

Fiscal Dominance in Emerging Economies

Introduction Fiscal dominance occurs when a government's substantial debt and deficits limit the effectiveness of monetary policy in controlling inflation. This condition is particularly relevant in emerging economies, where institutional weaknesses and macroeconomic instability often exacerbate fiscal and monetary policy interactions. This report summarizes key academic literature published in the last 15 years that examines fiscal dominance, focusing on its impact in emerging markets.

1. "Fiscal Dominance: How Worried Should We Be?" (2023, Mercatus Center)

- **Novelties:** This policy brief explores the interplay between fiscal and monetary policies, emphasizing the risks of fiscal dominance across different economies.
- **Data Used:** The study utilizes data on public debt levels, fiscal deficits, and monetary policy actions.
- **Methodology:** A qualitative review of existing literature and historical cases is employed to assess the prevalence and impact of fiscal dominance.
- **Findings:** The study concludes that in emerging markets, the risk of fiscal dominance is heightened due to weaker institutional frameworks, making it essential to strengthen fiscal discipline to ensure monetary policy effectiveness.

2. "Fiscal Dominance and Inflation: Evidence from Sub-Saharan Africa" (2024, Public Sector Economics Journal)

- **Novelties:** This paper investigates the relationship between fiscal dominance and inflation in Sub-Saharan Africa, providing empirical evidence from an underrepresented region.
- **Data Used:** The study analyzes panel data from multiple Sub-Saharan African countries over several decades.
- **Methodology:** Econometric models assess the impact of fiscal variables on inflation, controlling for macroeconomic factors.
- **Findings:** Fiscal dominance is more pronounced during periods of fiscal stress, particularly when alternative financing options are limited. High debt levels and deficits contribute to elevated inflation, highlighting the necessity of fiscal discipline.

3. "Fiscal Dominance and the Financial Resource Curse" (2024, Journal of International Economics)

- **Novelties:** The study models the banking sector under fiscal dominance, explaining why resource-rich economies often experience financial underdevelopment and macroeconomic volatility.
- **Data Used:** Data from various resource-rich emerging economies, including fiscal deficits, public debt, banking sector development, and economic growth indicators.
- **Methodology:** A theoretical model illustrating the mechanisms of fiscal dominance, supported by empirical analysis.
- **Findings:** Fiscal dominance in resource-rich economies leads to financial underdevelopment and macroeconomic instability, as governments rely heavily on resource revenues rather than fostering robust financial institutions.

4. "A New Test of Fiscal Dominance & Central Bank Independence" (2024, World Bank Working Paper)

- **Novelties:** The study introduces a new framework to assess the degree of fiscal dominance across countries by examining the consolidated government budget balance.
- **Data Used:** Government budget data, central bank balance sheets, and macroeconomic indicators from various economies.
- **Methodology:** The study proposes an empirical test to measure fiscal dominance and analyze the interactions between fiscal and monetary policies.
- **Findings:** Higher levels of fiscal dominance correlate with reduced central bank independence, leading to increased inflation rates. Strengthening institutional frameworks is crucial to mitigating fiscal dominance.

5. "Inflation and Exchange Rate Targeting Challenges Under Fiscal Dominance" (2020, National Bureau of Economic Research)

- **Novelties:** The paper examines the challenges faced by emerging markets in implementing inflation and exchange rate targeting policies under fiscal dominance.
- **Data Used:** Data from various emerging markets, focusing on fiscal indicators, inflation rates, exchange rate regimes, and monetary policy actions.
- **Methodology:** Econometric techniques are used to assess the effectiveness of inflation and exchange rate targeting in the presence of fiscal dominance.
- **Findings:** Fiscal dominance undermines inflation and exchange rate targeting regimes. In highly indebted emerging markets, monetary authorities struggle to maintain policy credibility, leading to higher inflation and exchange rate volatility.

Conclusion The reviewed literature highlights that fiscal dominance remains a significant challenge for emerging economies. The studies emphasize the necessity of maintaining fiscal discipline, improving institutional frameworks, and ensuring central bank independence to prevent fiscal imbalances from undermining monetary policy effectiveness. Addressing these challenges is essential for sustaining macroeconomic stability and long-term economic growth in emerging markets.

References

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