

Inflationary effects of fiscal policy: Evidence from FM-OLS analysis

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Abstract:

In the aftermath of Great Recession, where the monetary policy is long stayed muted, the consensus is set on two points as to the course of the fiscal policy: i) The size of fiscal multiplier is larger in recession times than in more stable periods, ii) As opposed to commonly believed, the fiscal policy is elastic enough in reacting within less than one quarter to an economic shock. The focus is therefore recently placed on assessing the size of multiplier in the literature of fiscal policy. Whilst the efforts to determine the size of the multipliers reveal various facts as to the conditions according to which the size of multipliers differs, few studies examine the interaction between the dynamics of both government expenditure and tax policies and the ones of the inflation. The main reason is obviously that the risk of inflation is far less in recessions than the the normal times. However, with few exceptions, recessions are not long lasted, especially in emerging market economies. Furthermore, if the inflation is persistent, then to what extent the fiscal policy practices, apart from the budget deficit and the debt dynamics, affect the inflation is still an open question. The latter is even more motivated in an economy where the government spending increases gradually in real terms and thus forcing the pattern of tax revenues to be spending-driven, with the aim of avoiding large budget deficit. In such a case, a relatively low level of budget deficit does not mean then a tight fiscal policy. This study aims to fill this gap by assessing whether the use of the fiscal policy contributes to the course of core inflation in Turkey within a fully modified OLS (FM-OLS henceforth) framework. The sample covers the period starting from 2011 to 2016, where Central Bank of Republic of Turkey (CBRT) shifts its monetary policy framework from explicit inflation targeting to a structure with broader emphasis on financial stability. The findings obtained from the cointegrating regression equation imply that the long-run relationship between the core price indices and fiscal policy variables is statistically significant and positive.

Keywords: Fiscal policy, fully modified OLS (FM-OLS), inflation, Turkish economy.

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