DEVELOPMENT BANK OF LATIN AMERICA AND THE CARIBBEAN

Comments on “Monetary/Fiscal policy mix in the current international context”

Adriana Arreaza, Director of Macroeconomic Studies

01/17/2023

Country, City

DEVELOPMENT BANK
OF LATIN AMERICA
AND THE CARIBBEAN

Content

1. The research insights
2. Comments
3. A view from LAC

DEVELOPMENT BANK
OF LATIN AMERICA
AND THE CARIBBEAN

The research insights

- Prof. Bianchi's recent line of research aims at understanding post-pandemic inflation in light of the regimes that conditioned inflation dynamics in the past

- From the historical analysis, he argues that the conquest of inflation since the 80s is better understood as a result of a policy mix shift from fiscal dominance to monetary dominance. In other words, *the ability of central banks to control inflation requires fiscal backing*

- He addresses the question of how to interpret post-pandemic inflation providing alternative scenarios

    A Fiscal Theory of Persistent Inflation (optimistic)
    Inflation as a Fiscal Limit (concerned)
    Who is Afraid of Eurobonds? (pessimistic)

DEVELOPMENT BANK
OF LATIN AMERICA
AND THE CARIBBEAN

General comments

- Coordination is crucial. Fiscal policy should be consistent with monetary goals, reducing the need for higher interest rates to reduce inflation. In turn, fiscal health lowers spreads, capping the neutral interest rates

- Credibility is crucial for the policy mix. The policy mix can only be effective if policies are credible. Policies must be ingrained in fiscal and monetary institutional frameworks that ensure credibility.

- Coordination can be challenging, and there are current examples of conflicts between the central bank and the treasury.

- Unexpected inflation may help debt stabilize in the short run, but it may have the opposite effect if entrenched.

DEVELOPMENT BANK
OF LATIN AMERICA
AND THE CARIBBEAN

General comments

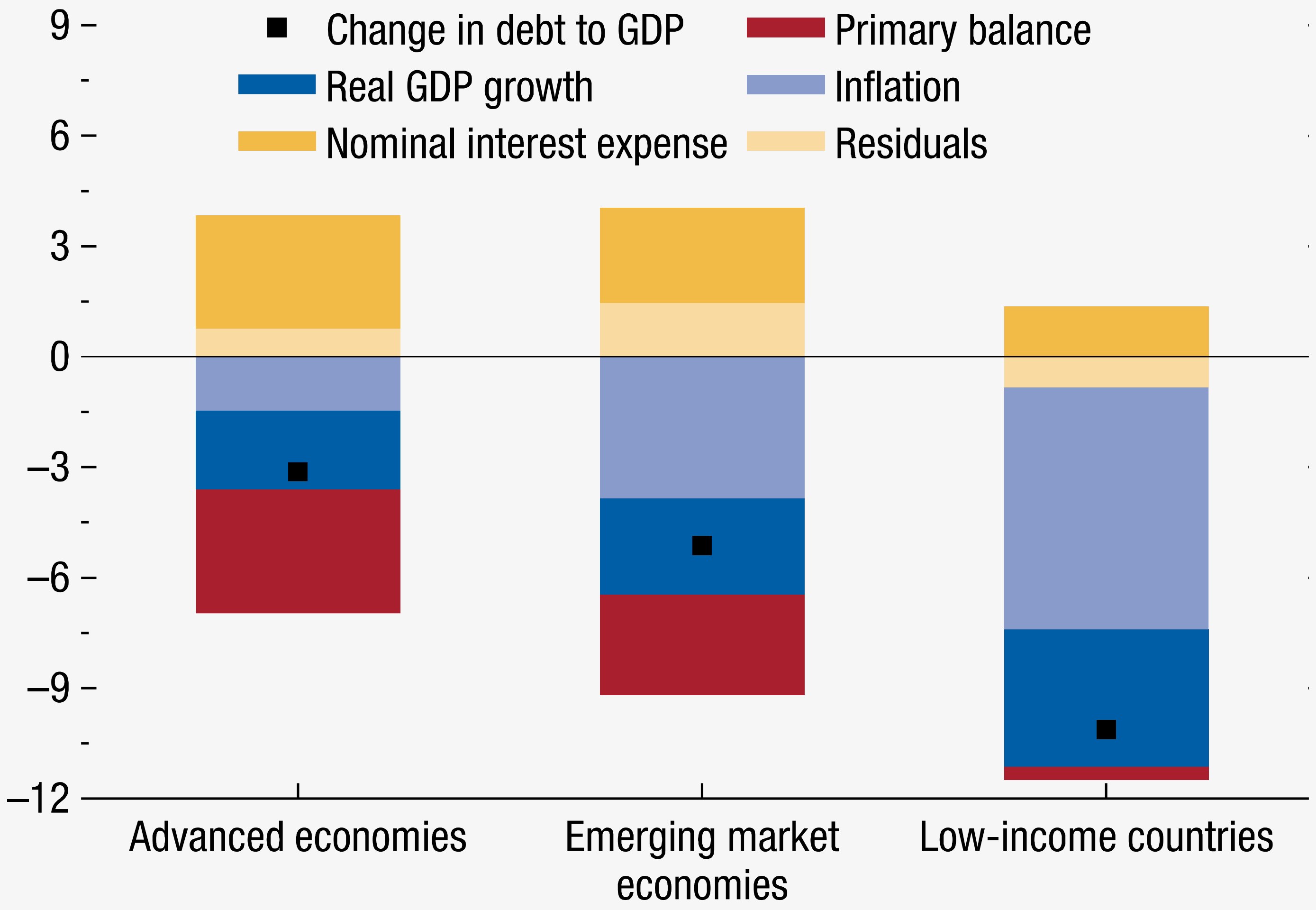
High inflation can influence debt ratios through higher nominal GDP and higher nominal interest rates.

Higher expected inflation can translate into higher nominal interest expenses and can cancel out the favorable effect of inflation on the debt ratio.

Unanticipated inflation jumps, on the other hand, affect debt ratios only through the channel of higher nominal GDP. (WEO, April 2023)

Contribution to Change in Debt to GDP during Reduction Episodes

Primary balance is more important in advanced economies, but growth and inflation play a bigger role in emerging market economies and low-income countries.

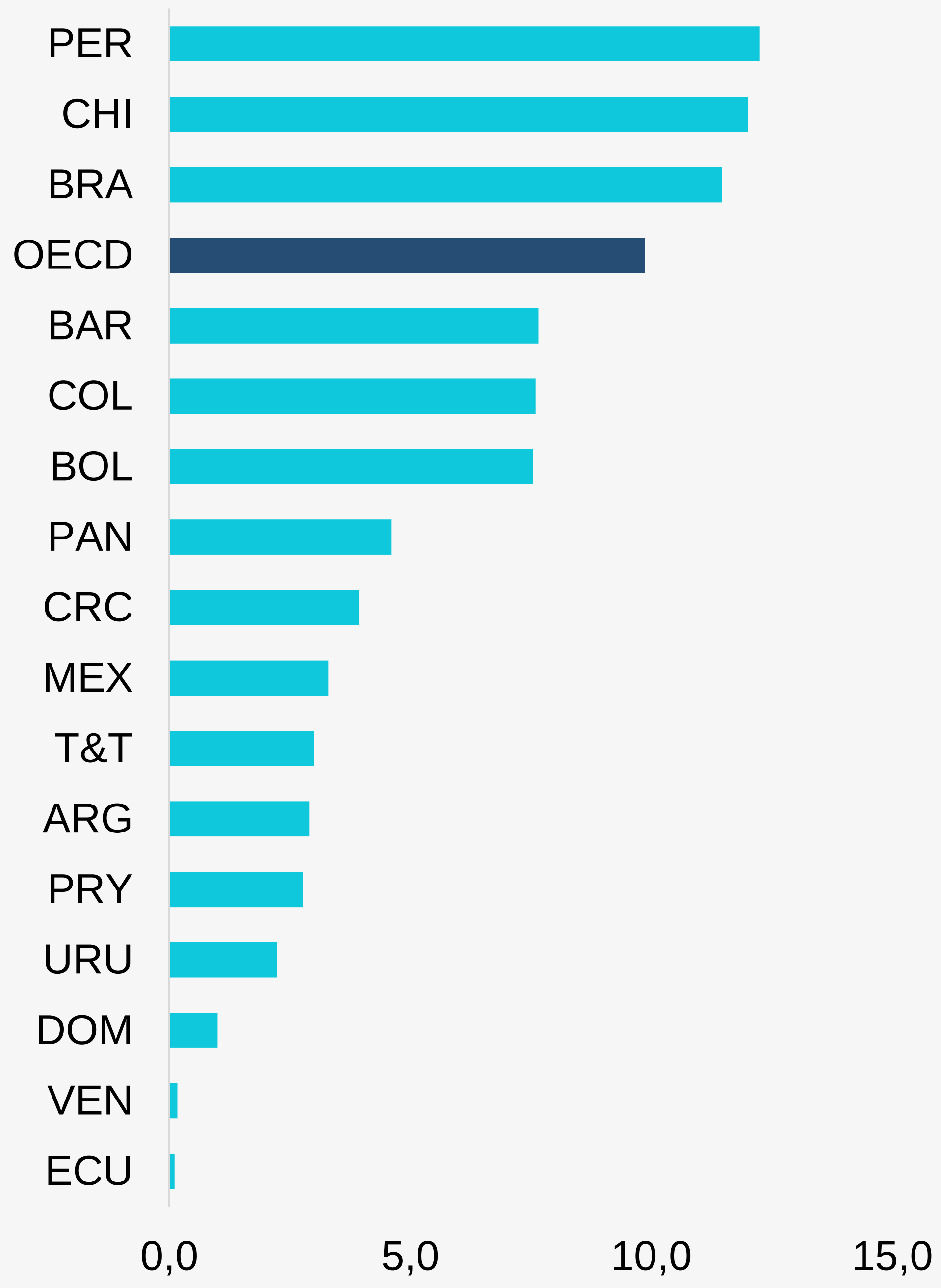


Source: WEO April 2023, IMF

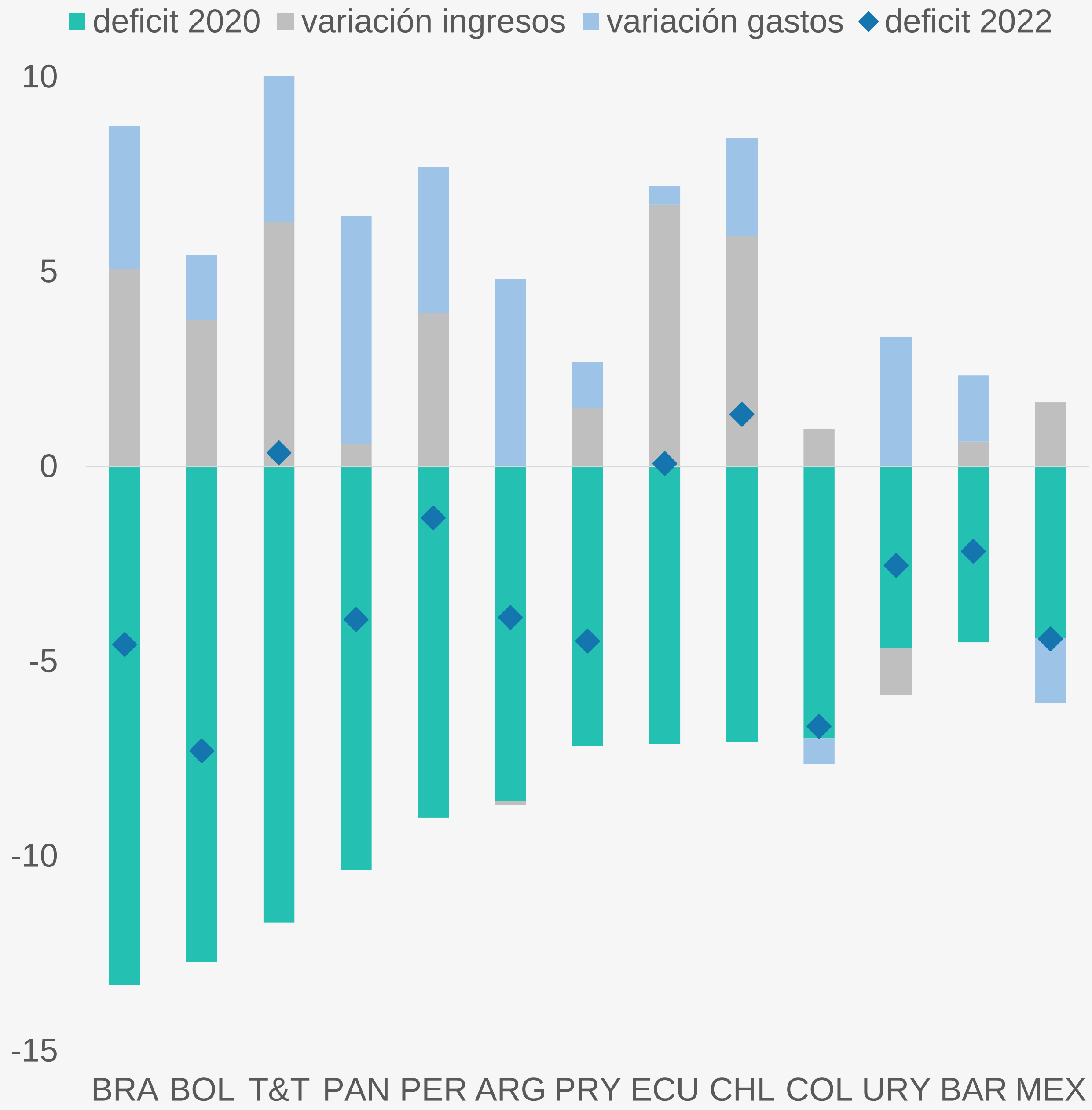
CAF DEVELOPMENT BANK OF LATIN AMERICA AND THE CARIBBEAN

A view from LAC

COVID fiscal pacakges
(sep 18 2020, % GDP)



Contributions to change in total deficit between 2020-2022
(% of GDP)



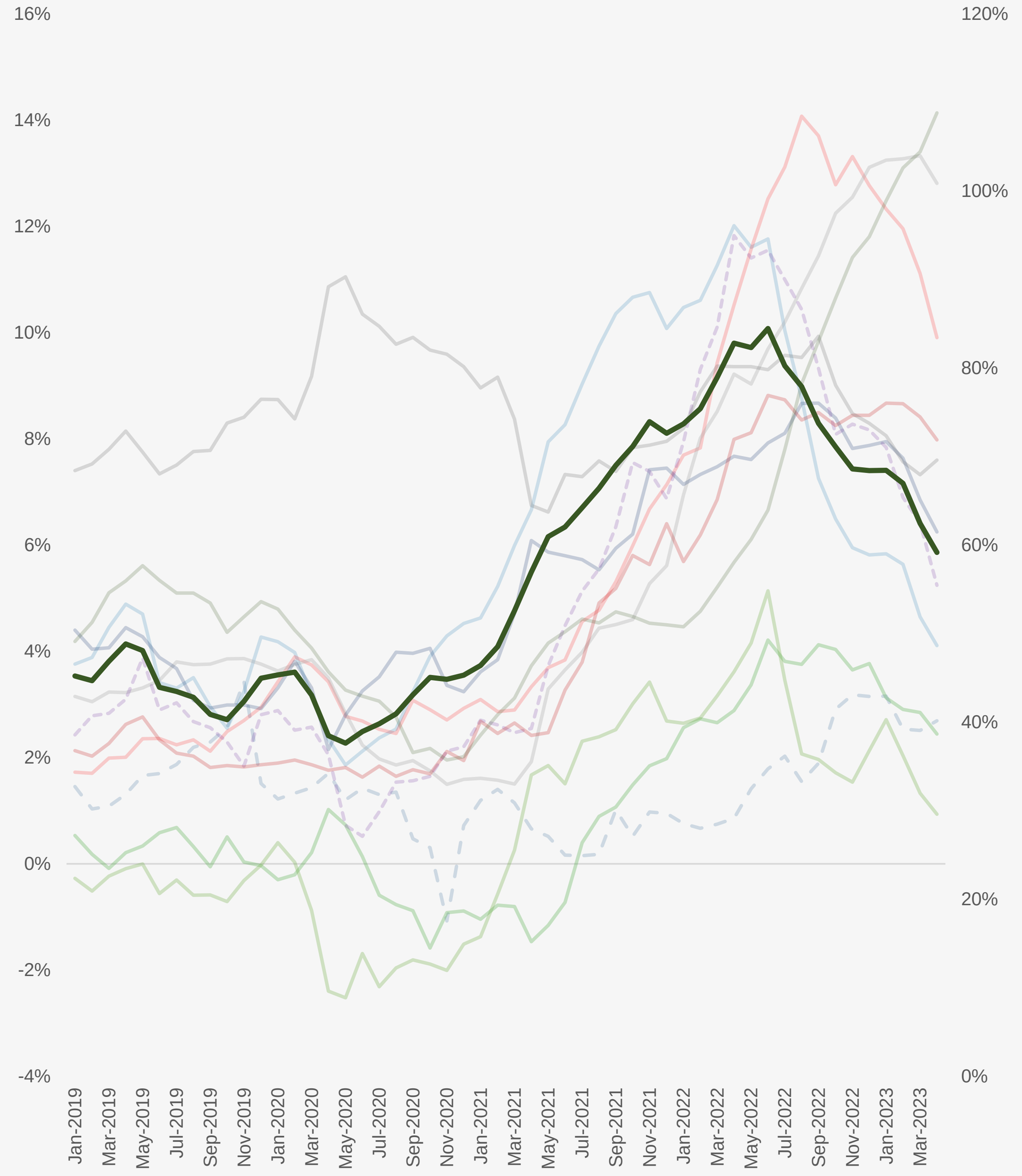
Necessary primary adjustment to stabilize debt and public debt adjustment
(General government, 2022 % GDP)

Source: CAF based on Official data and FMI WEO April 2023.

DEVELOPMENT BANK
OF LATIN AMERICA
AND THE CARIBBEAN

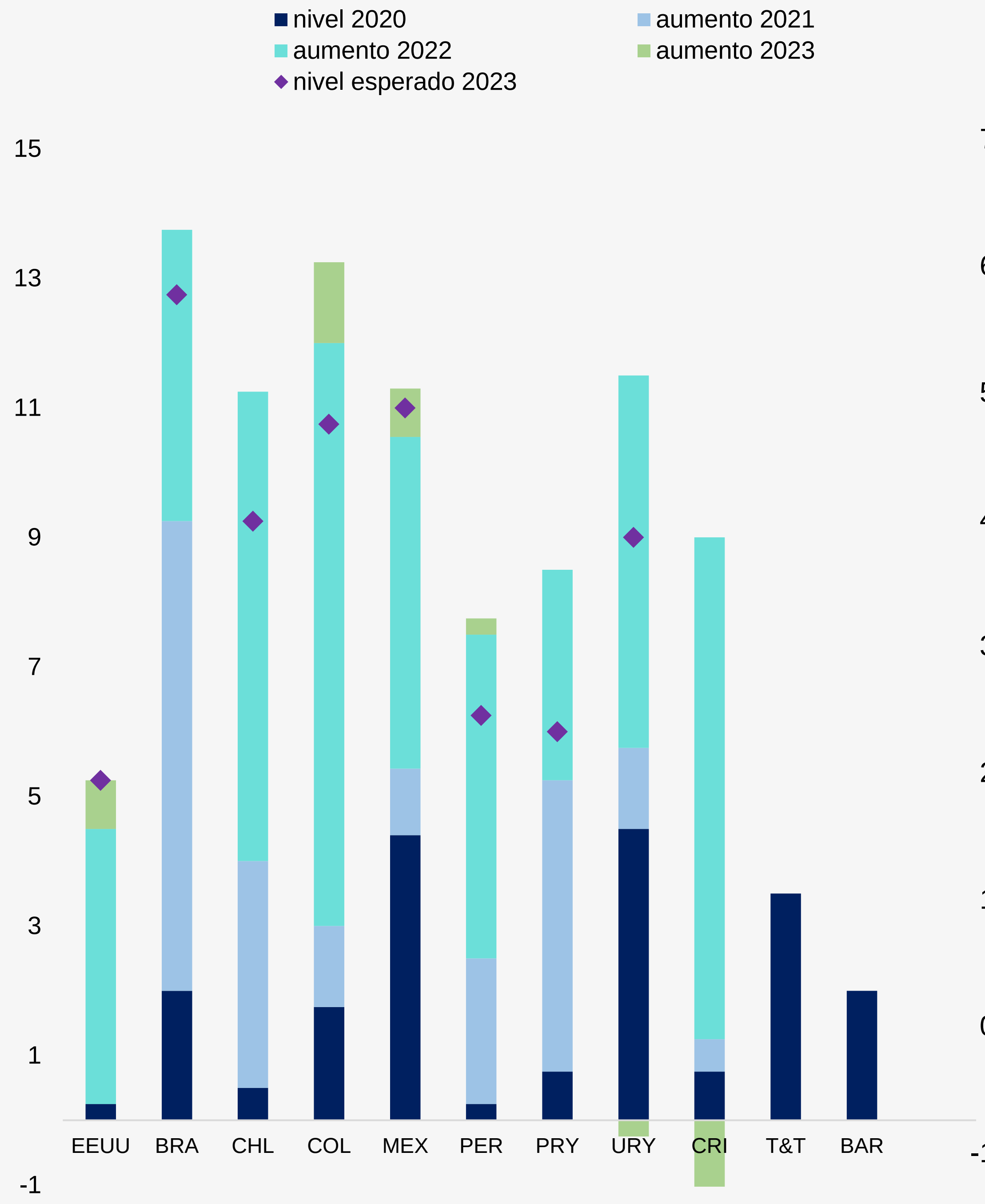
A view from LAC

Inflation LAC
(var %, yoy)

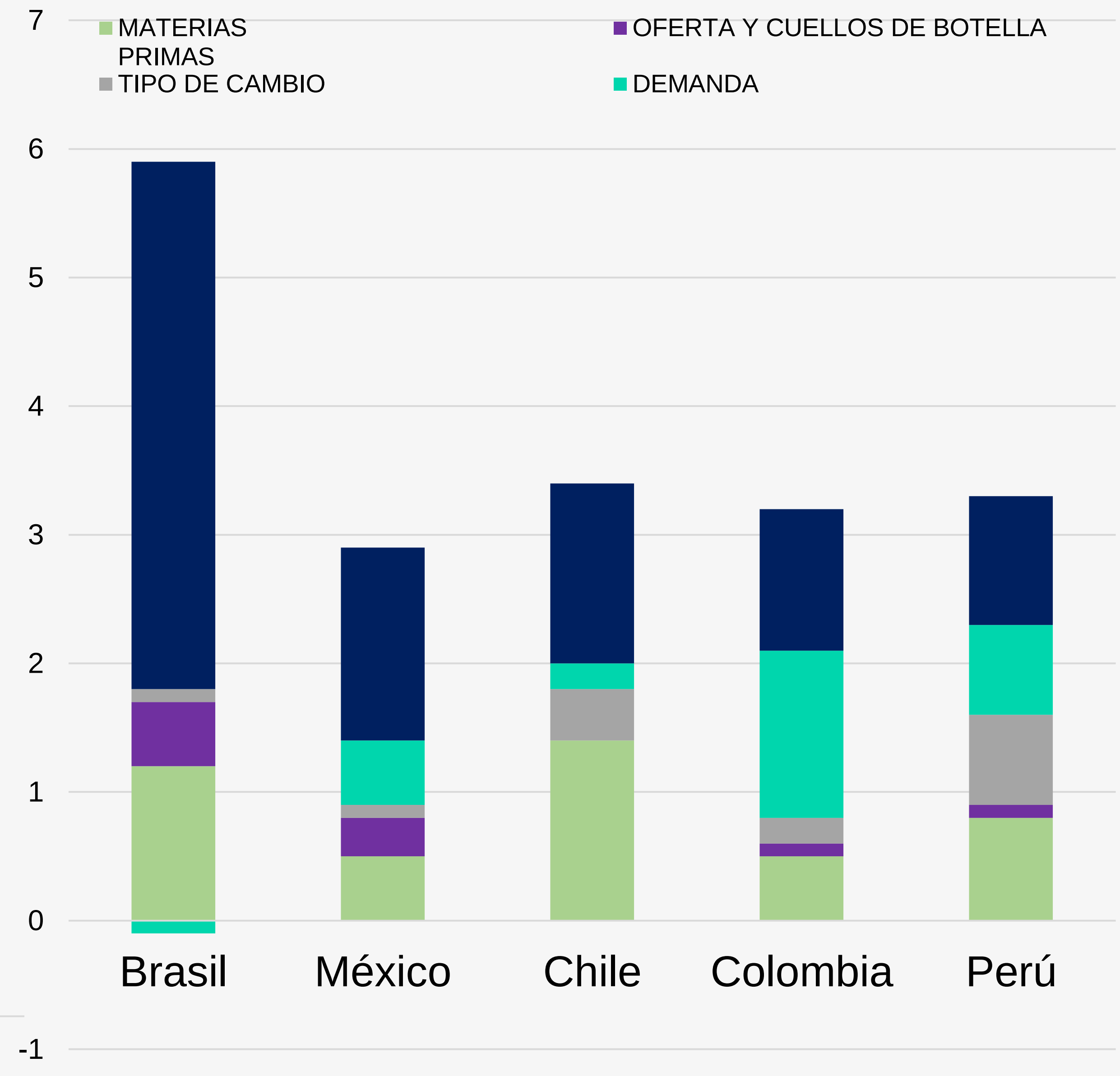


Source: CAF based on Official data and FMI WEO April 2023.

Interest rates 2020-2022



Contributions to the rise on average inflation
(jan 2020-apr 2021 to may2021-apr 2022)



Source: Banco de España, Informe de Economías latinoamericanas 2022.

DEVELOPMENT BANK
OF LATIN AMERICA
AND THE CARIBBEAN

A view from LAC

- Variations in the policy mix across countries: reasons for optimism, but also from concern

- Credibility is crucial for the policy mix

- Coordination is not always easy

- Challenges ahead

DEVELOPMENT BANK
**OF LATIN AMERICA
AND THE CARIBBEAN**

www.caf.com/en
@AgendaCAF