

Dow Jones **Newswires****New IMF Deficit-Inflation Study Finds Mixed Experience**

By John Connor

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WASHINGTON -(Dow Jones)- A strong positive association between fiscal deficits and inflation can be found among high-inflation and developing countries but not among low-inflation advanced economies, according to a new International Monetary Fund study.

IMF Economists Luis Catao and **Marco Terrones** observed that a well-established theory in macroeconomics is that fiscally dominant governments running persistent budget deficits sooner or later have to finance those deficits with money creation, thus producing inflation.

But they also said empirical work has had little success in uncovering a strong and statistically significant connection between fiscal deficits and inflation across a broad range of countries and inflation rates.

In their new IMF working paper, "Fiscal Deficits and Inflation," the authors used a very broad and up-to-date dataset, spanning 107 countries over the 1960-2001 period for a total of 3,607 "observations."

And they modeled the deficit-inflation relationship as intrinsically dynamic, explicitly distinguishing between the short run and the long run. "Such a distinction is crucial, because fiscal deficits need not lead to higher money creation and inflation in the short run, as governments can temporarily finance their deficits with borrowing," they said.

Catao and Terrones said their results "are much more favorable to fiscal-based theories of inflation than previous research had found.

"Fiscal deficits have been shown to matter not only during high and hyperinflation but also under moderate inflation ranges, even though the effects are substantially weaker in the latter case," they continued.

"Disaggregating by country groups, the deficit-inflation relationship comes out as surprisingly strong over a broad range of developing countries," in contrast with earlier literature, they said.

"On the other hand, and similarly to previous studies, we did not detect any positive and strong connection between deficits and inflation in advanced economies and low-inflation country groups," the authors said.

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