



EUROPEAN CENTRAL BANK

EUROSYSTEM

Fiskalrat Workshop

The inflation hangover in public finances

The long-term impact of
major inflation shocks on
public finances

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The views presented are not necessarily those of the ECB

Inflation shock is beneficial for public finances

- expenditures are nominally fixed while many taxes respond to changes in the price level
- government debt is in nominal terms

But other effects also need to be considered

- type of inflationary shock (external vs. domestic-demand driven)
- size of inflation shock (non-linearities may be at play)
- need for fiscal policy reaction
- monetary policy reaction
- structure of tax system, expenditures, public debt

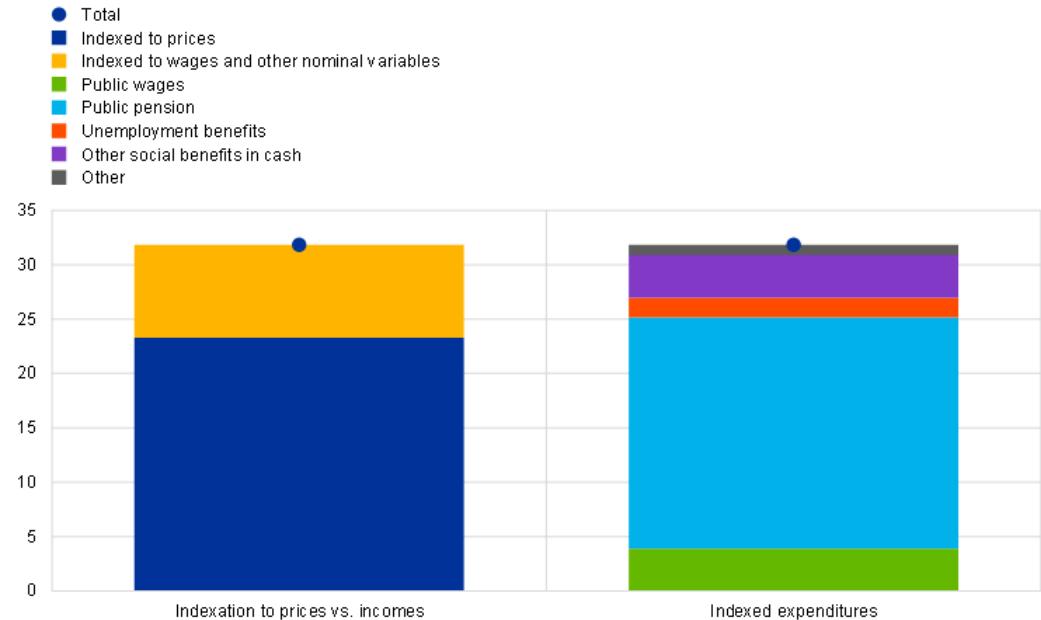
Indexation of public expenditure

Roughly one third of total government expenditure is indexed

- mostly to prices
- most public pensions

Automatic indexation of public spending, Euro Area

(percentages of total public expenditure at euro area aggregate level)



Source: ECB staff calculations based on a Working Group on Public Finance questionnaire.

Note: Data are aggregated at euro area level, based on a bottom-up approach at country level.

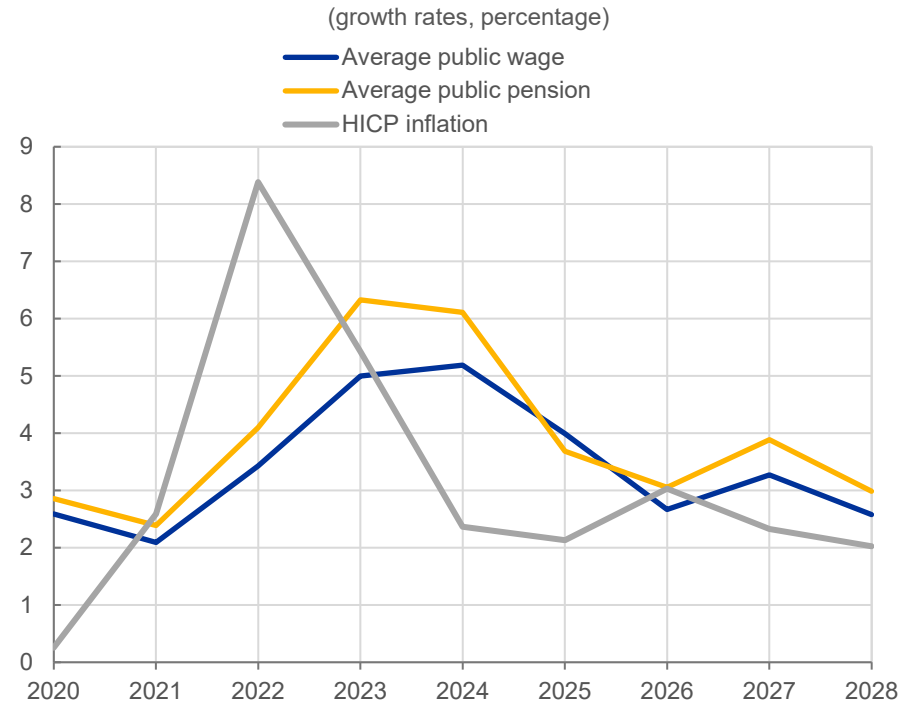
K. Bankowski, O. Bouabdallah, C. Checherita-Westphal, M. Freier, P. Jacquinot and P. Muggenthaler, Fiscal policy and high inflation, ECB Economic Bulletin 2/2023

Example: public wages, pensions

Public wages and pensions catch up inflation losses with a delay

- in part via backward indexation clauses
- in part via negotiated wages

Average Public Wages and Pensions, Euro Area



Sources: June 2026 ECB staff macroeconomic projections

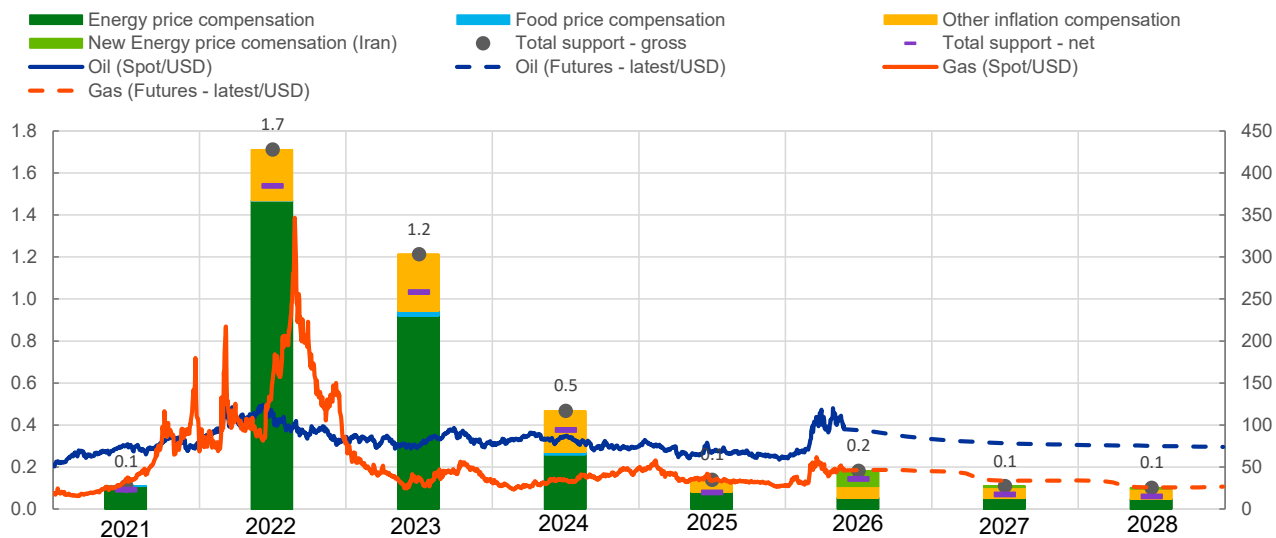
Notes: Average public wage is computed expenditure recorded under "Wages and salaries" (GFS) divided by the number of government employees. Average pension is computed as total expenditure on old age pensions and survivors' pensions divided by the number of pensioners. Growth rates are shown on an annual basis.

Government measures to address inflation shock

Government energy and food price compensation measures

Government responses to large inflation shock

- price compensation: energy, food
- income compensation for low-income households
- support for enterprises



Sources: June 2026 ECB staff macroeconomic projections, Refinitiv and ECB staff calculations, cut-off date: 27 May 2026.
Notes: Fiscal support refers to measures granted by governments since 2021, including small remaining support estimated before the current Iran conflict. New measures since the war in Iran are added in light green.

Overall impact on the budget balance: partial approach

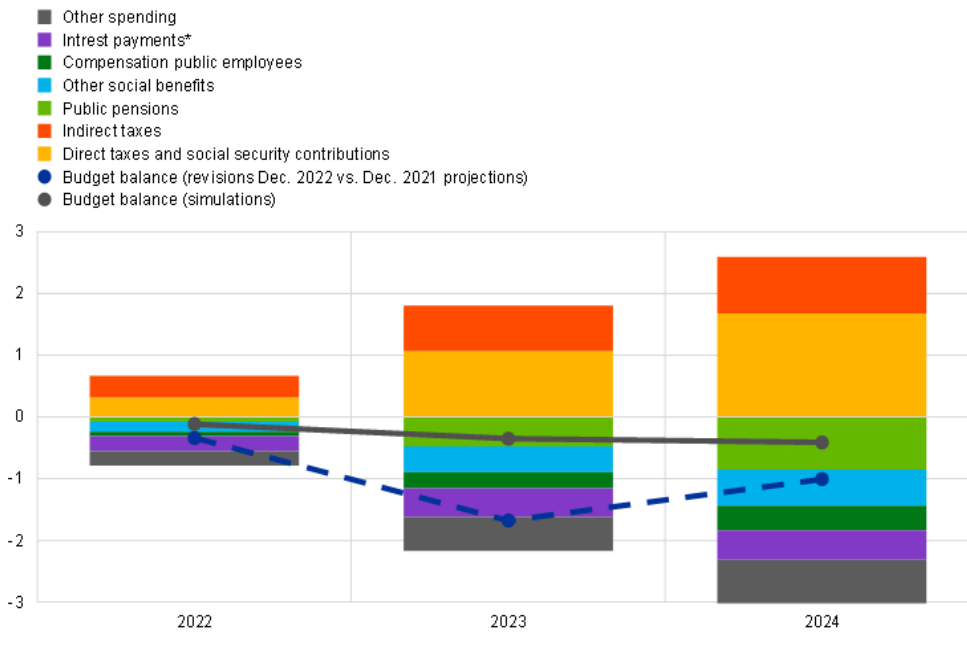
Direct partial effect of the inflation surprise on the budget balance

Taking purely automatic fiscal effects:

- inflation has slightly negative effect on the balance (solid line and decomposition bars)

Including fiscal and monetary policy responses:

- inflation effect becomes more negative (dotted line)

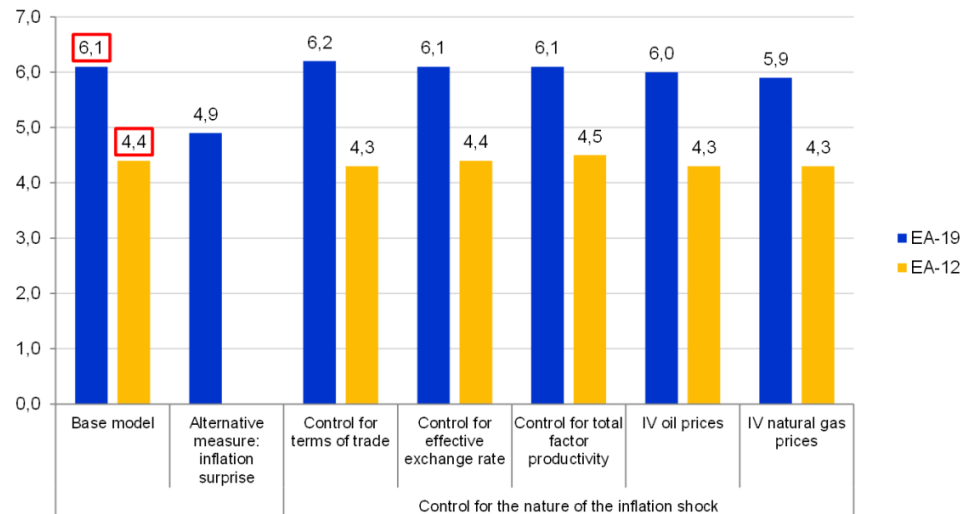


Past shocks: fiscal reaction functions non-linear in the size of inflation shock

The reaction of the primary balance to inflation (euro area, 1999-2022) ...

- turns negative with high inflation,
- particularly reflecting government support to cushion the impact of inflation

Inflation level at which fiscal impact turns negative



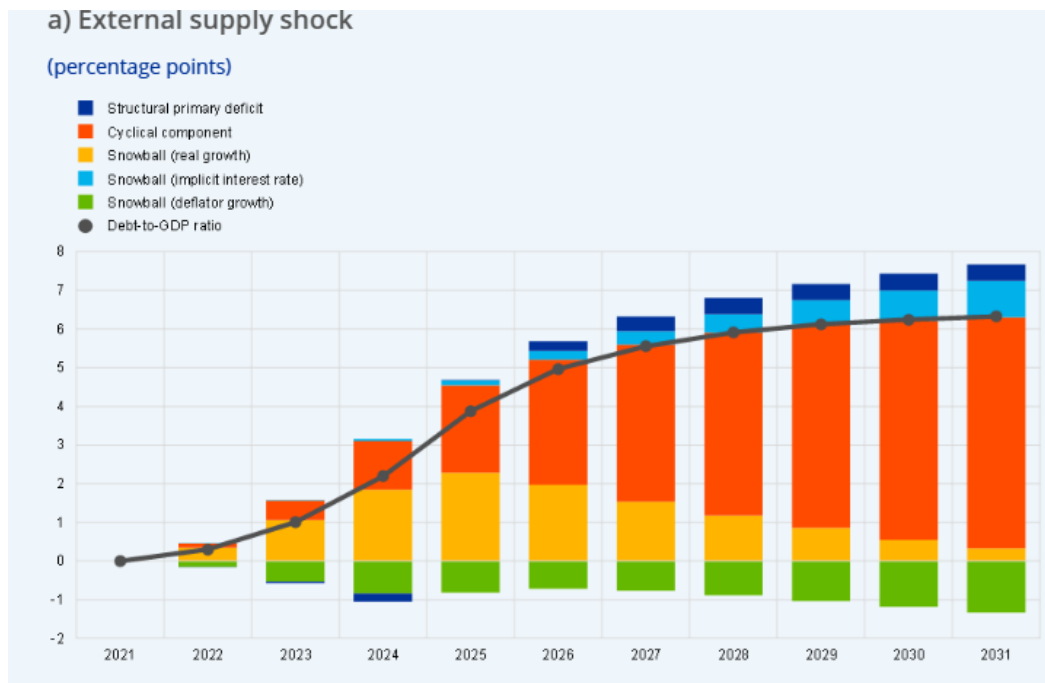
Source: Briodeau C. and C. Checherita-Westphal (2023).
Notes: The chart denotes the (statistically significant) turning points across various specifications, i.e. the level of inflation (or inflation surprise) above which the impact of inflation on the primary balance is estimated to be negative in our samples over 1999-2022. EA-12 refers to the sample of the twelve initial euro area members (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain). EA-19 includes all members of the euro area as of 2022 (i.e., EA-12 plus Cyprus, Estonia, Latvia, Lithuania, Malta, Slovakia, and Slovenia). IV denotes specifications in which the list of instrumental variables includes the change in oil prices or in natural gas prices.

General equilibrium approach: impact on public debt

External inflationary shock raises government debt ratio:

- stylised terms of trade shock (1pp increase in HICP over three years w/o monetary policies)
- fiscal reaction: automatic
- monetary policy: Taylor rule
- including impact of sovereign spread and GDP growth effects from uncertainty

Impact of inflation shock on debt ratio, big 4 countries



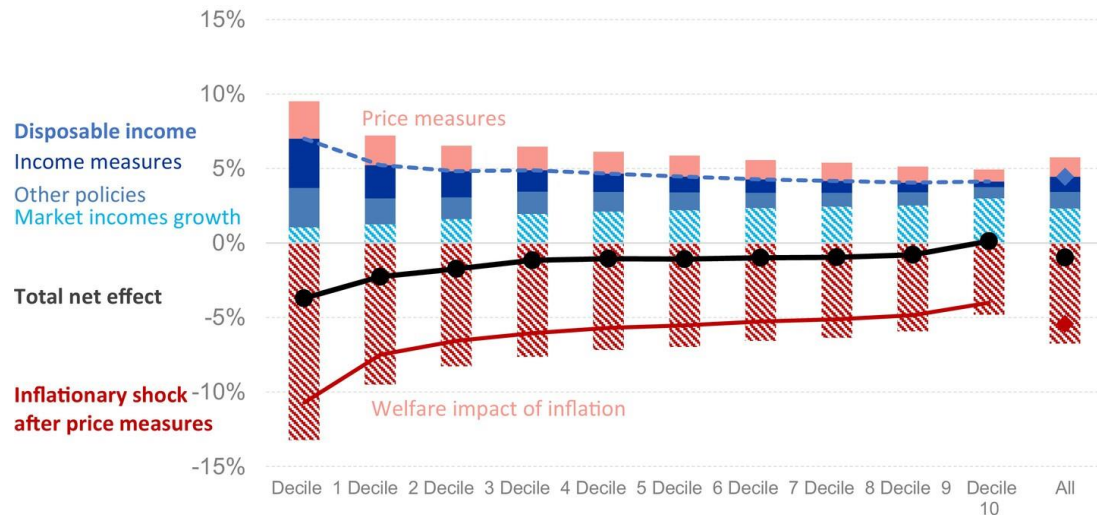
ECB Economic Bulletin 2/2023

Distributive impact of inflation measures

Unequal impact of inflation and policy measures

- lowest income decile most hit by inflation (red shaded)
- increase in market incomes (light blue) helps richest deciles most
- government measures correct the welfare impact only partially

Impact of inflation and policy measures by income decile (DE, GR, ES, FR, IT, PT)



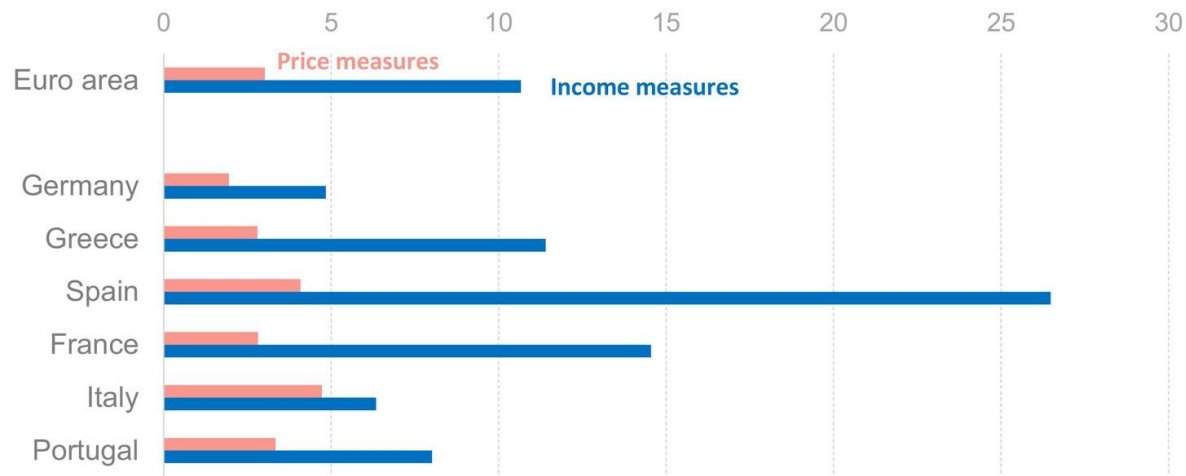
[Review of Income and Wealth, Volume: 71, Issue: 1.](#)

Income measures with much higher impact on welfare

Major difference in welfare impact of price vs. income measures

- untargeted price measures alleviate welfare gaps only marginally
- targeted income support much more effective in reducing welfare gap

Welfare effect of 1% of GDP price and income measures on lowest income quintile (DE, GR, ES, FR, IT, PT)



[Review of Income and Wealth, Volume: 71, Issue: 1.](#)

Conclusions

- Experience suggests that inflation shock will generally be negative for budget balances
- The overall impact depends to a large degree on the size and type of government measures
- The impact on debt sustainability hinges on policy choices:
 - the one-off beneficial (denominator-)impact from the inflation surprise may be overcompensated by future structural deficits, incl. from higher refinancing costs
- Targeted policy measures can alleviate much of the welfare impact of inflation at limited fiscal costs

Thank you very much for your attention!