Referee Report

Ref: MS 3202

Summary:

The paper deals with an interesting issue, namely the interaction of fiscal and monetary policy in a developing economy. In my opinion, however, the theoretical explanations could be improved and I see several problems regarding the empirical approach. My main comments are listed below.

Comments:

(1) Introduction: The authors often cite unpublished manuscripts but rarely refer to the most seminal articles in this field (Sargent and Wallace are briefly mentioned in Section 2.2 but not included in the list of references).

(2) Introduction: The authors should explain their contribution to the literature in more detail. What are the most closely related papers and how exactly do they add to this literature? Why is Kenya an interesting country to look at in comparison to other developing economies?

(3) Empirical model: Specifying a Taylor-type monetary policy reaction function might be appropriate for the United States, for instance, but it is less clear whether this also holds true for Kenya 1963-2014. It could be helpful to add a short historical section that comments on the conduct of monetary policy in Kenya in past decades.

(4) Empirical model: The authors should motivate their choice of a Markov Switching model more explicitly. It would also be helpful to add references to related econometric papers in the main text as well as some more technical details of the model in the appendix.

(5) Empirical model: The authors should discuss (and deal with) potential endogeneity issues (e.g. the problem of simultaneity when having the output gap on the right hand side of the equation). Moreover, the estimation might suffer from serial correlation of the errors.

(6) Empirical results: For comparison, the authors should also report the results of a simple OLS regression. Such a simpler model would also allow checking the temporal stability of the results by additionally running the regression based on a shorter sample that starts in 1980, for example. Furthermore, it would also be interesting to see the results when dropping the expenditure gap as explanatory variable (given revenues minus expenditures as dependent variable).

(7) Empirical results (fiscal policy): How can we economically interpret an output gap coefficient that is close to zero in regime 2 (what about automatic stabilizers)?

(8) Empirical results (monetary policy): How can we interpret the negative coefficient (albeit not statistically significant) for the inflation rate even in the active regime? Is this estimate a contradiction to what is stated in the abstract?

(9) Formatting: Page numbers are missing. Figures often lack labeling of the y-axis.