Monetary and Fiscal Policy Sustainability

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Monetary and fiscal policy sustainability has great importance in both developed and developing countries. Both policies play an important role in achieving economic growth and sustainable development. The sustainability of both policies, in addition to the coordination between them, enables the design and implementation of efficient and effective policies.

Sustainability Fiscal and Monetary Policies Markov Switching Modelling

1. Introduction

The sustainability of policies leads to the stability of markets for goods and services and reduces levels of risk in predicting the future. The main policies that can be used to achieve stability in the economy with fewer vulnerabilities are fiscal and monetary, and this can happen in full coordination between them [1]. However, the exchange rate regime that a country follows can determine the nature of sustainability between both policies. For example, under a fixed exchange regime, fiscal policy dominates monetary policy in a way that benefits countries by achieving equilibrium income and an increase in trade [2]. The switch of most countries towards flexible exchange regimes led to an unsustainable relationship between the two policies. Therefore, monetary and fiscal policies need to operate independently and should cooperate in achieving mutual interests and objectives. One of the most important strengths in which fiscal and monetary policies have to be prudent and predictable is the characteristic of sustainability. Despite the different objectives of fiscal policy and monetary policy, the main and final objective of all economic policies adopted by the government is to maximize the wealth of society and improve the level of its welfare. Both fiscal and monetary policies aim to achieve this goal by attaining sustainable growth and reducing unemployment rates, in addition to achieving stability in price welfare levels and controlling inflation rates to acceptable levels [3]. The focus on achieving their goals individually and in isolation from other economic goals may lead to unsustainability and economic imbalances that prevent the implementation of the economic strategies adopted by the government. According to [4], fiscal policy is considered sustainable if the current value of the budget deficit is in line with the trend of public debt; that is, the public budget deficit in a year is determined based on the outstanding public debt in the previous year. Regarding monetary policy, it is considered to be sustainable if real interest rates respond to changes in inflation rates [5][6]. In reality, the sustainability of both policies is different and depends on the adopted exchange rate regime and the nature of coordination between the two policies [7]. According to [8], a fixed-rate regime is not sustainable, especially if it is associated with large ongoing deficits and rising debt levels. Accordingly, under a fixed exchange rate regime and limited scope to use monetary policy, the stability of the economy relies on fiscal policy. On the contrary, with a floating exchange rate, monetary policy is more effective and sustainable than fiscal policy. Since 1996, fiscal policy has been the main policy that has had an effect on the Jordanian economy, with continuous government budget deficits and increasing public debt [1]. During the study period, budget deficit and public debt evolved rapidly due to regional and international crises accompanied by an influx of refugees and population growth [9][10]. Understanding the relationship between fiscal and monetary policy in a developing country like Jordan is vital for policymakers to achieve inclusive economic growth under various exchange rate regimes.

2. Monetary and Fiscal Policy Sustainability

A sustainable fiscal policy is defined as a policy that considers the ratio of debt to GDP to converge back to its initial level [11]. Similarly, ref. [4] illustrates that sustainability is about the way fiscal policy reduces high debt values. To clarify, it is the state of ensuring that the budget deficit and public debt are at a sustainable level. Accordingly, a sustainable monetary policy refers to anchoring inflation expectations for low and stable inflation [12]. However, after the high increase in the budget deficit, public debt, inflation, and unemployment in most developing countries, it became an important issue for policymakers to look for more sustainability in fiscal and monetary policies to find solutions to the increase in these indicators and their impact on the economy. Yet, the increase in crises and shocks that face both developing and developed countries gives both fiscal and monetary policies more importance to stabilizing the economy and achieving economic and social developments through increased economic growth and reducing unemployment and poverty rates. Both policies' objectives contribute to achieving these goals if more coordination exists between them. However, the increased budget deficit, public debt, poverty, and inflation rate call for more accommodating fiscal and monetary policies to stabilize developing countries' economies [13][14]. This is true for countries that are more vulnerable to external shocks and suffer from imbalances in their budget and balance of payments. Ref. [15] concluded that in all cases, it is necessary to carry out major reforms to support inclusive growth with a more sustainable fiscal space. Therefore, the strength of both fiscal and monetary sustainability was at the core of achieving economic development in developing countries. Several studies found weak coordination between the monetary and fiscal policies [16][17][18]. While fiscal policy focuses on reducing unemployment rates, even if this leads to an increase in inflation rates in the economy, the monetary policy aims at controlling inflation rates without paying attention to the budget deficit. In some cases, fiscal policy is found to be the dominant monetary policy, and price instability is a result of fiscal policy measures [19][20]. The channels through which both fiscal policy and monetary policy affect economic growth are important in the context of developing countries. According to [21], the effect of monetary policy on growth moves from money supply and prices to real GDP. The economy is considered under the control of fiscal policy if the dimensions of the current and future budget and the sources of funding are controlled by the Ministry of Finance. While the economy is entitled to be under the control of monetary policy, the primary budget deficit aims to reduce borrowing, and the Central Bank does not inject more liquidity into the market [22]. Under different exchange rate regimes, achieving monetary and financial sustainability depends on the exchange rate regime adopted by the country. In some cases, countries have fixed exchange regimes with capital control. In other cases, countries have fixed exchange regimes without capital control, and finally, countries have floating exchange regimes without capital control [23].

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