectations

	M1	M2	M3	M4	M5	M6
(1) Expected inflation rate	0.118***	0.143***	0.143***	0.122***	0.122***	0.122***
	(0.031)	(0.030)	(0.029)	(0.030)	(0.030)	(0.030)
(2) Inflation rate	0.314***	0.232***	0.226***	0.242***	0.243***	0.238***
	(0.012)	(0.012)	(0.013)	(0.012)	(0.012)	(0.012)
(3) Short term interest rate	-0.263***	-0.233***	-0.226***	-0.198***	-0.199***	-0.202***
	(0.021)	(0.022)	(0.023)	(0.022)	(0.023)	(0.023)
(4) Budget deficit to GDP (TC)		0.388***	0.390***	0.355***	0.350***	0.350***
		(0.036)	(0.036)	(0.036)	(0.036)	(0.036)
(3)x(4)			0.052**			
			(0.024)			
(5) Monetary contractivity index				-0.146***	-0.152***	-0.135***
				(0.010)	(0.011)	(0.011)
(4)x(5)					0.013	
					(0.011)	
(3)x(4)x(5)						-0.027**
						(0.013)
Obs	41.078	37.930	37.930	37.930	37.930	37.930
N-Groups	570	560	560	560	560	560
AR(1)-p	0.000	0.000	0.000	0.000	0.000	0.000
AR(2)-p	0.501	0.970	0.956	0.899	0.923	0.887
Hansen-p	0.741	0.876	0.889	0.875	0.870	0.882
Annual fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Monthly fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

- A rise in budget deficit counteracts the intended stabilizing effect on inflation expectations of contractionary monetary policy
- Subsample analysis shows this effect may be worse in period of higher deficit (post-2013)

State-dependent effect

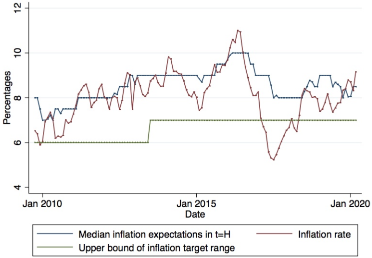
- What drives their attention to fiscal stance post-2013?
  - 1. Worries about fiscal sustainability
  - 2. Higher attention to news due to increased inflation
- Regarding 1., one could check whether the effect non-linear? (above a threshold?)

$$E_{it}(\pi_H) = \alpha_i + \beta_1 E_{it-1}(\pi_H)) + \beta_2 \pi_{t-1} + \beta_3 i_t^{st} + \beta_4 E_{it}(F_t) + \\ \beta_5 E_{it}(F_t)^2 + \beta_6 E_{it}(F_t)^2 E_{it}(F_t) + \epsilon_{it}$$

- Or use a fiscal sustainability index interacted with deficit to GDP (Lyziak and Mackewicz 2020)

State-dependent attention

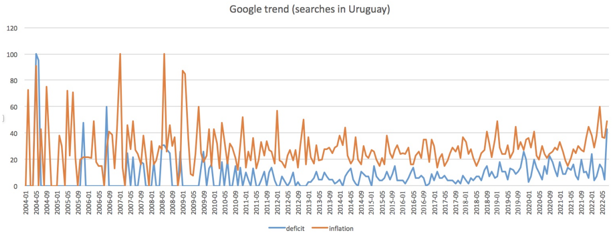
- Regarding 2., the literature has shown that forecasters ignore small surprises but update their forecasting rule after large surprises: **state-dependent attention**
- Post-2013 also features higher forecast errors (eye-balling)



- It would be interesting to test the interaction of forecast error with expected deficit, or a measure of attention

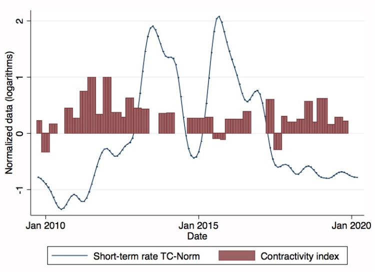
State-dependent attention & the media

- Time-varying attention on inflation and deficit evidenced in the data



- Media coverage has been shown to influence expectations (Larsen et al. 2021), as well as driving business cycles (Nimark 2019, 2021)
- An alternative measure for expectation of fiscal deficit other than the past fiscal deficit is to build an expectation measure based on newspaper articles (Factiva newspapers word searches, or Acosta 2022)

Contractivity index



- No clear correlation between the interest rate and the communication instrument: is it a strategy of the central bank?
- Are the results of both fiscal and monetary cancelling out because both monetary instruments contradict one another?
- Maybe it would be more convincing if plotting the difference with a measure of neutral rate or expectations of the neutral rate
- Does this index correlates with automated measures of sentiment?