ABSTRACT

The interaction between monetary and fiscal policy is crucial for attaining price stability. Likewise, the coordination or policy mix between those two different authorities is important (McCallum, 1984). Leeper and Leith (2016) argue that economcist often overlook the fiscal side when it comes to the causes of inflation and focus more on the monetary side. The Fiscal Theory of Price Level (FTPL) suggest that inflation is actually a joint phenomenon of both fiscal and monetary factors.

Policy mixes based on the scenarios developed (Scenario 1 and 2) indicate that inflation results from a combination of fiscal and monetary policy, wether fiscal policy is procyclical (expansionary) or countercyclical (during a recession), and whether monetary policy is countercyclical during both expansion and recession phases. This leads to higher price escalation. Technically, this study consists of two stages of examination aligned with the research questions and objectives; namely; 1) examining the interaction between fiscal and monetary policy on inflation, and 2) identifying fiscal and monetary policy regimes. This study employs Structural VAR to examine the interaction between the two policies and the Markov Switching Regime to identify the policy regimes.

This study finds that there is a disharmonious interaction between monetary and fiscal policy in stabilizing price levels, where monetary policy actually leads to higher inflation in ASEAN-5 countries. Based on the second stage, it was found that when the economy is in an expansion phase, the policy regime is MA/PF (monetary active and fiscal passive), but when in a recession phase the policy regime is MP/FA (monetary passive and fiscal active). This indicates that fiscal dominance occurs when the economy is in a recession.

Keywords: fiscal and monetary policy interaction; nature of policy regimes; policy dominance.