Discussion of: Fiscal or Monetary Dominance, the Case of Costa Rica

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Motivation

- In the last twenty years, the Central Bank of Costa Rica has maintained inflation under control
  - Central bank independence
  - Movement from crawling peg to managed floating exchange rate
  - Inflation targeting regime
- After the Great Recession of 2008 the fiscal stance of Costa Rica has deteriorated
  - Sustained fiscal deficits
  - Growing government debt (as % of GDP)
- Concern about the ability for Central Bank to continue fighting inflation
- This paper: Search for evidence of fiscal dominance
  - Different empirical approaches
  - Different sub-periods

Three Approaches

- Bivariate VAR between government surplus and debt
  - Unidirectional Granger causality from deficit to debt from 1991 to 2007
  - No evidence of Granger causality in any direction from 2008 onwards
  - Consistent with fiscal dominance, in which government balance exogenous
- Estimation of augmented Taylor rule
  - Government surplus and debt affect the monetary policy rate
  - More evidence in favor of fiscal dominance
- ARDL model to study long run relation between fiscal deficit and inflation
  - Based on Catao and Terrones (2005)
  - Significant positive effect in the 90s, not so afterwards
  - Yet more evidence of fiscal dominance

Some Comments

- The authors present a compeling case for fiscal dominance in Costa Rica in the 90s
  - Different approaches seem to point in the same direction
  - The case is less clear in the 2000s and onwards
  - Yet each approach has its own limitations (in particular the first two)
- Problems of identification
  - Long enough horizon?
  - Role of expectations and cyclical factors
- What do the sign of coefficients tells us?
  - The discussion on the possible corefficient signs in the VAR between deficit and debt felt a bit confusing
  - In the Taylor rule, a fiscal deficit seems to trigger a contractionary monetary response, raising interest rates
    - A case of game of chicken?

A Final Comment

- De Resende (2007) presents an alternative methodology to estimate the fraction of debt backed up by future primary surpluses, as opposed to seignoreage
    - He applies it to a cross-section of countries
    - Costa Rica has one of the lowest (only 24% of debt backed up by surpluses)
    - Mexico, for instance, has about 85%
- It would be useful to replicate this exercise to Costa Rica, distinguishing perhaps different subperiods