

# Discussion of 'Fiscal Sources of Inflation Risk in EMDEs'

By Ryan Banerjee, Aaron Mehrotra and Fabrizio Zampolli

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*The views expressed are my own and do not  
necessarily reflect official positions  
of the Federal Reserve System.*

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# Salient Contributions of the Paper

1. Effects of government deficits on inflation and exchange rates focusing on 26 EMDEs from 1960 to 2019
  - a. effects are nonlinear, larger in the right tails
  - b. more significant among EMDEs than among AEs
2. Macro-financial and institutional heterogeneity can be important: effects of higher deficits on inflation and exchange rates
  - a. larger when the share of foreign currency-denominated debt and/or foreign holdings of sovereign debt are high
  - b. smaller when pursuing inflation targeting

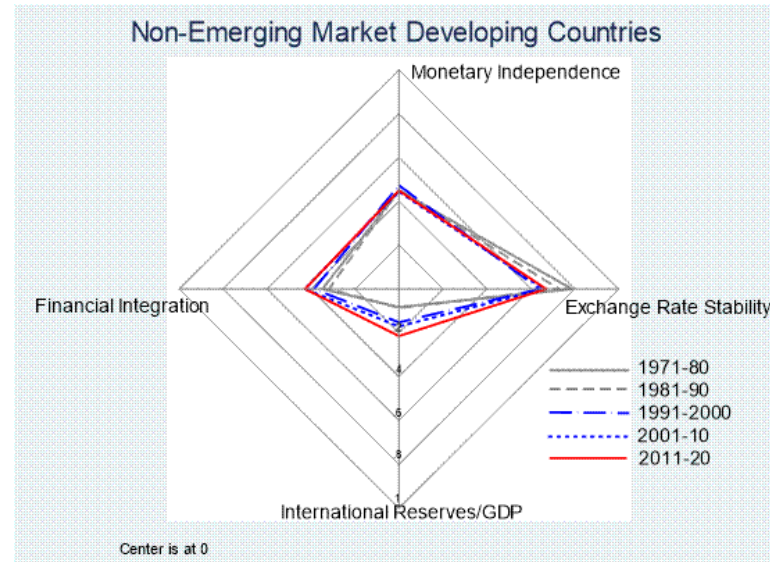
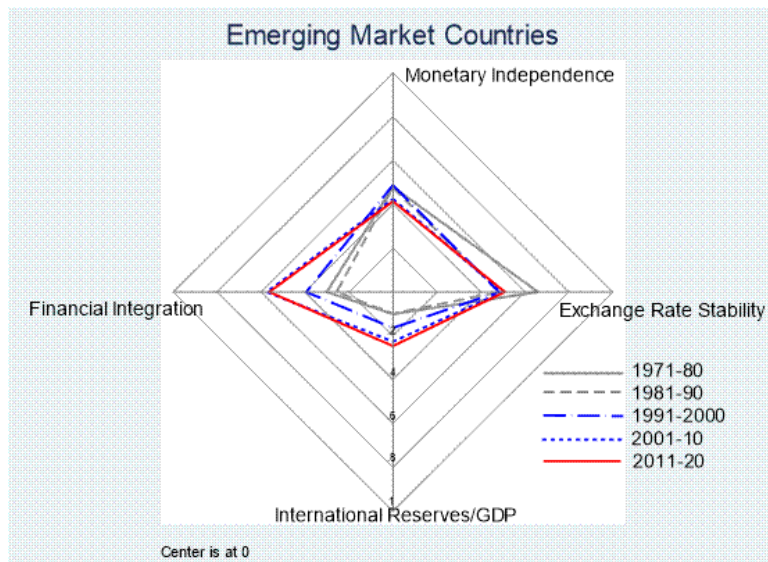
# Are There Other Mechanisms At Play?

- The impact of government deficits can work through
  - shifts in domestic absorption
  - external demand as it impacts the exchange rate – conditional on exchange rate pass-through
- Other channels
  - *Fiscal theory of the price level*: Should we also worry about shifts in future government deficits? – consider using surveys/forecasts
    - The fiscal roots of inflation by Cochrane (2022):  
<https://doi.org/10.1016/j.red.2021.06.002>
  - *The shadow of fiscal dominance*: Should we worry also about the level of government debt too? Primary vs. total gov't deficit?

# What Explains the Nonlinearities?

- Episodes of high inflation and elevated FX volatility tend to be associated with stronger estimated effects of government deficits
  - government deficits have larger effects and that is why inflation and FX volatility are high?
  - or is it because monetary policy is less effective, so inflation and FX volatility are high in general and also when driven by government deficits?
    - explore the monetary policy constraints for open economies: [https://web.pdx.edu/~ito/trilemma\\_indexes.htm](https://web.pdx.edu/~ito/trilemma_indexes.htm)
    - *other suggestion*: use the interest rate spread between the home country and the U.S. on the FX regressions

# What Explains the Nonlinearities?



# Just Do IT?

- Why do countries with an inflation-targeting (IT) regime tend to have more muted impacts from government deficits?
  - related evidence suggests EMDEs tend to improve more than AEs from adopting IT
    - Duncan *et al.* (2022): <https://doi.org/10.24149/gwp418>
    - depends on the institutional features and implementation of the IT framework – including a degree of exchange rate flexibility
- Why explore the performance of IT alone?
  - exchange rate pegs, monetary anchors, etc. (<https://www.elibrary-areaer.imf.org/Pages/ExchangeRegimes.aspx>)



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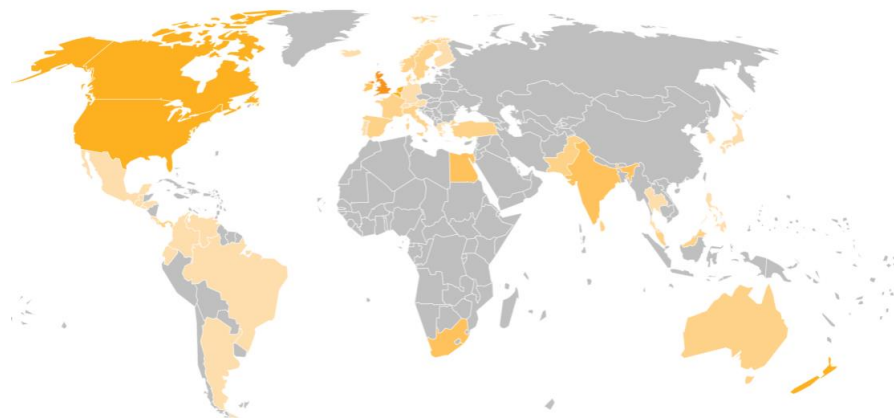
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**Thanks!**  
**(All comments welcome)**

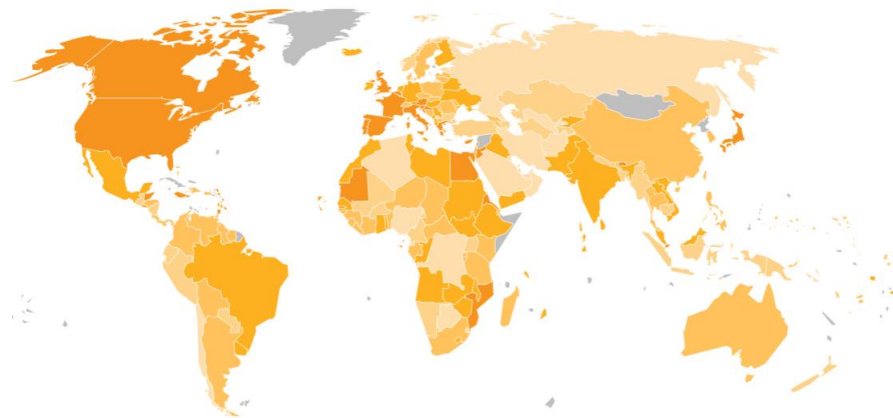
# Debt to GDP (1960 to 2015)



≤ 19.23 < ≤ 34.78 < ≤ 53.67 < ≤ 81.38 < no data

◀ 1946 1947 1948 1949 1950 1951 1952 1953 1954 1955 1956 1957 1958 1959 1960 1961 1962 1963 1964 1965 1966 1967 ▶

Source: Historical Public Debt (HPDD) (11/30/2016)  
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◀ 1946 1947 1948 1949 1950 1951 1952 1953 1954 1955 1956 1957 1958 1959 1960 1961 1962 1963 1964 1965 1966 1967 ▶

Source: Historical Public Debt (HPDD) (11/30/2016)  
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Source: Historical Public Debt Database (IMF)