

The Relationship between Fiscal and Monetary Policies in Colombia: An Empirical Exploration of the Credit Risk Channel

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AUTHOR OR EDITOR Lozano-Espitia, Ignacio Arias-Rodríguez, Fernando

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Publication Date: Tuesday, 19 of April 2022 Abstract

This paper aims to provide evidence on the relationship between fiscal and monetary policy in Colombia through an empirical exploration of the credit risk channel. Under this approach, fiscal policy plays an important explanatory role in the sovereign risk premium, which, in turn, could affect the exchange rate and inflation expectations. The Central Bank reacts to inflation expectations using the policy interest rate; consequently, such reaction could be indirectly influenced by fiscal behavior. Using monthly data from January 2003 to December 2019, we estimate both jointly and independently the reduced-form core equations of a system that describes the credit risk channel in a small open economy. Our findings are in line with the model predictions. Fiscal policy affected the country's sovereign risk during this period, but only slightly. Hence, there is insufficient evidence to sustain the idea that monetary policy has been significantly influenced by government fiscal management.