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 compelling 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 coefficient 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?
De Resende (2007) presents an alternative methodology to estimate the fraction of debt backed up by future primary surpluses, as opposed to seignorage. 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.