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Abstract *

Optimal Monetary and Fiscal Policy Mix: The Case for Turkish Economy

During the past two decades maintenance of low inflation "price stability" has become the principal focus of central banks around the world. If fiscal policy does not react to government s debt, monetary policy lose the ability to control the price level or real interest rate. Fiscal policy has to have a certain kind of discipline if a Central Bank is to have the functional independence to achieve price stability.

Sargent and Wallace (1981) mention about the link between fiscal and monetary policies and they argue that monetary policy will not always to be in a position to control inflation unless supported by fiscal policy. SW argue that the monetarist arithmetic might be misleading as it ignores the fact that governments are constrained by their intertemporal government budget. According to SW tight monetary policy may lead to an unsustainable debt financing process and higher inflation in the long run. In this framework inflation is a fiscal driven monetary phenomenon and nominal monetary growth is endogenously determined by the need to finance exogenously given deficit to satisfy the budget constraint.

Woodford (2001) asserts that a central bank maintaining price stability cannot be indifferent how fiscal policy is used. Woodford emphasizes the interaction between monetary and fiscal policy and stresses the effects of monetary policy on the real value of government debt through its effects on the price level, given the public debt is issued in nominal terms.

The following questions have to be answered:

Are only the Central Banks responsible for price stability?

How the fiscal policy should be conducted for the price stability? How does fiscal policy affect monetary policy and the Central banks?

The aim of this study is to analyze the optimal monetary and fiscal policy mix for Turkish economy. Optimal monetary and fiscal policy designs will be presented for Turkish economy for the next four years(2007-2010). Optimization experiment will be conducted under the fixed exchange rate regime and the flexible exchange rate regime. The optimization experiment is carried out using the optimum control algorithm OPTCON and a macroeconometric model of the Turkish economy. It is assumed that Turkish policy makers aim at high GDP growth rate, low inflation rate and low unemployment rate, balanced budget and low current account deficit over the optimization horizon 2007 to 2010.

*Jan Whitwell entry