Chapter 20
Monetary and Fiscal Policy Interactions: An Empirical Evidence from Turkey

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ABSTRACT
While the role of fiscal policy in price level determination was neglected by the conventional theory, a new point of view was adapted by the Fiscal Theory of the Price Level. In the context of the new theory, monetary and fiscal policy interactions were taken into account and the role of fiscal policy was underlined. This paper investigates the monetary and fiscal policy coordination in Turkey during the period 1989.1-2012.2 and sub-periods 1989.1-2001.1 and 2001.2-2012.2. In order to reveal if financial policies are monetary dominant or fiscal dominant in aforementioned periods, bounds testing procedure is applied by using quarterly data. While the empirical test results related to the entire period of 1989.1-2012.2 and sub-period of 1989.1-2001.1 indicate fiscal policy dominant regime, the findings regarding 2001.2-2012.2 imply monetary policy dominant regime in Turkey.

INTRODUCTION
Due to the serious consequences in terms of economic growth and welfare, price stability is one of the most researched topics in economics. The determinants of price level and inflation have long been a central concern for economists in that sense. The conventional monetarist view has emphasized the importance of an independent central bank and has held that high inflation can only be ultimately triggered by high rates of money growth. The roots of this argument go to Milton Friedman’s famous dictum that “inflation is always and everywhere a monetary phenomenon”. The view that inflation is always a monetary phenomenon has a long tradition based on the quantity theory of money (QTM). In its simplest form, the QTM says that changes in money supply growth are followed by equal changes in the inflation rate.

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In the context of traditional approach, monetary policy was accepted as one of the most important policies affecting the level of prices in the economy, they believed that controlling the supply of money was the route to low inflation. Hence, following that approach, an increasing number of countries have granted their central banks political independence and charged them with the task of the maintenance of price stability in the 1970s. However, this view was later on criticized seriously and came under attack.

Against this robust theoretical background, attention has increasingly been given to the role of fiscal policy in determining inflation since the 1980s. The “unpleasant monetarist arithmetic” of Sargent-Wallace (1981) unveiled the fiscal roots of inflation. The main result of the seminal paper by Sargent-Wallace is that persistent fiscal imbalances put pressure on the central bank to finance the government deficits, so the effectiveness of monetary policy in controlling inflation depends critically on its coordination with fiscal policy (Buti, 2003).

Following Sargent-Wallace, a considerable amount of literature has stressed that fiscal shocks affect price level, and specifications of fiscal policy matter for the consequences of monetary policy. The theory in which intertemporal budget constraint plays the key role is called “The Fiscal Theory of the Price Level (FTPL) or The New Theory of Price Determination”. New view of price determination suggests that the statutory independence of the central bank may not be sufficient to achieve the goal. The central bank can only achieve price stability if it is supported by an appropriate fiscal policy. If required measures are not taken to assure an appropriate fiscal policy, the objective of price stability may not be obtained despite the independence of the Central Bank.

As a result, while the conventional view makes a clear definition of the actions and limitations of the monetary and fiscal policies, both Sargent and Wallace and advocates of the Fiscal Theory of the Price Level put forward that it is not possible to make such a strict distinction between the monetary and fiscal authorities as two different parts of the government and their relationship has important consequences on the price level. After these theoretical debates, an increasing attention has been given to the relationship and coordination between the monetary and fiscal policies in the extant literature.

In the context of the Fiscal Theory of Price Level, monetary and fiscal policy interactions were taken into account and the role of fiscal policy was underlined. The Turkish economy is an interesting case of study to bring out the importance of monetary and fiscal policy coordination. Examining how budget deficits were balanced will allow us to determine the dominant policy regime along the period of analysis.

Turkey has experienced high inflation rates, increasing public sector deficits, pressure of the government borrowing on thin financial markets over the decades after the liberalization. On the fiscal side, high financing requirement of the government with high real interest rates and a very sharp increase in the public debt to GDP ratio brought the debate of fiscal sustainability issues and deteriorated macroeconomic imbalances extensively.

In order to solve the problem, a permanent improvement in the revenue and expenditure balance of the public sector was needed. In this respect, the year 2001 constituted a cornerstone in the economic history of Turkey by the introduction of a new reform programme, “Transition to a Stronger Economy”. The main aim of this program was to restrain inflation by restoring fiscal discipline, reducing the public debt, introducing social security reform and inflation targeting.

The goal of this chapter is to empirically analyse the monetary and fiscal policy coordination in Turkey by applying autoregressive distributed lag (ARDL) cointegration procedure over the period 1989.1-2012.2 and the sub-periods of 1989.1-2001.1 and 2001.2-2012.2. The remainder of the chapter is organized as follows. The following section addresses the theoretical background, specifications of the Fiscal Theory of Price Level and literature review. The Turkish economy is briefly discussed for the
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