Fiscal Dominance Cycles, Macroeconomic Dynamics, and Debt Risk in China

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Preliminary

Abstract

Fiscal dominance need not be permanent to matter. This paper estimates a Markov-switching New Keynesian DSGE model for China, 1993:Q1--2023:Q4, in which policy rules and shock volatility switch separately. The estimates describe recurrent movement between monetary-led active-monetary/passive-fiscal (AM/PF) and fiscal-led passive-monetary/active-fiscal (PM/AF) regimes, rather than a fixed regime or a one-time transition. Regime switching changes how given shocks are translated into inflation, interest rates, and government debt. Counterfactuals imply that stronger PM/AF during the Global Financial Crisis would have raised inflation, nominal rates, and debt, while the corresponding COVID effect is smaller. Simulations after 2023 show that greater confidence in AM/PF lowers the debt path and its upper tail. The paper's message is that fiscal space depends not only on current fiscal support, but also on the credibility of the policy mix expected to back future liabilities

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Keywords: Fiscal Dominance, Monetary-fiscal Policy Interactions, Markov-switching DSGE, Government Debt Dynamics, Counterfactual Aanalysis

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