

ABSTRACT

The credibility of monetary policy is an important component in supporting the effectiveness of monetary policy (Kydland and Prescott 1977; Barro and Gordon 1983). However, central banks are often faced the problems that could distort the credibility of their policy, one of them is inconsistency between the policy sectors, fiscal and monetary policy (Warjiyo and Juhro 2017).

Most studies that discuss about the influence of fiscal policy on monetary policy emphasize the condition of public debt that causes the reduction of the ability (or credibility) of monetary policy (as in Sargent and Wallace 1981; and Blanchard 2004). Whereas, this study aims to examine the interaction of fiscal and monetary policies specifically on the effect of fiscal policy on the credibility of monetary policy through fiscal policy behavior in responding to the business cycle. By an examination of fiscal policy cyclicity behavior, we can further analyze the effect of fiscal policy on monetary policy based on fiscal policy behavior and /or actions, not only based on the condition (solvency) of the fiscal authority itself.

Technically, this study contains two stages of examination that are adjusted to the formulation and objectives of the study: (1) examination of the effect of fiscal policy cyclicity behavior on inflation dynamics (inflation rate); and (2) examining the influence of the cyclical behavior of fiscal policy on the credibility of monetary policy. This study uses Arellano-Bond's GMM Estimator.

This study found the significant relationship between the degree of cyclicity of fiscal policy to inflation rate and credibility of monetary policy. If fiscal policy tends to respond to the business cycle in a pro-cyclical manner, it will lead to an increase in the inflation rate and reduced credibility of monetary policy. In addition, this study also found that public debt does not have a significant influence on the credibility of monetary policy. Based on this finding, this study criticizes Blanchard's fiscal dominance theoretical construction which considers that an increase in public debt will always be accompanied by an increase in the risk of insolvency without taking into account the structure of demand and supply of public debt and the motives behind public debt management policy. On the other hand, it shows us that cyclical behavior of fiscal policy could be an alternative explanation to captures the phenomenon of fiscal dominance.

Keywords: credibility of monetary policy, cyclicity behavior of fiscal policy, internal inconsistency, and fiscal dominance.