Correspondence between Author, Editor (Economic Papers) and Publisher (Wiley) From September 24 2019 (First Submission) to March 5, 2021 (Publication Volume and Issue Assigned)

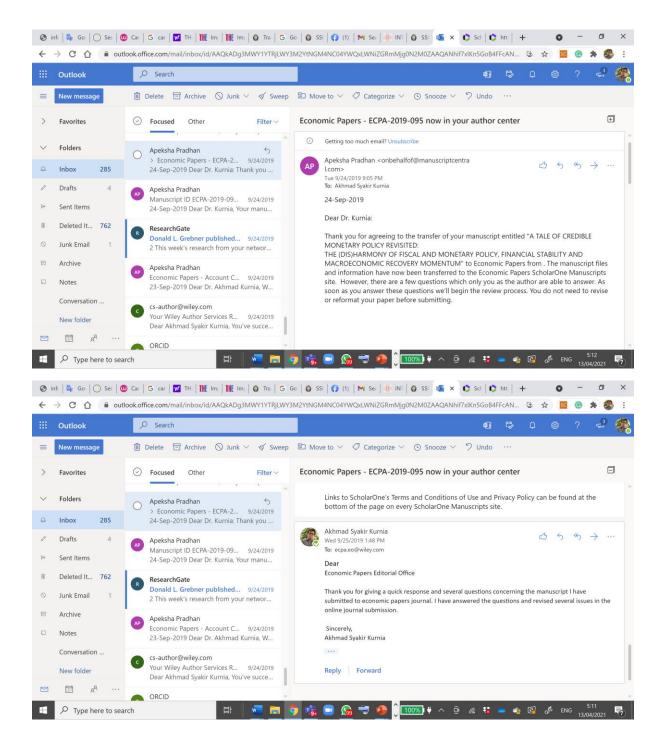
Inflation and Financial Stability Trade-off: Role of Monetary Policy Credibility and Fiscal Cyclicality

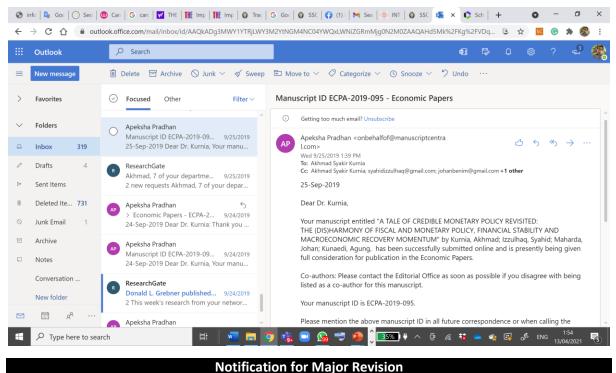
Akhmad Syakir Kurnia, Syahid Izzulhaq, Johan Beni Maharda, Agung Kunaedi

Economic Papers, Volume 40, Issue 1, https://onlinelibrary.wiley.com/toc/17593441/2021/40/1

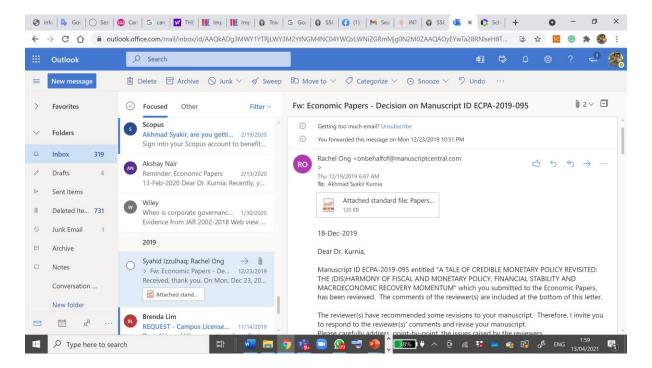
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5 Most Recent E-mails	ACTION	STATUS	ID	TITLE	SUBMITTED	DECISIONED
Before You Submit		ADM: Editorial Office, Economic Papers Accept (30-Jul-2020) View decision letter	ECPA- 2019- 095.R2	Inflation and Financial Stability Trade-off: Role of Monetary Policy Credibility and Fiscal Cyclicality	02-Jul-2020	30-Jul-2020
	a revision has been submitted (ECPA-2019- 095.R2)	Contact Journal ADM: Editorial Office, Economic Papers Minor Revision (19-May-2020) a revision has been submitted view decision letter Contact Journal	ECPA- 2019- 095.R1	Inflation and Financial Stability Tradeoff: Role of Monetary Policy Credibility and Fiscal Cyclicality View Submission	24-Feb-2020	19-May-2020
	a revision has been submitted (ECPA-2019- 095.R1)	ADM: Editorial Office, Economic Papers Major Revision (18-Dec-2019) a revision has been submitted view decision letter Contact Journal	ECPA- 2019- 095	A TALE OF CREDIBLE MONETARY POLICY REVISITED: THE (DIS)HARMONY OF FISCAL AND MONETARY POLICY, FINANCIAL STABILITY AND MACROECONOMIC RECOVERY MOMENTUM	25-Sep-2019	18-Dec-2019
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First Submission via <u>https://mc.manuscriptcentral.com/ecpa</u> and Receive Notification September 24, 2019





December 19, 2019



Referee Report For "A Tale of Credible Monetary Policy Revisited: The (Dis)harmony of Fiscal and Monetary Policy, Financial Stability and Macroeconomic Recovery Momentum"

December 3, 2019

This paper argues that "credible monetary policy has been the scapegoat for the crisis caused by the recklessness of fiscal policy in response to the business cycle" (p.1). This is an interesting topic, but the paper needs to be re-written and the analysis developed before being publishable.

1 Major Comments

- *Economic Papers* is an applied, general interest, journal. Writing in a style where there are propositions is not suited to the audience of this journal.
 - I would suggest that the authors review every equation and whether they are necessary.
 - The theoretical model section seems too long at present for the material covered.
 - At least one of the propositions is redundant. Proposition 4 is assumed in the text immediately above it. As the propositions aren't proved, moving away from this format seems desirable. If they are maintained, some of them need to be re-worded so as to be clearer (e.g. Propositions 5 and 6).
- The authors need to use the model to demonstrate how it supports their argument better. For example, is it possible to show the effect of fiscal policy being set in a different way through simulations? In other words, can estimates for selected countries be obtained of how GDP growth would have evolved with counter-cyclical fiscal policy?

1

- The estimated contribution of pro-cyclical fiscal policy in causing the financial crisis by the authors is presently not clear. Even if a simulation cannot be done, this needs to be demonstrated better.
- The claim on page 4 "In contrast, if the fiscal policy is countercyclical, there are no reasons for monetary policy to raise interest rates. Besides, counter-cyclical fiscal policy could restrain excessive booms and busts in a beneficial manner,..." is strong and not enough evidence is provided in the paper to justify it. Likewise, the discussion on page 17 says "We validate that a credible monetary policy does not always generate financial instability, and it is essentially a matter of fiscal policy...". I don't think the evidence presented currently does validate this.
- Motivation as to why using a panel is an appropriate way to conduct the analysis could be given (e.g. on page 11).
- The empirical section needs to be documented better.
 - The frequency of the data is not clear. It should be stated at the beginning of Section 3.
 - The reason for using System GMM is not explained.
 - The instruments used need to be stated, and what they are instrumenting for.
 - Are fixed effects included? Is this, together with the lag, why system GMM is used? For a macro panel 2SLS may be preferred, as one can get a lot of instruments with GMM, some of which are weak. See Judson and Owen (1999). Your tables seem to suggest a large number of instruments are being used.
 - The notation needs to be clearer about whether the level or growth rates of variables are being used.
- In constructing variables the Hodrick-Prescott Filter is used. An example is the trend is used to proxy inflation expectations. As the Hodrick-Prescott filter is a two-sided filter this will introduce leads into your regressions, which is problematic. Using a survey measure of inflation expectations would be preferable, although I realize there may be data limitations for some countries in your panel.
- Databases of financial crises exist (e.g. Laeven and Valencia 2018). These could be compared to the results from your timing.
- Why focus on the volatility of stock prices, rather than their level? Stock price misalignment conceptually is closer to the level of prices being high, especially relative to fundamentals. Could the average Price-to-Earning ratio in each country be used?

2 Minor Comments

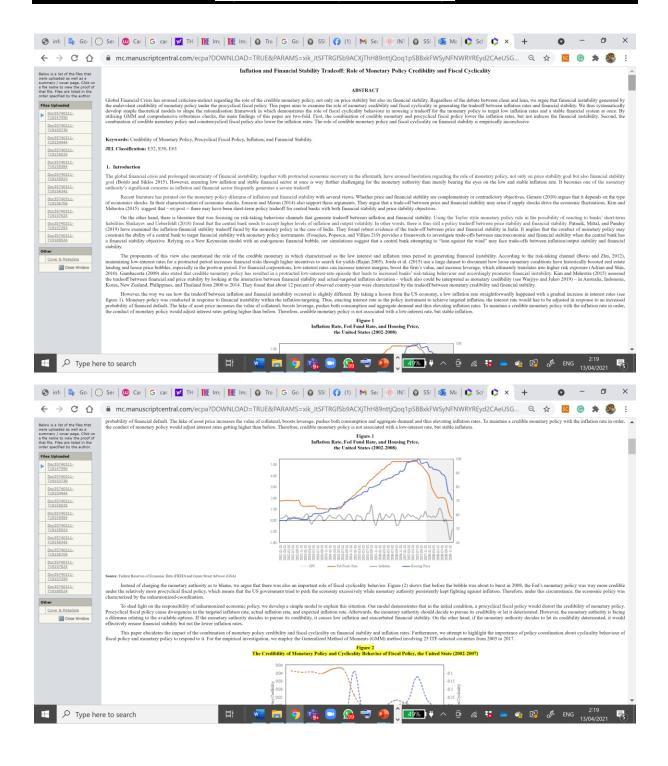
- The title is too long.
- Using house prices, rather than just equities, would strengthen the paper. The BIS maintain a database that could be useful.
- The graphs need to be re-drawn so as the grid lines line up with the axes labels see, for example, the right-hand sides of Figure 1 and Figure 2.
- Is k = 1 in Equation 7 a typo?
- The notation of the asset price deviation σ is potentially confusing, given it's usually used for the standard deviation.
- The description of the asset price bubble on page 8 is too long.
- The definition of the credibility of monetary policy in the first paragraph of Sub-section 3.1 is unnecessarily wordy.
- The sign of the change in the CMP variable as the credibility increases could be stated explicitly to aid interpretation.
- Equation 18 could be trimmed.
- Why not allow the output gap to influence inflation in Equation 19?
- In Equation 1 a lag of inflation is now being referred to as inflation expectations (page 15), whereas before it was trend inflation.
- Why use money supply growth, rather than interest rates, to capture the stance of monetary policy in Equation 19?
- Why does Minsky motivate a second lag of stock market volatility? (page 14)
- Making which equations the columns correspond to in Table clearer would aid the reader.
- There are a lot of estimates included in the Tables in Appendix B. Are these all necessary?
- There are small drafting issues throughout the paper, e.g. missing articles/propositions (e.g. the third paragraph of page 19).
- I would suggest not ending the paper on "Suggestions for Further Research", and instead emphasizing the contributions of the paper, although that is personal preference.

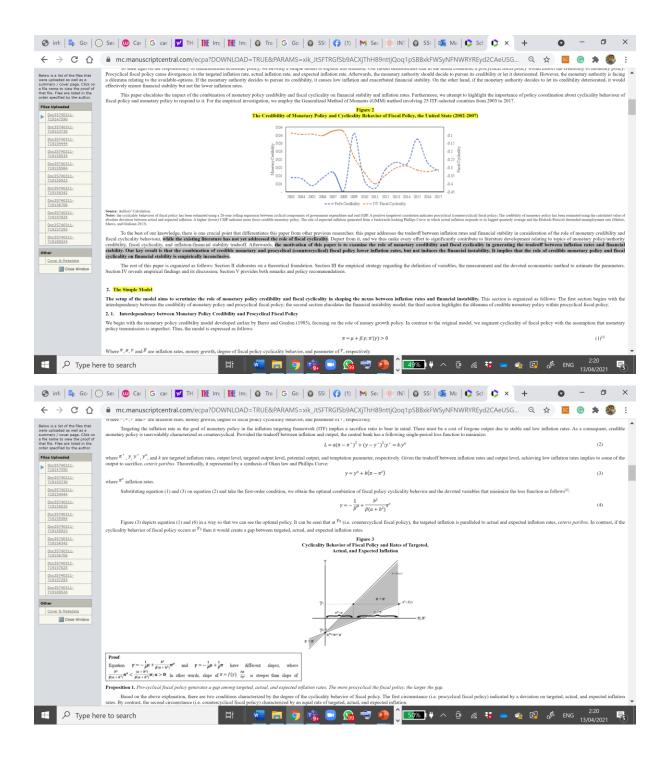
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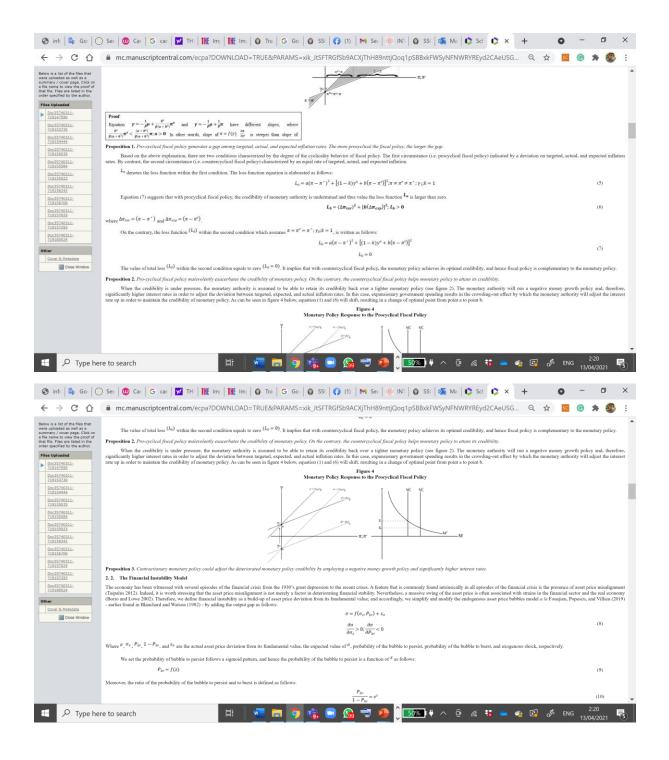
Judson, Ruth A. & Owen, Ann L., 1999. "Estimating dynamic panel data models: a guide for macroeconomists," Economics Letters, Elsevier, vol. 65(1), pages 9-15, October.

Luc Laeven & Fabian Valencia, 2018. "Systemic Banking Crises Revisited," IMF Working Papers 18/206, International Monetary Fund.

Responses to Comments from referee, Revision submitted on February 24 2020 https://mc.manuscriptcentral.com/ecpa







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5740311- 55584	Proposition 4. The higher the increase of the interest rates, the larger the asset price deviates from its fundamental value.
5740311- 55923	2. 3. The Dilemma of the Credible Monetary Policy Under the Procyclical Fiscal Policy
5740311- 56342	The channel would be explained by the combination of propositions by which formulated earlier. Figure 5 shows the channel through which the nature of cyclicality behaviour of fiscal policy would transmit different outcomes in terms of inflation rules and the state of the state
5740311- 56706	the probability of a bubble to burst (or financial stability). We divide the channel into two natures: procyclical fiscal policy (first nature) and countercyclical fiscal policy (second nature).
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	(proposition 3). As an outcome, the interest rate crawls up and boosts up the probability of default via asset price pass-through mechanism (proposition 4). Therefore, maintaining a credible monetary policy would cost financial instability.
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as Uploaded	The Cyclicality Behavior of Fiscal Policy		
Doc35740311- 719147590	The cyclicality behavior of a fiscal policy is related to how the fiscal policy (e.g., tax, spending, and deficit/surplus budget policy) responds towards the business cycles. Fiscal policy is said as procyclical when fiscal authority	responds to	the econor
Doc35740311- 719153730	expansion by expansionary fiscal policy and responds to the economic recession by contractionary fiscal policy (Kaminsky, Reinhart, and Végh 2004). There are several approaches to identify fiscal policy cyclicality behavior, given devoted variables and measurement technique. Tornell and Lane (1999), Talvi and Végh (2005), Ilzetzki (2011), Park (2012), Frankel, Vegh		(2012)
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Doc35740311- 719155584	This paper operates a 20-year window rolling regression for cyclical component of both government spending and Gross Domestic Product (GDP) to obtain cyclicality coefficient for each individual and time of Ozkan 2015; Frankel, Vegh, and Vuletin 2013) Furthermore; a positive correlation indicates that fiscal policy is procyclical, vice versa: Specifically, the measurement of fiscal cyclicality behavior categorized as follows:		
Doc35740311- 719155923 Doc35740311- 719156342	$\tilde{p}_{124} \begin{cases} 1 \ge \tilde{p}_{124} > 0, for \ procyclical \ fiscal \ policy \\ -1 \le \tilde{p}_{124} < 0, for \ countercyclical \ fiscal \ policy \end{cases}$		(14)
Doc35740311: 719156706	Where ^{II} is rolling window and ^{\$\vec{p}_{12.1}\$} is the rolling regression coefficient between two cyclical components of government spending and GDP. The Financial Instability		
0c35740311- 19157025			
0c35740311- 19157293 0c35740311- 19180524	Each episode of crisis generatives a growing body of iterature exponentially that leads to the wide-ranging definition of financial instability. Nevertheless, the broad literature converges to the identical core meaning that is the system. financial system fails to function (World Bank 2015). Unfortuntedy, it is difficult to find out "one-size fits all" meaning due to the broad dimension of the system; and hence the measure of financial stability is usually providel by its As was discussed entire, financial instability is characterized by an increased deviation of asset price any from its findmental value (i.e. asset price missignments). Nevertheless, the spacetion in mind is which indicat	ymptom.	
er Cover & Metadeta	reflects the asset price mislignment. The severe worldwide history of crises (e.g., the tuip crisis, the south sea bubbles, 2008 global manical crisis, so on, and so forth) has captured asset price mislignment occurrence, which is is the downtime of the sock market (channessen 2017). Markin (2017). Trajunito (2012) developed the asset price mislignment indicators using the stock-market-based data. The result shows hand the periods that were quoted as of severe booms periods or busts in asset prices. Likewise, VIA (2000), Okim, Shinakwa, and Shintsaka (2010), Malkiel (2010), Fourjies, Popescu, and Villica (2019) use the stock-market-based data. The Standar Capital International (MSC) cases in the set of the state price misalignment. The sevent bases that were quoted as a first price misalignment market-based indicator, market-based indicator, namely stock market volatility. It implies that excessive stock volatility indicates asset price misalignment.	fentically cl e indicators	aracterized can locate
	3.3. Model Specification The objective of this paper is to explain the malevolent-effects of credible monetary policy under the procyclical fiscal policy on the inflation rate and financial stability. The models directly sentimise the effect of the credible monetar and financial stability conditional to the cyclicality behaviour of fiscal policy.	ry policy on	inflation ra
	Furthermore, the model estimates contain the interaction-term variable of monetary credibility (CMP) and fiscal cyclicality (PCB). We technically use the term of primary-effect for the coefficient of CMP and the augmente term coefficient. The interaction-term variable facilitates us to analyse the consequences for each kind of fiscal cyclicality behaviour towards the impact of the credible monetary authority on inflation rates, economic growth, and final	d-effect for ncial stabili	the interact
	We depart with the first model estimate aiming to estamine the impact of the credible monetary policy on inflation rates under the procyclical fiscal policy. This estimate follows the standard determination model of inflation the rate, exchange rates, unemployment rates, and public debt as controlled variables (see, e.g., Woodford 1994; Totonchi 2011; Alisa 2015). The model is shown as follows:	nat includes	money grov
	$\pi_{i,i} = a_b + \delta_1 \pi_{i,i-1} + a_i (CMP_{i,i} \times FCB_{i,i}) + \gamma Z_{i,i} + u_{i,i}$	(15)
	$\pi_{ij} = a_0 + \delta_j \pi_{ij-1} + (a_1 + a_2 F C B_{ij}) C M P_{ij} + Y Z_{ij} + u_{ij}$	2:2	1 –
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v is a list of the files that	Furthermore, the model estimates contain the interaction-term variable of monetary credibility ("") and this adjust ("") by technically use the term of primary-effect for the coefficient of "" and the augmente term coefficient. The interaction-term variable facilitates us to analyse the consequences for each kind of fiscal cyclicality ("") by technically the technical use the impact of the credibility or inflation rates, economic growth, and final cyclicality ("") and the augmente	d-effect for	the interact
uploaded as well as a nary / cover page. Click on name to view the proof of lie. Files are listed in the specified by the author.	We depart with the first model estimate aiming to examine the impact of the crofible monetary policy on influion rates under the procyclical fiscal policy. This estimate follows the standard determination model of inflation the rate, exchange rates, unemployment rates, and public dots as controlled variables (see, e.g., Woodford 1994; Totonchi 2011; Alisa 2015). The model is shown as follows:		
specified by the author.	$\pi_{i,t} = \alpha_{ij} + \delta_i \pi_{i,t-1} + \alpha_i CMP_{i,t} + \alpha_2 (CMP_{i,t} \times FCB_{i,t}) + \gamma \mathbf{Z}_{i,t} + u_{i,t}$		
	$\pi_{i,t} = a_0 + \delta_1 \pi_{i,t-1} + (a_1 + a_2 F C B_{i,t}) C M P_{i,t} + y \mathbf{Z}_{i,t} + u_{i,t}$	(15)
10c35740311- 19147590 10c35740311- 19153730	Where #, CMP, FCB, YZ are inflation rate, monetary policy credibility, cyclicality character of fiscal policy, and vector of parameter and controlled variables respectively. a1 and a2FCB12 denote the primary-effect and augmented	-effect of m	onetary pol
10:35740311- 19154444 10:35740311- 19155035	credibility. Lastly, we proceed to the second model estimate aiming to analyze the aftermaths of monetary policy credibility on financial stability conditional to the cyclicality behavior of fiscal policy. Specifically, the specification or several control variables such as trade openness, exchange rates, and Debt to GDP Ratio (see Alexakis, Apergis, and Xanthakis 1996, Nikananeh 2016; Huang 2017) The model is shown as follows:	of the mode	also invol
	$p_{12} = a_2 + b_3 p_{12-1} + a_5 (M p_1 + a_5) (M p_2 +$		
0:35740311- 19155584 0:35740311-	$\rho_{ij} = a_0 + \delta_{3j}\rho_{ij} - 1 + (a_0 + a_{1j})\mathcal{F}\mathcal{B}_{ij}) - \mathcal{M}\mathcal{M} + \mathbf{q}_{ij}$ $\rho_{ij} = a_0 + \delta_{3j}\rho_{ij} - 1 + (a_0 + a_{1j})\mathcal{F}\mathcal{B}_{ij}) \mathcal{M}\mathcal{M} + \mathbf{q}_{ij} + \mathbf{q}_{ij}$		(16)
10155023			
	Where $\rho_{\tau} \tau q_{\tau}$ and $(a_{g} + a_{1g} r c_{B(z)})$ are stock volatility, the vector of parameters and control variables, and the net effect of monetary policy credibility on stock volatility.		
Doc35740311- 719155923 Doc35740311- 719156342 Doc35740311-	Where $\rho_z \cdot i Q_z$ and $(a_y + a_{11F} C B_{LL})$ are stock volatility, the vector of parameters and control variables, and the net effect of monetary policy credibility on stock volatility. As we are dealing with the inclusion of lazered decendent variables in the model, the standard namel data repression would lead to based and inconsistent estimation since the Lazered Dependent Variables (LDV)	would be co	orrelated w
Doc35740311- 719156342 Doc35740311- 719156706	As we are dealing with the inclusion of lagged dependent variables in the model, the standard panel data regression would lead to biased and inconsistent estimation since the Lagged Dependent Variables (LDV) the Composite Error Term (CET) by construction (Baltagi 2005). We thus employ the Generalized Method of Moment (GMM). However, in deciding between Differenced- or System GMM that would be employ	yed, we fol	low stands
0035740311- 19156342 0035740311- 19156705 0035740311- 19157025	As we are dealing with the inclusion of lagged dependent variables in the model, the standard panel data regression would lead to biased and inconsistent estimation since the Lagged Dependent Variables (LDV) the Composite Error Term (ET) by construction (Bialog 2006). We thus employ the Generalized Method of Moment (GNM), However, in deciding between Differenced- or System GNM that would be employ procedure developed by Stephen Bond (Rochma 2007). The rela of thum has recritically detecting the selection between Difference-O.	yed, we fol MM ^{(δ} _{FD –}	low stand ^{GMM)} , Poe
0235740311- 19156342 0235740311- 19156706 0235740311- 19157025	As we are dealing with the inclusion of lagged dependent variables in the model, the standard panel data regression would lead to biased and inconsistent estimation since the Lagged Dependent Variables (LDV) the Composite Error Term (CET) by construction (Baltagi 2005). We thus employ the Generalized Method of Moment (GMM). However, in deciding between Differenced- or System GMM that would be employ	yed, we fol MM ^{(δ} _{FD –}	low stand ^{GMM)} , Poe
×35740311- 9156342 ×35740311- 9156705 ×35740311- 9157025 ×35740311- 9157293	As we are dealing with the inclusion of lagged dependent variables in the model, the standard panel data regression sould lead to biased and increasistent estimation since the Lagged Dependent Variables (LDV) the Composite Error Term (CET) by construction (Baltag) 2005). We thus employ the Generalized Method of Moment (GMM), However, in deciding between Differenced- or System GMM that would be employ procedure developed by Stephen Bond (Rochama 2007). The rules of thumb are critically deciding the selection between Difference-or System GMM in which utilizes the first order LDV's coefficient of Difference- Loss Square (δ_{FE}), and Fixed Effect (δ_{FE}). The estimated δ_{FE} is considered to be biased upwards, while estimated value the of δ_{FE} is considered to be biased downwards (Bond 2002). When the estimated value of closer to δ_{FE} than to δ_{FES} , System GMM is suitable for estimation, rice versa (Roodman 2009). Table 1	yed, we fol MM ^{(δ} FD –	low stand ^{GMM)} , Poe
oc35740311- 19156342 oc35740311- 19156706 oc35740311- 19157029 oc35740311- 191570291	As we are dealing with the inclusion of lagged dependent variables in the model, the standard panel data regression would lead to biased and inconsistent estimation since the Lagged Dependent Variables (LDV) the Composite Error Term (ET) by construction (Bialag 2005). We thus employ the Generalized Method of Moment (GNM). However, in deciding between Differenced- or System GMM that would be employ procedure developed by Stephen Bond (Rodoma 2007). The relas of thum has are richted Judentifiing the selection between Difference-or System GMM in while utilizes the first order LDV's coefficient of Difference-Order LDV's coefficient of	yed, we fol MM ^{(δ} FD –	low stand: ^{GMM)} , Poo
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the files that		Pooled Least Square (δ_{PLS})	.5632988	.6417423					
		Fixed Effect (δ_{FE})	.3171388	.6030496					
ew the proof of		Difference GMM	.2214667	.6123579					
r page. Click on ew the proof of e listed in the ry the author.		(δ_{FD-GMM})	S						
d				$E < \delta_{FD-GMM} \ll \delta_{PLS}$					
11-	From the table (1) we obtained the estimated values o this case, therefore, System GMM is suitable for estimating more suitable for the second model estimate.								
11-									
11-	4. Results								
11-	This section elucidates the estimation results and its discussion.	It begins with statistical inferences followed by the	construe of the meaning of empiri	ical findings within the theoretical fra	mework discussed e	earlier.			
	4.1. Estimation Result								
11-						-			
11-	We begin by exploring the empirical relationship between inflati which formed by significant positive primary-effect and insigni	ion rates and monetary policy credibility under the ificant augmented-effect. It implies that the cyclica	lity behavior of fiscal policy does	a policy (model 1). The result shows a not affect the outcomes of monetary	a positive net-effect	ation rate redu	tion. In off	binty on ter words	s, it sue
	inflation remains low along with a more credible monetary po-	licy, irrespective of the cyclicality behavior of fis	cal policy. However, we also fou	nd that actual inflation has not drive	n by the one-year	lagged inflatio	n. It indicat	tes the fl	lexibility
11-	changing.								
11-			Table 2						
			Estimation Results						
11-					del Estimates				
11-			п	Dependent Variable:		Deper	dent Varia	ble:	
				Inflation .1861313		Sto	ck Volatili	t y	
11-	Inflation (-1)			(.1166045)					
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 a more approximate provide processing of the processing o	her Cover & Metadata	B) First. our robustness test shows that the role of monetar While the interaction term between monetary credibility and	y credibility in lowerin fiscal cyclicality empi	ng inflation is empirically irically insignificant. This	robust. From five estin finding suggests that fis	ations, we found that four est cal cyclicality would not disru	timations indicate that the lo upt the advantage of monetary	wer CMP (i.e., credible m y credibility in lowering th	nonetary policy), the inflation rates.	the lower inflatio	on rates
<text></text>	Close Window	role of monetary credibility in causing financial instability (financial stability is robustly inconclusive. While the robust for financial instability, although effectively lower the inflati	e.g., Rajan 2005; Gaml ness test estimatios for	netary credibility and the bacorta 2009; Kim and M r financial stability indica	enteraction term do not iehrotra 2015; Shukayev tes a self-driven effect is	significantly affect financial s and Ueberfeldt 2018; Fouejier a which lagged dependent vari	stability. However, this is an a, Popescu, and Villieu 2019, iable robustly significant. Th	important finding. Althou), our result demonstrates terefore, our results show	igh existing literal that the impact of that monetary cre	monetary credib dibility is not the	ises the sility or e drive
The problem of the p		This paper aims to examine the role of monetary credibilit	ty and fiscal cyclicalit ing a tradeoff for the n	ty in generating the trade nonetary policy to target I	off between inflation ra ow inflation rates and st	tes and financial stability. We able financial system at once.	e thus systematically develo When the fiscal policy is pro-	p simple models to shape cyclical and the monetary	e the rationalisati authority decides	on framework in to pursue its cre	n which dibility
 The product of second se		policy and procyclical fiscal policy would generate the l inflation rates. This finding proves our third proposition (see	ower inflation rates proposition 3). Altho	at the expense of finan- ough pro-cyclical fiscal r	cial stability. Second, o solicy would initially de	ur findings also illustrate that teriorate the credibility of n	the combination of credible sonctary policy by generati	e monetary policy and co ng a gap between target	untercyclical fisca ed. actual. and ex	al policy also lov xnected inflation	ower the
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Tailing Interpretation	er specified by the author.	behaviour. First, our results demonstrate that the combination policy and procyclical fiscal policy would generate the l	on of credible moneta ower inflation rates	ry and procyclical fiscal at the expense of finan-	policy lower the inflatio rial stability. Second, o	in rates, but not induces the fi ur findings also illustrate that	inancial instability. It contra the combination of credible	e monetary policy and co	at a combination untercyclical fisca	n of credible mo al policy also lov	onetary ower the
201324241 Control 1000000000000000000000000000000000000		the monetary authority would try to attain its credibility	by employing a negation by employing a negating a second s	ough pro-cyclical fiscal p tive money growth polic	y, which also significan	tly increases interest rates, to	onetary policy by generati o adjust the deviation betwo	ng a gap between target een targeted, expected, a	ed, actual, and es nd actual inflatio	spected inflation on rates.	a rates.
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Finally, as exhibited in the table (4), the combination of exclude monetary policy and procyclical inputs of the accerbate financial stability. The paper found that the index of role of financial stability is empirically weather of the index of monetary excluding on financial stability is empirically weather of the index of monetary excluding on financial stability is empirically weather of the index of monetary excluding on financial stability is empirically weather of the index of monetary excluding on financial stability is empirically weather of the index of monetary excluding on financial stability is empirically weather of the index of monetary excluding on financial stability is empirically weather of the index of monetary excluding on the index of monetary excluding o				Monetary Policy		Low; Inconclusive Low;					
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ZININGIA fiscal cyclicality on financial stability is empirically inconclusive. Statistical cyclicality on financial stability is empirically inconclusive. 5.1 Suggestions for Further Research Conc X.Msmath Sol. Suggestions for Further Research The are several empty spaces in this paper. First, this paper excludes the role of macroprodential policy as one of the actors in which assumes a 'lema-sagainst-the-wind' policy. Second, it implies that there could be a dynamic interaction between fiscal meetary, and macroprodential policy in determining both inflation rates and financial stability regarding their cyclicality behavior. Those empty spaces could be satisfied with the more comprehensive construction, such as a game-theoretical financial stability regarding their cyclicality behavior. Those empty spaces could be satisfied with the more comprehensive construction, such as a game-theoretical financial stability regarding their cyclicality behavior. Those empty spaces could be astisfied with the more comprehensive construction, such as a game-theoretical financial stability regarding their cyclicality behavior. Those empty spaces could be astisfied with the more comprehensive construction, such as a game-theoretical financial stability regarding their cyclicality of the actors in which assumes a 'lema-sagainst-the-wind' policy. Second: it more than a game-theoretical financial stability regarding their cyclicality of financial stability regarding their cyclicality of financial stability and Stock Prices: Evidence from ACCH Effects." International Advances in Economics 3 (2): 101–11. https://doi.org/10.19640/jbe.v3a2a7. Balagi, Badi II. 2005. Econometric Analysis of Panel Data. Stability. West Stass PO19 SSQ. Englant: Theoretical Disclossica about the Philips Curve." Journal of International Bainess and		self-dr iven.									
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. Files are listed in the pecified by the author.	Variables		Operational Description		M	easurement/Unit of Accout	Sour	ces
Uploaded	The Credibility of Monetary Policy	Smoothed value of	absolute deviation between actu	al and expected inflation.		$CMP = \frac{ \pi - \pi^{e} }{(1 + \pi - \pi^{e})} \times 100$	Author's calcula International	
x35740311- 9147590 x35740311-					$\hat{\sigma}_{12,i}^{2}(n) =$	$\frac{1}{n-1}\sum_{m=1}^{n} (y_m - \hat{\mu}_m(n))(y_m - \hat{\mu}_m(n))$		
9153730 ×35740311-	Cyclicality Behavior of Fiscal Policy	Correlation between c	clical components of government	nt expenditure and real GDP.		$\hat{\mu} = i \frac{1}{ z } + i \frac{\delta_{111}^2(0)}{\delta_{122}(n)} = \frac{\delta_{111}^2(0)}{\delta_{122}^2(n) \times \delta_{122}(0)}$	World Bank Data, I	Penn World Table
9154444 <u><35740311-</u> 9155035	Cyclically Deliaston of Fiscal Folky		n cyclical components of real GD omponents of government expen			rrelation coefficient (20 years window) $\tau_t^e = \alpha_t + \beta y_t^e + \varepsilon_t$	WOLD Date Jone, 1	enn word note
<u>c35740311-</u> 9155584	Inflation Rates		The annual growth rate of CI		The rolling re	gression coefficient (20 years window) Percentage change (2010=100)	Bank for Internati	onal Settlement
<u>-35740311-</u> 9155923	Public Debt		General government gross de	bt.		Percentage of GDP	World Econor	nic Outlook
35740311- 156342	Money Growth		Growth of Broad Money (M.	2)		Percentage change	World Ba	nk Data
35740311- 156706	Exchange Rates		Real effective exchange rates (RI	EER).		Index (2010=100)	IFS and	FRED
15740311- 157025 15740311-	Stock Volatility	Stock price volatility	is the average of the 360-day vol market index.	latility of the national stock		Index	Global Financial Dev (GFD	
35740311- 157293 35740311- 180524	MSCI	М	organ Stenley Capital Internation	al Index		Index	Bloom	berg
	Bank Z-score	Th	e default probability of the Banki	ing sector		Index	Global Financial Deve	elopment Indicato
er & Metadata	Unemployment Rate		Unemployment to Labor Force I	Ratio.		Percentage	World Econor	nic Outlook
	Appendix B. Robustness Test Estimations		Estimate	Table 5 or Selection for Robustness CI	hocks			
		ariable Combinations		δ _{PLS}	δεε	δ _{FD-GMM}	Estimator Selection	No
	CMP	Fiscal Cyclicality (Rolling Regression) Fiscal Cyclicality (Rolling Correlation)	Inflation Rates	.5685337 .5715414	.2965623 .3440067	.1962958 .2510438	System GMM System GMM	(1) (2)
	CMP	Fiscal Cyclicality (Rolling Regression)	Inflation Rates	.4800608	.2226913	.296512	System GMM	(3)
	CMP (Backward Phillips	Fiscal Cyclicality (Rolling Correlation) Fiscal Cyclicality (Rolling Correlation)	Inflation Rates	.4904 .5660908	.2414336	.3353058 .2180608	System GMM System GMM	(4)
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oc35740311- 19147590			Estimator	Selection for Robustness	Checks			
0c35740311-		Variable Combinations		δ_{PLS}	δ _{ΓΕ}	δ_{FD-GMM}	Estimator Selection	Ne
19153730	CMP (HP-Fiber)	Fiscal Cyclicality (Rolling Regression)	Inflation Rates	.5685337	.2965623	.1962958	System GMM	(1,
loc35740311-		Fiscal Cyclicality (Rolling Correlation) Fiscal Cyclicality (Rolling Regression)		.5715414 .4800508	.3440067 .2226913	.2510438 .296512	System GMM System GMM	(2
19154444	CMP (Target Inflation)	Fiscal Cyclicality (Rolling Regression) Fiscal Cyclicality (Rolling Correlation)	Inflation Rates	.4800508	.2414336	.3353058	System GMM	(3)
loc35740311- 19155035	CMP (Backward Phillips Curve)	Fiscal Cyclicality (Rolling Correlation)	Inflation Rates	.5660908	.2414336	.2180608	System GMM	(5
oc35740311- 19155584	Cavey		Stock Price Volatility	.5743819	.4791726	.585641	Diff-GMM	(6
oc35740311-		Fiscal Cyclicality (Rolling Regression)	MSCI Index	.8898372	2129971	221106	System GMM	(7
19155923	CMP		Bank Z-score	.9172721	.2880967	.3519971	System GMM	(8
oc35740311- 19156342	(HP-Filter)		Stock Price Volatility	.5730945	.4844711	.5929925	Diff-GMM	(9
0c35740311- 19156706		Fiscal Cyclicality (Rolling Correlation)	MSCI Index	.8705414	2493745	2595465	System GMM	(1
oc35740311-			Bank Z-score	.9131476	.2904428	.3597646	System GMM	(1)
19157025			Stock Price Volatility	.6779525	.5752592	.5904581	System GMM	(12
oc35740311- 19157293		Fiscal Cyclicality (Rolling Regression)	MSCI Index	.8709964	3661545	3663554	System GMM	(13
oc35740311- 19180524	CMP		Bank Z-score	.9009344	.272782	.3034565	System GMM	(1-
	(Target Inflation)		Stock Price Volatility	.6786673	.5712177	.5879271	System GMM	(15
r		Fiscal Cyclicality (Rolling Correlation)	MSCI Index	.8538441	3659896	3661496	System GMM	(16
over & Metadata			Bank Z-score	.9048147	.2712191	.2964842	System GMM	0
Close Window		Fiscal Cyclicality (Rolling Regression)	MSCI Index	.6013967	1538404	4620121	System GMM	(18
		Fiscal Cyclicality (Rolling Regression)	Bank Z-score	.9237517	.2759005	.313381	System GMM	(15
	CMP (Backward Phillips Curve)		Stock Price Volatility	.6031414	.4940704	.6345261	Diff-OMM	(20
	Curvey	Fiscal Cyclicality (Rolling Correlation)	MSCI Index	.1013874	1590937	1639219	System GMM	(21
			Bank Z-score	.9237792	.288805	.3200157	System GMM	(23
	Notes: Table (5) shows the results for GMM estimator estimated δ_{PEE} is considered to be biased upwards, while	selection. The rules of thumb are critically of estimated value the of δ_{FE} is considered to b	deciding the selection between Differe be biased downwards (Bond 2002). Wh	nce- or System GMM in which on the estimated value of δ_{FD} –	h utilizes the first order LDV's GMM lies below or closer to δ_{FE}	coefficient of Difference-GMM (δ than to δ_{PLS} , System GMM is suitab	$r_D - ame)$, Pooled Least Square (δ_{PLS}) , and F ble for estimation, vice versa (Roodman 2009).	/ixed Effect (δ _F

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cified by the author.	Inflation (-1)	.1151723 (.1080789)	.1661463 (.1136786)	.355563*** (.0832793)	.380169*** (.0928975)	.1930638* (.1164458)			
ploaded	Stock Volatility (-1)						.585641*** (.0360393)		
35740311- 147590	MSCI (=1)							.4583961*** (.0696368)	
35740311- 153730	Bank Z-score (-1)								.3693287 (.2977206)
<u>35740311-</u> 154444	Monetary Credibility (HP-Filter)	.1894311*** (.0717202)	.0481322 (.0597511)				73.68911 (-3.860479)	.55161** (.273004)	-16.48531 (27.56051)
35740311- 155035	Monetary Coedibility (Target Inflation)			1.035659*** (.1636926)	.886655*** (.154974)				
35740311- 155584	Monetary Credibility (Backward-Phillips)					.0384936*** (.0109615)			
35740311- 155923	Monetary Credibility (HP-Filter) × Fiscal Cyclicality (Rolling Correlation)		.3615075** (.1655804)		.1254651				
35740311- 156342	Monstary Credibility (Targat Inflation) × Fiscal Cyclicality (Rolling Correlation) Monetary Credibility (Backward-Phillips) × Fiscal				(.2994679)	025391*			
35740311- 156706	Momentry Credibility (Bolling Correlation) Cyclicality (Rolling Correlation) Momentary Credibility (HP-Filter) ³⁶ Fiscal Cyclicality	.0727115				(.0145016)	-3.860479	7163799*	-8.802333
5740311- 57025	(Rolling Regression) Monetary Coefficienty (Target Inflation) × Fiscal Cyclicality	(.1309639)		373918			(252.4202)	(.4233533)	(36.41416)
35740311- 157293	(Rolling Regression) Monstary Credibility (Backward-Phillips) * Fiscal			(.7695605)					
15740311- 80524	Cyclicality (Rolling Regression) Trade Openness						-10.34142	026919	-5.516071
JUL I	Money Growth	0012045***	.0011093***	.0004687**	.00045**	.0012558***	(7.789426)	(.0244826)	(4.611552)
r & Metadata	Real Effective Exchange Rates	(.0003174) 0006311***	(.0003228) 0005635***	(.0002093) 0002946**	(.000205) 0002413**	(.0003439) 000612***	1184691***	0001428	0275043
Close Window	Unemployment Rate	(.0001699) .0013861	(.000156) .0024956	(0001302) .0035236	(.0001297) 0014456	(.0001833) 0054631	(.0445191)	(.0001195)	(.0371379)
	Public Debt	(.0522805) 0001462*** (.0000507)	(.0485775) 0001291*** (.0000418)	(.024482) 0000996** (.0000393)	(.0223983) 000088*** (.0000265)	(.0430383) 000136** (.0000573)	0525308* (.0269908)	0001487 (.0001264)	.026472 (.0439433)
	Constant	.084406	.0761532	.0381895	.0328324	.0828307	(.038146	12.51702
	Serial Correlation (#-Prob.)	(0196644) 0.233	(.0178055) 0.321	(.0141701) 0.138	(.0140682) 0.244	(.0204109) 0.236	0.017	(.0339263) 0.319	(0.037739)
	Hansen Test (Chi-squared Prob.)	0.182	0.149	0.181	0.209	0.105	0.074	0.095	0.143
	Wald-Stat (5)	160.35***	280.26***	276.73***	282.17***	135.89***	313.54***	11835.08***	25.66***
	Number of Instruments	21	21	21	21	21	18	20	19
	Number of Observation	341	341	255	255	341	301	350	325
	Number of Group (Countries)	25	25	22	22	25	24	25	25
	Estimator	System GMM	System GMM	System GMM	System GMM	System GMM	Diff- GMM	System GMM	System GMM
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a list of the files that	Real Effective Exchange Rates	0006311*** (.0001699)	0005635*** (.000156)	0002946** (0001302)	0002413** (.0001297)	000612*** (.0001833)	1184691*** (.0445191)	0001428 (.0001195)	0275043 (.0371379)
oaded as well as a / / cover page. Click on ne to view the proof of	Unemployment Rate	.0013861 (.0522805)	.0024956 (.0485775)	.0035236 (.024482)	0014456 (.0223983)	0054631 (.0430383)			
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loaded	Constant	.084406 (0196644)	.0761532 (.0178055)	.0381895 (.0141701)	.0328324 (.0140582)	.0828307 (.0204109)		.038146	12.51702
5740311-	Serial Correlation (#-Prob.)	0.233	0.321	0.138	0.244	0.236	0.017	0.319	 0.079
7590	Hansen Test (Chi-squared Prob.)	0.182	0.149	0.181	0.209	0.105	0.074	0.095	0.143
740311- 3730	Wald-Stat (5)	160.35***	280.26***	276.73***	282.17***	135.89***	313.54***	11835.08***	25.66***
	Number of Instruments	21	21	21	21	21	18	20	19
5740311- 54444	Number of Observation	341	341	255	255	341	301	350	325
5740311-	Number of Group (Countries)	25	25	22	22	25	24	25	25
5035	Estimator	System GMM	System GMM	System GMM	System GMM	System GMM	Diff- GMM	System GMM	System GMM
5740311- 55584				Tat	de 7				
5740311- 55923				Robustness Check	Estimations (Cont.)				
5740311-		(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
6342	Inflation (-1)								
740311- 6706	Stock Volatility (-1)	.5929925 (.0369287)			.7137078*** (.0306916)			.7128825*** (.02988)	
740311- 7025	MSCI (-1)		.5597915*** (.0760003)			.4530592*** (.0460616)			.4068674*** (.0544863)
740311-	Bask Z-score (-1)			.4416043** (.2223191)			.4459455**** (.1288408)		
740311- 10524	Menetary Credibility (HP-Filter)	56.428 (63.19469)	.7880887*** (.2362766)	2.147491 (13.0813)					
0.21.3	Monetary Credibility (Target Inflation)				71.55204* (40.80733)	1.449086 (1.272966)	-61.67428** (28.6019)	84.36188 (55.81598)	2.555912 (1.937766)
& Metadata	Monetary Credibility (Backward-Phillips)								
Close Window	Monetary Credibility (HP-Filter) × Fiscal Cyclicality (Rolling Correlation)	34,54817 (127.6395)	-1.042697*** (.3674838)	-40.7567 (25.8360)					
	Monetary Credibility (Target Inflation) × Fiscal Cyclicality (Rolling Correlation)							-72.89408 (71.65577)	-3.134832 (2.428237)
	Menetary Credibility (Backward-Phillips) * Fiscal Cyclicality (Rolling Correlation)								
	Monetary Credibility (HP-Filter) × Fiscal Cyclicality (Rolling Regression)								
	Monetary Credibility (Target Inflation) × Fiscal Cyclicality (Rolling Regression)				-121.9966 (105.3892)	-2.838662 (2.596454)	109.0014 (127.4641)		
	Menetary Credibility (Backward-Phillips) × Fiscal Cyclicality (Rolling Regression)								
	Trade Openness	-10.05006 (7.579046)	0186079 (0001673)	-3.288141 (4.643107)	.2644512 (1.915103)	0276476 (.0284717)	-3.87171 (3.765149)	.2769076 (1.884359)	0259595 (.0264635)
	Money Growth								
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s a list of the files that	Monetary Credibility (Backward-Phillips)										
loaded as well as a ry / cover page. Click on ime to view the proof of	Monetary Coedibility (HP-Filter) × Fiscal Cyclicality (Rolling Correlation)	34.54817 (127.6395)	-1.042697*** (.3674838)	-40.7567 (25.8360)							
. Files are listed in the secified by the author.	Monetary Credibility (Target Inflation) × Fiscal Cyclicality (Rolling Correlation)							-72.89408 (71.65577)		-3.134832 (2.428237)	
Jploaded	Monetary Credibility (Backward-Phillips) * Fiscal Cyclicality (Rolling Correlation)										
<u><35740311-</u> 9147590	Monetary Credibility (HP-Filter) * Fiscal Cyclicality (Rolling Regression)										
<35740311- 9153730	Monetary Credibility (Target Inflation) × Fiscal Cyclicality (Rolling Regression)				-121.9966 (105.3892)	-2.838662 (2.596454)	109.0014 (127.4641)				
< <u>35740311-</u> 9154444	Menetary Credibility (Bockward-Phillips) × Fiscal Cyclicality (Rolling Regression)					0276476	-3.87171			0259595	
<35740311- 9155035	Trade Openness	-10.05006 (7.579046)	0186079 (+.0001673)	-3.288141 (4.643107)	.2644512 (1.915103)	0276476 (.0284717)	-3.87171 (3.765149)	.2769076 (1.884359)		0259595 (.0264635)	
35740311- 155584	Meney Growth	1162055***	0001673*	0374014	0906943***	0001368	.006114	0916869***		0002922	
c35740311- 9155923	Real Effective Exchange Rates Unemployment Rate	(.044701)	(.0000984)	(.038767)	(.0236311)	(.0001628)	(.0578936)	(.0243835)		(.0002391)	
:35740311- 0156342	Public Debt	0542053** (.0272469)	0001249 (.0000959)	.0135088 (.0408877)	0075211 (.0089414)	0001667 (.0001661)	.038502 (.0321212)	0083826 (.0094561)		0002459 (.0002173)	
:35740311- 156706	Constant		.033761 (.0264938)	11.51689 (5.211145)	13.27583 (2.980716)	.0359786 (.0364985)	7.878765 (6.132884)	13.36284 (3.000944)		.0522996 (.0448089)	
:35740311-	Serial Correlation (#-Prob.)	0.012	0.313	0.060	0.006	0.331	0.121	0.005		0.350	
157025	Hansen Test (Chi-squared Prob.)	0.072	0.192	0.106	0.100	0.147	0.363	0.100		0.228	
35740311- 157293	Wald-Stat (5)	347.33***	75216.34***	14.25***	1067.34***	8982.41***	63.88***	1157.96***		4743.81***	
	Number of Instruments	18	20	19	20	20	19	20		20	
c35740311- 9180524	Number of Observation	301	350	325	262	264	242	262		264	
	Number of Group (Countries)	24	25	25	22	22	22	22		22	
	Estimator	Diff- GMM	System GMM	System GMM	System GMM	System GMM	System GMM	System GMM		System GMM	_
er & Metadata					ble 8 Estimations (Cont.)						
			(17)	(18)	(19)	(20)		(21)		(22)	-
	Inflation (-1)										_
	Stock Volatility (=1)					.6345261 (.0394838)					
	MSCI (-1)			1218784 (.0757746)				2199843*** (.0191145)			
	Bank Z-score (=1)		4101696** (.1627433)		.4098119* (.2192062)					.41571* (.2163226)	
	Monetary Coedibility (HP-Filter)										
	Monetary Credibility (Target Inflation)		-35.91764 (37.88998)								
	AND A REPORT OF A DESCRIPTION			.680515***	-2,365832	91.05579		.871723***		-2.264424	_
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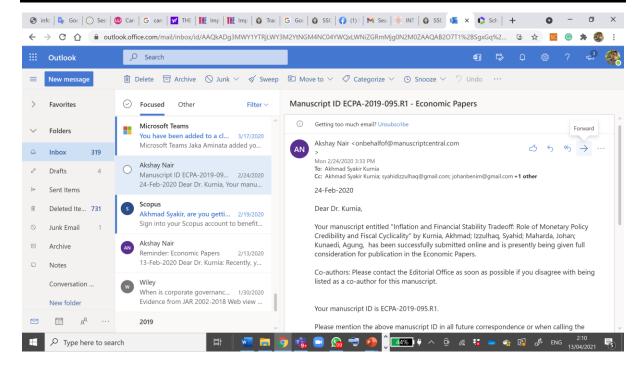
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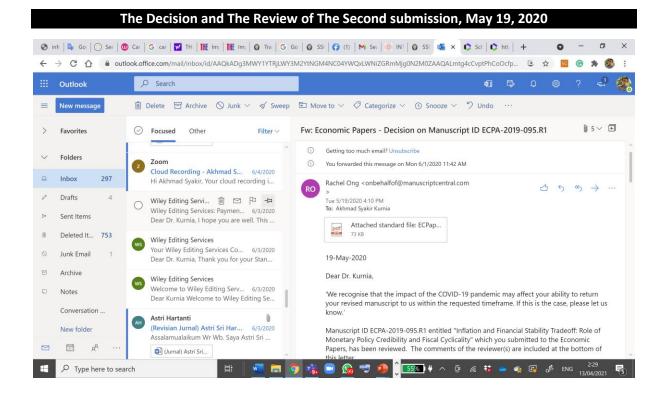
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Inflation (-1)	(2.7	(1-1)	(1-7	(8-1)	(44)	(11)
				.6345261		
Stock Volatility (-1)				(.0394838)		
MSCI (-1)		1218784 (.0757746)			2199843*** (.0191145)	
<u>.</u>	.4101696**	(.0121140)	.4098119*		(00)(140)	.41571*
Bank Z-score (-1)	(.1627433)		(.2192062)			(.2163226
Monetary Credibility (HP-Filter)						
	-35.91764					
Monetary Credibility (Target Inflation)	(37.88998)					
- Monetary Credibility (Backward-Phillips)		.680515*** (.22345)	+2.365832 (2.768966)	91.05579 (56.31462)	.871723**** (.0559297)	-2.264424 (1.781357
	.1233256	(intervery	(accessed)	frank rush	(months)	(1.10130)
Monstary Coadibility (HP-Filter) * Fiscal Cyclicality (Rolling Correlation)	(73.24986)					
Monstary Credibility (Target Inflation) × Fiscal Cyclicality (Rolling Correlation)						
Monetary Credibility (Backward-Phillips) * Fiscal Cyclicality (Rolling				-106.9841*	9378477***	1.800333
Correlation)				(60.20992)	(.0600361)	(2.397058
∴ Monetary Credibility (HP-Filter) × Fiscal Cyclicality (Rolling Regression)						
∠ Monetary Credibility (Target Inflation) × Fiscal Cyclicality (Rolling Repression)						
 Regression) Monetary Credibility (Backward-Phillips) * Fiscal Cyclicality (Rolling 		-1.400019**	3.311494			
 Regression) 		(.559179)	(8.242095)			
Trade Openness	-3.825095 (3.175609)	.0328576 (.0213088)	-5.804255 (3.81637)	-7.357433 (9.330561)	0003367 (.011884)	-5.63175 (3.886811
Meney Growth						
data Real Effective Exchange Rates	.0003135	.0001749	0389234	1538543***	.0000989	037682
e Window	(.0481607)	(.000243)	(.0356007)	(0519987)	(.0002484)	(.03586)
Unemployment Rate						
Public Debt	.0407978 (.0321265)	0001548 (.0001394)	.0227526 (.0427816)	0766065** (.0364582)	0000108	.0221612 (.0420777
	8.239772	0387694	(342/816) 12.73614	(3064582)	(.0003486) 0224872	(.042077) 12,49747
Constant	(5.387295)	(.0321112)	(4.820543)		(.0268464)	(4.933419
Serial Correlation (#-Prob.)	0.123	0.355	0.072	0.022	0.355	0.074
Hansen Test (Chi-squared Prob.)	0.594	0.205	0.307	0.057	0.102	0.298
Wald-Stat (5)	40.03***	2658.39***	14.85***	409.43***	4933.60***	169.14**
Number of Instruments	19	20	19	18	20	19
Number of Observation	242	350	325	301	350	325
Number of Group (Countries)	22	25	25	24	25	25
Estimator	System GMM	System GMM	System GMM	Diff- GMM	System GMM	System GMM
Note: (1) and (2) represent the results of the first second, and third model astimates.		OMM dan *** at 10 percent. 5 percent and 1 percent.	ont musectively. Nonberg in the recombin-	USISI ses. (.). represent Windmeijer standaol error.		relation (represented by z-r

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19147590	poor touch with the existing literature.								
loc35740311- 19153730	2. The paper has an improper								
19154444	introduction, in the sense that an introductory section should include the								
	background of the study, the research								
oc35740311- 19155035	gap, objective, motivation, result, and outline. I suggest that the majority of								
oc35740311- 19155584	the introductory section as it is can be recast into a new section on stylized								
oc35740311-	facts.								
0:35740311-	Theoretical 1. I would suggest that the authors	Model Section 1. After we reviewed the necessities of our							
x35740311- 9156342	review every equation and whether	equations, we recognized that the							
0c35740311- 19156706	they are necessary. 2. The theoretical model section seems	equations are elaborated too long. We exclude the following equations: 4, 5,							
0c35740311- 19157025	too long at present for the material covered.	10, and 13. 2. We have revised our propositions to be							
	3. At least one of the propositions is	more efficient and clearer-stated.							
0c35740311- 19157293	redundant. Proposition 4 is assumed in the text immediately above it. As the	 Proposition 4 is removed as we recently aware that it was inconsistent with the 							
oc35740311- 19180524	propositions aren't proved, moving away from this format seems desirable.	model specification and results'							
r	If they are maintained, some of them	interpretation (proposition 4 as reviewers have mentioned).							
over & Metadata	need to be re-worded so as to be clearer (e.g., Propositions 5 and 6).								
Close Window	The authors need to use the model to	1. Our theoretical model is aimed to							
	demonstrate how it supports their argument better. For example, is it	elaborate our rational transmission to explain how procyclical fiscal policy							
	possible to show the effect of fiscal policy being set in a different way through	may play an important role in determining the outcome of the credible							
	simulations? In other words, can	monetary policy, especially on inflation,							
	estimates for selected countries be obtained of how GDP growth would have	growth and financial stability. Thus, model simulations possibly would not							
	evolved with counter-cyclical fiscal policy?	be conducted in this regard. 2. But we extend our rational							
	poncy	demonstration to the explanation of							
		countercyclical fiscal policy (section II.3).							
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Notification of the second submission after First Revision, February 24 2020





Referee Report for "Inflation and Financial Stability Tradeoff: Role of Monetary Policy Credibility and Fiscal Credibility" Revision 1

May 6, 2020

1 Summary

This paper investigates the role of fiscal policy in influencing trade-offs for monetary policy between stabilising inflation and maintaining financial stability.

2 Major Comments

- I thank the authors for their responses to my previous suggestions and the edits they have done. The paper has improved.
- This paper needs to be thoroughly proof-read/edited. Issues such as missing articles and odd phrasing (e.g. "criticism-instinct") detract from the paper. The authors should consider getting it professionally proof read.
- It is not clear how proposition 4, and the sentence immediately above it, follow from the model. The log odds of the asset price bubble bursting are assumed to decrease as the interest rate increases. How does this imply that higher interest rates increase the asset price bubble?
- I still find the use of stock volatility to measure asset price misalignments. While periods of high volatility may follow asset price misalignments, these are different concepts.
 - One option may be to use a test such as Phillips and Shi (2020). This can be implemented using their package in R. Doing this would mean the equation being estimated would have to change (as the dependent variable would be a binary indicator).
 - Alternatively, as mentioned in my previous comments the authors try other measures - e.g. the difference between actual and average Price-to-Earnings (PE) ratio for the major share price index for each country. I realise that the models where prices and earnings cointegrate (e.g. Campbell and Shiller 1989) may not always work, but

extreme PE ratios might still indicate misalignment. The authors do try the MSCI, however, wouldn't it be this de-trended which is the better measure of misalignment?

 If the authors wish to keep with stock volatility the language in their paper should focus on that, or at least financial stability, rather than referring to asset price misalignments. This might involve removing much of the "Financial Instability Model" sub-section.

3 Minor Comments

3.1 The Simple Model

- It could be made explicit that money growth is the instrument of monetary policy here (although later in Figure 4 money demand is introduced).
- In the paragraph above equation 1 it could be made clearer that inflation is now also determined by fiscal policy, and how to interpret γ.
- A sentence could be added to explain how fiscal policy has real effects in this model.
- The authors could note that Equation 3 is a Lucas Surprise Supply curve.
- It is unclear what is meant by "Assuming that time is consistent" in footnote 2 on page 6.

3.2 The Financial Instability Model

- The model includes the expected value of the asset price bubble. How is that determined.
- It could be noted that z is the log odds.
- there is an erroneous reference to Equation (16).
- In Figure 5 it could be made clearer that "Decisions" refer to the decisions of the central bank.

3.3 Empirical results

- Referring to "data", rather than "observation", would be better in the new material in Sub-section 3.1 (page 11).
- The number of decimal places in the tables seem excessive.
- Using a survey-based measure of inflation expectations would strengthen the paper.

- It would be useful to see the results of simple 2SLS (i.e. Anderson and Hsiao 1982) as a reobustness exercise.
- Presumably the robustness tables will be published as an on-line appendix, rather than being included.

4 Reference

Anderson, T.W., and C. Hsiao (1982) "Formulation and Estimation of Dynamic Models Using Panel Data," *Journal of Econometrics*, 18, 47-82.

Phillips, P. C. B. and S. Shi (2020) Real time monitoring of asset markets: Bubbles and crises, *Handbook of Statistics*, H. D. Vinod and C.R. Rao eds., Volume 42, 2, Pages 61-80.

Campbell, J. Y., and R. J. Shiller. (1989) "The Dividend-Price Ratio and Expectations of Future Dividends and Discount Factors." *The Review of Financial Studies*, 1, pp. 195-228.

Third Submission and Responses to The Review: June 27, 2020

A Rejoinder to Comments on

Inflation and Financial Stability Tradeoff: Role of Monetary Policy Credibility and Fiscal Cyclicality"

Economic Papers Journal (the Economic Society of Australia)

We would like to thank the reviewers for the valuable comments that improve this paper. The table below lists our responses to the comments:

Comments	Responses
Major Co	mments
This paper needs to be thoroughly proofread/edited. Issues such as missing articles and odd phrasing (e.g., criticism-instinct) detract from the paper. The authors should consider getting it <i>professionally</i> proofread.	We sent the paper to the Wiley Editing Service, and got valuable inputs. We have made revisions as advised (the editing certificate is attached).
It is not clear how proposition 4, and the sentence immediately above it, follow from the model. The log odds of the asset price bubble bursting are assumed to decrease as the interest rate increases. How does this imply that higher interest rates increase the asset price bubble?	We restated proposition 4 to be more explicit as it seems inadequate to support our argument: Proposition 4. The higher the increase of the interest rates (Δr) leads to reduced z. In turn, it escalates the probability of the bubble to burst $(1 - P_{br})$ and lowers the probability of the bubble to persist (P_{br}). Since $\partial \sigma / \partial P_{br} < 0$, the lower P_{br} thus induces the asset price misalignment.
 I still find the use of stock volatility to measure asset price misalignments. While periods of high volatility may follow asset price misalignments, these are different concepts. One option may be to use a test such as Phillips and Shi (2020). This can be implemented using their package in R. Doing this would mean the equation being estimated would have to change (as the dependent variable would be a binary indicator). Alternatively, as mentioned in my previous comments the authors try 	For the measurement of financial instability (i.e., asset price misalignment), we acknowledged that the concept between stock price volatility and asset price misalignment is different. It is also too costly if we use Phillips and Shi (2020) as we have to meet the deadline. In this regard, therefore, we adopt detrended MSCI estimated using an absolute gap between actual MSCI and its fundamental value. ¹ In this regard, therefore, the period of excessive asset price misalignment is identified by widened detrended MSCI.

¹ Fundamental values of MSCI are estimated using Hodrick-Prescott Filter.

 other measures - e.g. the difference between actual and average Price-to-Earnings (PE) ratio for the major share price index for each country. I realise that the models where prices and earnings co-integrate (e.g. Campbell and Shiller 1989) may not always work, but extreme PE ratios might still indicate misalignment. The authors do try the MSCI, however, wouldn't it be this detrended which is the better measure of misalignment? If the authors wish to keep with stock volatility the language in their paper should focus on that, or at least financial stability, rather than referring to asset price misalignments. This might involve removing much of the "Financial Instability Model" sub-section. 	Besides, the stock price volatility is no longer being used.
Minor Co	mments
"The Simp	le Model"
It could be made explicit that money growth is the instrument of monetary policy here (although later in Figure 4 money demand is introduced).	Revised (see page 5, the first paragraph in subsection 2.1).
In the paragraph above equation 1 it could be made clearer that inflation is now also determined by fiscal policy, and how to interpret.	Revised (see page 5, the second paragraph in subsection 2.1).
A sentence could be added to explain how fiscal policy has real effects in this model.	Revised (see page 5, the second paragraph in subsection 2.1).
The authors could note that Equation 3 is a Lucas Surprise Supply curve.	Revised.
It is unclear what is meant by "Assuming that time is consistent" in footnote 2 on page 6.	Revised: "Assuming that monetary policy is time consistent, $k = 1$, which implies targeted output equal to its potential, and the central bank set the targeted inflation rates equals to zero (Blinder 2000)."
"The Financial S	•
The model includes the expected value of the asset price bubble. How is that determined.	Revised: " First, the expected value of σ is the expectation adaptive feature that captured the agent's expectation on future σ value based on their specific memory in the past. In other words, it suggests that the bubble is self-driven and could be changing without any connection to fundamental

	factors. For instance, the asset price bubble is thus self-fulfilling when $\partial \sigma_e > 1$ where characterizes the over-optimistic market expectations." (see Page 9)
It could be noted that <i>z</i> is the log odds.	Revised.
There is an erroneous reference to Equation (16).	Revised.
In Figure 5 it could be made clearer that "Decisions" refer to the decisions of the central bank.	Revised.
"Empirica	Results"
Referring to "data", rather than "observation", would be better in the new material in Sub-section 3.1 (page 11).	Revised.

Reference

Blinder, Alan S. 2000. "Central-Bank Credibility: Why Do We Care? How Do We Build It?" *American Economic Review* 90(5): 1421–31.

1. Introduction

The global financial crisis and the prolonged uncertainty of financial instability, together with a protracted economic recovery in their aftermath, have aroused hesitation regarding the role of monetary policy. This hesitation is not only on price stability goals but also on financial stability goals (Bordo and Siklos, 2015). However, ensuring low inflation and a stable financial sector at once is much more challenging for the monetary authority than merely focusing on a low and stable inflation rate. It becomes one of the monetary authority's significant concerns, as inflation and the financial sector frequently generate a severe trade-off.

Recent literature has pointed out the monetary policy dilemma of inflation and financial stability from several viewpoints. Geraats (2010) argues that whether price and financial stability are complementary or contradictory objectives depends on the type of economic shocks. In their characterisation of economic shocks, Jonsson and Moran (2014) also support these arguments. They argue that a trade-off between price and financial stability may arise if supply shocks drive economic fluctuations. Kim and Mehrotra (2015) suggest that—ex-post— there may have been a short-term policy trade-off for central banks with both financial and price stability objectives.

There is a growing literature that focuses on risk-taking behaviour channels that generate a trade-off between inflation and financial stability. Using the Taylor-style monetary policy rule in the possibility of reacting to banks' short-term liabilities, Shukayev and Ueberfeldt (2018) find that central banks need to accept higher levels of inflation and output volatility. In other words, there is still a policy trade-off between price and financial stability. Patnaik, Mittal, and Pandey (2019) examine the inflation-financial stability trade-off faced by monetary policy in the case of India. They find robust evidence of the trade-off between price and financial stability. This implies that the conduct of monetary policy may constrain the ability of a central bank to target financial stability with monetary policy instruments. Fouejieu, Popescu, and Villieu (2019) provide a framework to investigate trade-off between macroeconomic and financial stability when the central bank has a financial stability objective. Relying on a New Keynesian model with an endogenous financial bubble, their simulations suggest that a central bank attempting to 'lean against the wind' may face trade-off between inflation/output stability, and financial stability.

The proponents of this view also mention the role of credible monetary policy in defining what is characterised as the low interest and inflation rates period in generating financial instability. According to the risk-taking channels Borio and Zhu (2012), maintaining low-interest rates for a protracted period increases financial risks through higher incentives to search for yields (Rajan, 2005). Jordà, Schularick, & Taylor (2015) use a large dataset to document how loose monetary conditions have historically boosted real estate lending and house price bubbles, especially in the post war period. For financial corporations, low-interest rates can increase interest margins, boost the firm's value, and increase leverage, which ultimately translates into higher risk exposure (Adrian and Shin 2010). Gambacorta (2009) also states that credible monetary policy has resulted in a protracted low-interest-rate episode that leads to an increase in banks' risk-taking behaviour, and accordingly promotes financial instability. Kim and Mehrotra (2015) assess the trade-off between financial and price stability by looking at the interaction between financial stability and actual-targeted inflation deviation-which can also be interpreted as monetary credibility (see Warjiyo and Juhro, 2019)-in Australia, Indonesia, Korea, New Zealand, Philippines, and Thailand from 2000 to 2014. They find that about 12% of the observed countryyears are characterised by the trade-off between monetary credibility and financial stability.

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However, the way we see how the trade-off between inflation and financial instability occurs is slightly different. Looking at the US economy, a low inflation rate straightforwardly occurs with a gradual increase in interest rates (see figure 1). Monetary policy is implemented in response to financial instability within inflation-targeting. Thus, when using the interest rate as the policy instrument to achieve targeted inflation, the interest rate would have to be adjusted in response to an increased probability of financial default. The hike of asset price increases the value of collateral, boosts leverage, pushes both consumption and aggregate demand, and thus elevates inflation rates. To maintain a credible monetary policy with the inflation rate in order, the conduct of monetary policy will adjust interest rates upwards. Therefore, a credible monetary policy is not associated with a low interest rate but with stable inflation.

Figure 1 is here

Instead of charging the monetary authority with blame, we argue that there is also an important role of fiscal cyclicality behaviour. Figure (2) shows that before the bubble was about to burst in 2008, the Fed's monetary policy was more credible under the relatively more procyclical fiscal policy, which means that the US government tried to push the economy excessively while the monetary authority persistently kept fighting against inflation. Therefore, under this circumstance, the economic policy was characterised by unharmonised coordination.

To shed light on the responsibility of an unharmonised economic policy, we develop a simple model to explain this situation. Our model demonstrates that in the initial condition, a procyclical fiscal policy distorts the credibility of monetary policy. Procyclical fiscal policy causes divergences in the targeted inflation rate, actual inflation rate, and expected inflation rate. Afterwards, the monetary authority must decide whether to pursue its credibility or let it deteriorate. However, the monetary authority faces a dilemma related to the available options. On one hand, if the monetary authority decides to pursue its credibility, it causes low inflation and exacerbates financial instability. On the other hand, if the monetary authority decides to let its credibility deteriorate, it will effectively ensure financial stability but not lower inflation rates.

This paper elucidates the impact of the combination of monetary policy credibility and fiscal cyclicality on financial stability and inflation rates. Furthermore, we attempt to highlight the importance of policy coordination on the cyclical behaviour of fiscal policy, and the monetary policy to respond to it. For the empirical investigation, we employ the Generalised Method of Moments (GMM) method involving 25 selected inflation targeting framework (ITF) countries from 2003 to 2017.

Figure 2 is here

To the best of our knowledge, there is one crucial point that differentiates this paper from previous research. This paper addresses the trade-off between inflation rates and financial stability considering the role of monetary credibility and fiscal cyclicality behaviour, while the existing literature has not yet addressed the role of fiscal cyclicality. Thus, we make every effort to significantly contribute to the development of literature related to the topics of monetary policy/authority credibility, fiscal cyclicality, and inflation-financial stability trade-off. Another motivation of this paper is to examine the role of monetary credibility and fiscal cyclicality in generating the trade-off between inflation rates and financial stability. We find robust evidence

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that suggests that a credible monetary policy generates a trade-off between inflation and financial stability if the fiscal policy is procyclical.

The rest of this paper is organised as follows. Section II elaborates on a theoretical foundation. Section III presents the empirical strategy regarding the definition of variables, the measurements, and the devoted econometric method to estimate the parameters. Section IV presents the empirical findings and its discussion. Section V provides both remarks and policy recommendations.

2. Simple Model

The setup of the model aims to scrutinise the role of monetary policy credibility and fiscal cyclicality in shaping the nexus between inflation rates and financial instability. This section is organised as follows. The first section begins with the interdependency between the credibility of monetary policy and procyclical fiscal policy. The second section elucidates the financial instability model. Finally, the third section highlights the dilemma of credible monetary policy within procyclical fiscal policy.

2.1. Interdependency between Monetary Policy Credibility and Procyclical Fiscal Policy

We begin with the monetary policy credibility model developed by Barro and Gordon (1983), focusing on the role of the money growth policy. In this model, we augment the cyclicality of fiscal policy with the assumption that monetary policy transmission is imperfect. Thus, the model is expressed as follows:

$$\pi = \mu + \beta.\gamma; \, \pi'(\gamma) > 0 \tag{1}$$

where π , μ , γ , and β are inflation rates, money growth, degree of fiscal policy cyclicality behaviour, and parameter of γ , respectively. Equation (1) describes a positive relationship between inflation rates and cyclical behaviour of fiscal policy. $\pi'(\gamma) > 0$ indicates that if the fiscal policy is procyclical, then the constant money growth policy is more inflationary. Therefore, it also shows the imperfect transmission of monetary policy ($\pi \neq \mu$). Kaminsky, Reinhart, and Végh (2004), Mcmanus and Ozkan (2015), and Izzulhaq and Kurnia (n.d.) have revealed that the pro-cyclical fiscal policy may affect the inflation rates by 'turning sunny days into scorching infernos'. That is, pro-cyclical expansions in government expenditure excessively boost the aggregate demand, set the economy into the 'over-heated' circumstances, therefore causing the inflation rates to soar.

Targeting the inflation rate as the goal of monetary policy in ITF implies a sacrifice ratio to be borne in mind. There must be a cost of forgone output due to stable and low inflation rates. Consequently, a credible monetary policy is unavoidably characterised as countercyclical. Provided the trade-off between inflation and output, the central bank has the following singleperiod loss function to minimise:

$$L = a(\pi - \pi^*)^2 + (y - y^*)^2; y^* = k.y^n$$
(2)¹

¹ Assuming that monetary policy is time consistent, k = 1, which implies targeted output equal to its potential, and the central bank sets the targeted inflation rates equals to zero (Blinder, 2000).



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ceteris paribus. Theoretically, it is represented by a Lucas supply shock:

$$y = y^n + b(\pi - \pi^e) \tag{3}$$

where π^e is the expected inflation rate.

Substituting equations (1) and (3) in equation (2) and taking the first-order condition, we obtain the optimal combination of fiscal policy cyclicality behaviour and the devoted variables that minimise the loss function as follows:

$$\gamma = -\frac{1}{\beta}\mu + \frac{b^2}{\beta(a+b^2)}\pi^e \tag{4}$$

Figure (3) depicts equations (1) and (6) in a way so that we can see the optimal policy. At γ_0 (i.e., countercyclical fiscal policy), the targeted inflation is parallel to the actual and expected inflation rates, *ceteris paribus*. In contrast, if the cyclical behaviour of fiscal policy occurs (at γ_1), then it creates a gap between targeted, actual, and expected inflation rates.

Figure 3 is here

Proof:
Equations
$$\gamma = -\frac{1}{\beta}\mu + \frac{b^2}{\beta(a+b^2)}\pi^e$$
 and $\gamma = -\frac{1}{\beta}\mu + \frac{1}{\beta}\pi$ have different slopes, where $\frac{b^2}{\beta(a+b^2)}\pi^e < \frac{(a+b^2)}{\beta(a+b^2)}\pi$; $a > 0$. In other words, slope of $\pi = f(\gamma)$, $\frac{\partial \pi}{\partial \gamma}$ is steeper than slope of $\pi^e = f(\gamma)$, $\frac{\partial \pi^e}{\partial \gamma}$

Proposition 1. *Procyclical fiscal policy generates a gap between targeted, actual, and expected inflation rates. The more procyclical the fiscal policy, the larger the gap.*

Based on the above explanation, there are two conditions characterised by the degree of cyclical behaviour of fiscal policy. The first circumstance (i.e., procyclical fiscal policy) is indicated by a deviation in targeted, actual, and expected inflation rates. In contrast, the second circumstance (i.e., countercyclical fiscal policy) is characterised by an equal rate of targeted, actual, and expected inflation.

 L_a denotes the loss function within the first condition. The loss function equation is as follows:

$$L_a = a(\pi - \pi^*)^2 + \left[(1 - k)y^n + b(\pi - \pi^e) \right]^2; \pi \neq \pi^e \neq \pi^*; \gamma_1; k = 1$$
(5)

Equation (7) suggests that with procyclical fiscal policy, the credibility of monetary authority is undermined, and thus value of the loss function L_{α} is larger than zero.

$$\boldsymbol{L}_{\boldsymbol{b}} = (\Delta \boldsymbol{\pi}_{tar})^2 + [\boldsymbol{b}(\Delta \boldsymbol{\pi}_{exp})]^2; \boldsymbol{L}_{\boldsymbol{b}} > \boldsymbol{0}$$
(6)

where $\Delta \pi_{tar} = (\pi - \pi^*)$ and $\Delta \pi_{exp} = (\pi - \pi^e)$.

On the contrary, the loss function (L_b) within the second condition, which assumes $\pi = \pi^e = \pi^*$; $\gamma_0; k = 1$, is as follows:

$$L_{b} = a(\pi - \pi^{*})^{2} + [(1 - k)y^{n} + b(\pi - \pi^{e})]^{2}$$

$$L_{b} = 0$$
(7)

The value of the total loss (L_b) within the second condition equals zero $(L_b = 0)$. This implies that with a countercyclical fiscal policy, the monetary policy achieves its optimal credibility, and hence fiscal policy is complementary to the monetary policy.

Proposition 2. Procyclical fiscal policy malevolently exacerbates the credibility of monetary policy. On the contrary, the countercyclical fiscal policy helps monetary policy to attain its credibility.

When credibility is under pressure, the monetary authority is assumed to be able to regain its credibility via a tighter monetary policy (see Figure 2). The monetary authority will run a negative money growth policy and, therefore, significantly increase interest rates to adjust the deviation between targeted, expected, and actual inflation rates. In this case, expansionary government spending results in the crowding-out effect by which the monetary authority will adjust the interest rate up to maintain the credibility of monetary policy. As can be seen in Figure 4 below, equations (1) and (6) will shift, resulting in a change of optimal point from point a to point b.

Figure 4 is here

Proposition 3. Contractionary monetary policy could adjust the deteriorated monetary policy credibility by employing a negative money growth policy and significantly higher interest rates.

2. 2. Financial Instability Model

The economy has witnessed several episodes of financial crises, from the 1930's Great Depression to the recent crises. A feature that is commonly found intrinsically in all episodes of the financial crises is the presence of asset price misalignment (Taipalus, 2012). Indeed, it is worth stressing that asset price misalignment is not merely a factor in deteriorating financial stability. Nevertheless, a massive swing in the asset price is often associated with strains in the financial sector and the real economy (Borio and Lowe, 2002). Therefore, we define financial instability as the build-up of asset price deviation from its fundamental value. Accordingly, we primarily simplify the endogenous asset price bubbles model *a la* Fouejieu, Popescu, and Villieu (2019), earlier found in Blanchard and Watson (1982):

$$\sigma = f(\sigma_{e}, P_{br}) + \varepsilon_{\sigma}$$

$$\frac{\partial \sigma}{\partial \sigma_{e}} > 0; \frac{\partial \sigma}{\partial P_{br}} < 0$$
(8)

where σ , σ_e , P_{br} , $1 - P_{br}$, and ε_{σ} are actual asset price deviation from its fundamental value, expected value of σ , probability of the bubble to persist, probability of the bubble to burst, and exogenous shock, respectively.

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In this model, therefore, there are two main drivers of the asset price misalignment: expectations and the probability of the bubble to persist. First, the expected value of σ is the expectation adaptive feature that captures the agent's expectation of future σ value based on their specific memory in the past. In other words, it suggests that the bubble is self-driven and may change without any connection to fundamental factors. For instance, the asset price bubble is self-fulfilling when $\partial \sigma_e > 1$, which characterises the over-optimistic market expectations (Fouejieu, Popescu, and Villieu, 2019). For the value of P_{br} , we define P_{br} in a sigmoid pattern in which the probability of the bubble to persist is a function of z:

$$P_{br} = f(z) \tag{9}$$

where z is defined as the log odds ratio between P_{br} and $1 - P_{br}$,

$$\ln\left(\frac{P_{br}}{1-P_{br}}\right) = z \tag{10}$$

Based on equation (10), it can be seen that larger the increase (decrease) in interest rates, larger (lower) the probability to default, $(1 - P_{br})$, and hence the lower (higher) the value of z will be. z, as the log ratio of the probability to persist to the probability to default, can be taken as an inquiry for risk-taking behaviour of economic agents, which is sensitive to the change in interest rate.

$$z = f(\Delta r); \frac{\partial z}{\partial (\Delta r)} < 0 \tag{11}$$

Equation (11) implies that tightening monetary policy (increased interest rate) leads to larger pessimism, and risk-averse behaviour reduces demand for credit, high loan loss provisions, and a higher probability of the bubble to burst (Warjiyo and Juhro, 2019). In addition, higher interest rates imply higher borrowing costs. Shrunk leverage increases financial risk and consequently exacerbates financial stability (Dell'Ariccia, Laeven, and Marquez, 2014). Since the deviation of the actual asset price from its fundamental value increases, the probability of the bubble to burst becomes larger.

Proposition 4. The higher increase of the interest rates (Δr) leads to reduced z. In turn, it escalates the probability of the bubble to burst $(1 - P_{br})$ and lowers the probability of the bubble to persist (P_{br}) . As $\frac{\partial \sigma}{\partial P_{br}} < 0$, the lower P_{br} thus induces asset price misalignment, σ .

2. 3. Dilemma of the Credible Monetary Policy under the Procyclical Fiscal Policy

This channel can be explained by the combination of propositions formulated earlier. Figure 5 shows the channel through which the nature of the cyclical behaviour of fiscal policy transmits different outcomes in terms of inflation rates and the probability of a bubble to burst (or financial stability). We divide the channel into two type: procyclical fiscal policy (first nature) and countercyclical fiscal policy (second nature).

Figure 5 is here

In the first type, the outcome depends on the decisions undertaken by the monetary

authority in response to deteriorating credibility. This creates a monetary policy dilemma. Deteriorating credibility of the monetary policy originating from procyclical fiscal policy is indicated by the larger gap between targeted, actual, and expected inflation rates (Propositions 1 and 2). Attempting to regain the credibility will imply negative money growth and higher interest rates (Proposition 3). As an outcome, the interest rate crawls up and boosts the probability of default via an asset price pass-through mechanism (Proposition 4). Therefore, maintaining a credible monetary policy costs financial instability.

Hypothesis 1. Under the procyclical fiscal policy, a more credible monetary policy would generate a lower inflation rate, but with a more unstable financial sector.

What if the monetary authority does nothing to retain its credibility and lets the deterioration take place? Under these circumstances, the financial sector and the macroeconomy adversely generate a trade-off. Since the monetary authority does not lift the interest rate, the financial sector remains relatively stable (Proposition 4). However, it sacrifices the inflation rates, where an unreliable monetary policy lets the broadened gap between the actual and expected rate of inflation to persist (Proposition 2). In other words, the financial sector is stabilised at the expense of the inflation rate, which is costly for the economy.

Hypothesis 2. A less credible monetary policy under the procyclical fiscal policy would ensure financial stability, but at the expense of the inflation rate.

On the contrary, under the second type, the monetary authority would not face a dilemma. The countercyclical fiscal policy ensures lower output gaps. Therefore, it becomes a benevolent complement to monetary policy (Proposition 2). Thus, under this circumstance, monetary authority attains and chooses to maintain its credibility. Thus, monetary authority has no reason to increase interest rates significantly, which in turn lowers the probability of the bubble to burst (Proposition 4). As a result, the economy is characterised by a low inflation rate and a low probability of the bubble burst.

Hypothesis 3. Credible monetary policy and countercyclical fiscal policy promote both stable financial sectors and low inflation rates.

Empirical Strategy

2.4. Data

We construct a dataset covering 25 selected ITF countries² (i.e., Argentina³, Australia, Brazil, Canada, Chile, Colombia, Ghana, Iceland, India⁴, Indonesia, Israel, Japan (See Hong, Anand, and Hul (2019)), Mexico, New Zealand, Norway, Peru, Philippines, Poland, Republic of Korea,

² See Hammond (2012) for Australia, Brazil, Canada, Chile, Colombia, Ghana, Iceland, Indonesia, Israel, Mexico, New Zealand, Norway, Peru, Philippines, Poland, Republic of Korea, Romania, South Africa, Sweden, Turkey, and United Kingdom.

³ See Argentina's inflation targeting regime Press Conference on September 26, 2016

⁽https://www.bcra.gob.ar/Noticias/Regimen_de_Metas_de_Inflacion_en_Argentina_i.asp).

⁴ See Reserve Bank of India Act, 1934 (As amended by the Finance, No. 2, Act, 2019), Chapter IIIF Monetary Policy, Point 45ZA.

⁸

Romania, South Africa, Sweden, Turkey, the United Kingdom, and the United States⁵) from 2003 until 2017 from various data sources (see Appendix A).

2.5. Identifying the Technical Definition of Variables

Credibility of Monetary Policy

A growing body of literature suggests numerous technical approaches to define the extent of credible monetary policy. Warjiyo and Juhro (2017) define monetary policy credibility as the deviation of actual and targeted inflation. The larger the deviation of actual inflation from the target, the less credible the monetary policy. Fritsche, Slacalek, and Dovern (2009) and Kabundi and Mlachila (2018) define the credibility of monetary policy using disagreement among inflation forecasters. Less disagreement implies higher monetary policy credibility. In other words, the credibility of monetary policy using the inflation persistence approach reflecting public responsiveness to the monetary policy. Higher persistence of the inflation rate indicates lesser responsiveness of the public to the monetary policy.

Although the definitions vary, there is a core value of the Credibility Hypothesis (CH) in those definitions. In verbatim, CH is articulated as the foregone output costs of a disinflationary episode that will be smaller if the public correctly believes that the attempt will not be abandoned (see Fellner (1979)). This implies that a credible monetary policy is the outcome of harmonised-interaction between public and monetary authority, as indicated by the successful measures of the monetary authority to set the actual and expected inflation precisely at the same level.

We measure the credibility of the monetary policy using the following formula:

$$CMP = \frac{|\pi - \pi^e|}{(1 + |\pi - \pi^e|)} \times 100$$
(12)

where *CMP*, π , and π^e are the credibility of monetary policy, actual inflation rates, and expected inflation rate, respectively. In measuring the expected rate of inflation, we forecast it from a backward-looking Phillips curve in which actual inflation responds to its lagged quarterly average and to the Hodrick-Prescott detrended unemployment rate (Matteo, Marco, and Giuliana, 2013).

Cyclical Behaviour of Fiscal Policy

The cyclical behaviour of fiscal policy is related to how fiscal policy (e.g., tax, spending, and deficit/surplus budget policy) responds to business cycles. Fiscal policy is said to be procyclical when fiscal authority responds to economic expansion through an expansionary fiscal policy and responds to economic recession by a contractionary fiscal policy (Kaminsky, Reinhart, and Végh, 2004).

⁵ See FOMC meeting minutes on January 25, 2012: The Federal Reserves (the Fed) officially reached a broad agreement on the following principles regarding its longer-run goals and monetary policy strategy: Promoting maximum employment, stable prices, and moderate long-term interest rates. The Fed also formally set the medium-term inflation rates at 2 percent.

⁹

There are several approaches to identifying fiscal policy cyclicality behaviour, given devoted variables, and measurement techniques. Tornell and Lane (1999), Talvi and Végh (2005), Ilzetzki (2011), Park (2012), and Frankel, Vegh, and Vuletin (2013) have used government spending, whereas Kaminsky, Reinhart, and Végh (2004) and Camous and Gimber (2018) have used tax revenue as the fiscal instrument proxy. This shows that government spending is frequently applied to identify fiscal policy cyclicality behaviour instead of tax revenue. Park (2012) argues that using tax revenue as the variable leads to biased estimation because tax revenue inherently correlates with business cycle determinants, which are tax rates. In contrast, many papers frequently employ a regression approach to identify the fiscal policy cyclicality behaviour coefficient. However, these papers focus on the determinant factors of fiscal cyclicality behaviour. In contrast, this paper utilises fiscal cyclicality behaviour as an independent variable.

This paper uses a 20-year window rolling regression for the cyclical component of both government spending and Gross Domestic Product (GDP) to obtain cyclicality coefficients for each individual and time observation (Mcmanus and Ozkan 2015; Frankel, Vegh, and Vuletin, 2013). Furthermore, a positive correlation indicates that fiscal policy is procyclical, and *vice versa*. Specifically, the measurement of fiscal cyclicality behaviour is categorised as follows:

$$\hat{\rho}_{12,t} \begin{cases} 1 \ge \hat{\rho}_{12,t} > 0, for \ procyclical \ fiscal \ policy \\ -1 \le \hat{\rho}_{12,t} < 0, for \ countercyclical \ fiscal \ policy \end{cases}$$
(13)

where *n* is the rolling window and $\hat{\rho}_{12,t}$ is the rolling regression coefficient between the two cyclical components of government spending and GDP.

Financial Instability

Each episode of crisis generates a growing body of literature exponentially, leading to the wideranging definitions of financial instability. Nevertheless, the broad literature converges to the identical core meaning, that is the system-wide episode in which the financial system fails to function (World Bank, 2015). Unfortunately, it is difficult to find out the 'one-size fits all' meaning due to the broad dimension of the system. Hence, the measure of financial stability is usually proxied by its symptoms.

As discussed earlier, financial instability is characterised by an increased deviation of asset price away from its fundamental value (i.e., asset price misalignments). Nevertheless, the question is which indicator best approximately reflects the asset price misalignment. The severe worldwide history of crises (e.g., the tulip crisis, the south sea bubbles, the 2008 global financial crisis, and so on) has captured asset price misalignment occurrence, which is identical to the downturn of the stock market (Johannessen, 2017). Meanwhile, similar to Johannessen (2017), Taipalus (2012) developed the asset price misalignment indicators using stock-market-based data. Their results show that the indicators can locate the periods that are quoted as severe boom or bust periods in asset prices. Likewise, Vila (2000), Okina, Shirakawa, and Shiratsuka (2001), Malkiel (2010), and Fouejieu, Popescu, and Villieu (2019) use stock-market-based indicators, specifically the Morgan Stanley Capital International (MSCI) stock index as a measure of asset price bubbles. This suggests that the stock market may approximately reflect asset price misalignment. For the asset price misalignment measure, we adopt the detrended MSCI index, estimated using an absolute gap

between the actual MSCI index and its fundamental value.⁶ Therefore, in this regard, a period of excessive asset price misalignment is identified by a widened detrended MSCI index.

2. 6. Model Specification

The objective of this paper is to explain the malevolent effects of credible monetary policy under the procyclical fiscal policy on the inflation rate and financial stability. The models scrutinise the effect of a credible monetary policy on inflation rates and financial stability conditional on the cyclical behaviour of fiscal policy.

Furthermore, the model estimates contain the interaction-term variable of monetary credibility (CMP) and fiscal cyclicality (FCB). We technically use the term of primary effect for the coefficient of CMP and the augmented effect for the interaction term coefficient. The interaction-term variable facilitates the analysis of the consequences of each kind of fiscal cyclicality behaviour towards the impact of the credible monetary authority on inflation rates, economic growth, and financial stability.

We start with the first model estimate, aiming to examine the impact of a credible monetary policy on inflation rates under a procyclical fiscal policy. This estimate follows the standard determination model of inflation, which includes the money growth rate, exchange rates, unemployment rates, and public debt as controlled variables (see e.g., Woodford, 1994; Totonchi, 2011; Alisa, 2015). The model is as follows:

$$\pi_{i,t} = \alpha_0 + \delta_1 \pi_{i,t-1} + \alpha_1 CMP_{i,t} + \alpha_2 (CMP_{i,t} \times FCB_{i,t}) + \gamma \mathbf{Z}_{i,t} + u_{i,t}$$

$$\pi_{i,t} = \alpha_0 + \delta_1 \pi_{i,t-1} + (\alpha_1 + \alpha_2 FCB_{i,t}) CMP_{i,t} + \gamma \mathbf{Z}_{i,t} + u_{i,t}$$
(14)

,

where π , *CMP*, *FCB*, γZ are inflation rate, monetary policy credibility, cyclicality character of fiscal policy, and vector of parameter and controlled variables, respectively. α_1 and $\alpha_2 FCB_{i,t}$ denote the primary effect and augmented effect of monetary policy credibility, respectively.

Lastly, we proceed to the second model estimate, aiming to analyse the aftermath of monetary policy credibility on financial stability conditional on the cyclical behaviour of fiscal policy. Specifically, the model also involves several control variables such as trade openness, exchange rates, and debt to GDP ratio (e.g., see Fouejieu et al., 2019) The model is as follows:

$$\rho_{i,t} = \alpha_8 + \delta_3 \rho_{i,t-1} + \alpha_9 CMP_{i,t} + \alpha_{10} (CMP_{i,t} \times FCB_{i,t}) + \tau \boldsymbol{Q}_{i,t} + u_{i,t}$$

$$\rho_{i,t} = \alpha_8 + \delta_3 \rho_{i,t-1} + (\alpha_9 + \alpha_{10} FCB_{i,t}) CMP_{i,t} + \tau \boldsymbol{Q}_{i,t} + u_{i,t}$$
(15)

where ρ , τQ , and $(\alpha_9 + \alpha_{10}FCB_{i,t})$ are stock volatility, the vector of parameters and control variables, and the net effect of monetary policy credibility on stock volatility, respectively.

As we are dealing with the inclusion of lagged dependent variables in the model, the standard panel data regression would lead to biased and inconsistent estimation because the Lagged Dependent Variables (LDV) would be correlated with the Composite Error Term (CET)

⁶ Fundamental values of MSCI are estimated using the Hodrick-Prescott Filter.

¹¹

by construction (Baltagi, 2005). Thus, we employ the Generalised Method of Moment (GMM). However, in deciding between the Differenced- or System-GMM to be employed, we follow the standard procedure developed by Stephen Bond (Roodman, 2009). The rules of thumb critically decide the selection between Difference- or System-GMM, which utilises the first-order LDV coefficient of Difference-GMM (δ_{FD-GMM}), Pooled Least Square (δ_{PLS}), and Fixed Effect (δ_{FE}). The estimated δ_{PLS} is considered to be biased upwards, while the estimated value of δ_{FE} is considered to be biased downward (Bond, 2002). When the estimated value of δ_{FD-GMM} lies below or closer to δ_{FE} than to δ_{PLS} , System-GMM is suitable for estimation, and *vice versa* (Roodman, 2009).

Table 1 is here

From Table (1), we obtained the estimated values of δ_{FD-GMM} , δ_{PLS} , and δ_{FE} for the first and second model estimates. For the first model estimate, we see that δ_{FD-GMM} lies below δ_{FE} and δ_{PLS} ($\delta_{FD-GMM} < \delta_{FE} < \delta_{PLS}$). Therefore, System-GMM is suitable for estimating the first model. For the second model, the estimated value of δ_{FD-GMM} is greater than δ_{FE} and relatively far below δ_{PLS} . Therefore, estimation using System-GMM is more suitable for the second model.

3. Results

This section elucidates the estimation results and discusses them. It begins with statistical inferences followed by the construe of the meaning of empirical findings within the theoretical framework discussed earlier.

3.1. Estimation Result

Table 2 shows the estimation results. We begin by exploring the empirical relationship between inflation rates and monetary policy credibility under the procyclical fiscal policy (model 1). The results show a positive net effect of monetary policy credibility on inflation rates, formed by significant positive primary effect and insignificant augmented effect. This implies that the cyclical behaviour of fiscal policy does not affect the outcomes of monetary credibility on the inflation rate reduction. In other words, it suggests that inflation remains low along with a more credible monetary policy, irrespective of the cyclical behaviour of fiscal policy. However, we also found that actual inflation is not driven by one-year lagged inflation. This indicates the flexibility of price changes.

Table 2 is here

A significant effect of money growth on the inflation rate with a positive sign indicates that higher the growth of money, higher the inflation rates. The result is parallel to the classical theory of money or the monetarist view (see Friedman (1968)). A significant effect of exchange rates with a negative sign on the parameter suggests that currency depreciation leads to higher inflation. The result provides evidence to the exchange rates pass-through hypothesis (see Taylor (2000)). A significant effect of public debt on the inflation rate with a negative sign on the parameter indicates that an increase in public debt irregularly reduces inflation rates. Higher public debt potentially reduces the incentive to accumulate more public debt, and prioritises fiscal sustainability instead (Park, 2012).

¹²

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Finally, we wrap up the estimations by scrutinising the empirical relationship between monetary policy credibility and financial stability under the procyclical fiscal policy. The estimation output shows that a credible monetary policy generates higher asset price misalignment under a procyclical fiscal policy. Technically, it is indicated by a negatively significant net effect under the procyclical fiscal policy. In contrast, under the countercyclical fiscal policy, the credible monetary policy maintains a stable financial system, which is indicated by a positive net effect. The remaining variables of the model estimate show a significantly negative effect of the first lagged asset price misalignment on its actual value. This finding contradicts our theoretical foundation. However, it is consistent with the Minsky Instability Hypothesis, which states that a stable condition may actually induce instability in the future (Angerma, 2013).

3.2. Robustness Checks

To ensure robust estimations, we employ estimation consistency checks with different variable measurements. First, the expected inflation, which is a component of monetary credibility (CMP) measurement, is estimated using the Hodrick–Prescott Filter (HP-Filter). Correia, Neves, and Rebelo (1995) explain that the backward-forward model estimation of HP Filter performs well in measuring the approximate value of expected inflation rates. The second strategy to afford robust findings and rationalisations is that we not only employ a rolling regression for the cyclical behaviour of fiscal policy measurement, but also a rolling correlation with a 20-years window ($\hat{\tau}_{,t}$). It measures the correlation between the cyclical component of real GDP and government expenditure. Therefore, the measurement of fiscal cyclicality behaviour is interpreted as follows:

$$\hat{\tau}_{,t} \begin{cases} 1 \ge \hat{\tau}_t > 0, for \ procyclical \ fiscal \ policy \\ \hat{\tau}_t = 0, \ for \ acyclical \ fiscal \ policy \\ -1 \le \hat{\tau}_t < 0, \ for \ countercyclical \ fiscal \ policy \end{cases}$$
(16)

For the last robustness check, we strive to scrutinise the consistency estimation for the financial system stability variable, as it is problematic to find out a 'one-size fits all' measurement due to the broad dimension of the system. Hence, we also operate the Bank Z-score as the financial system stability variable. Bank Z-score is frequently used and becomes a popular indicator of financial system stability because of its ability to capture the banking system's risk-taking behaviour (Li and Malone, 2016). This strategy is essential because it implies that our robustness check on financial system stability comprises not only a test for measurement consistency but also a consistency test to check if the assumption of financial stability is different from what we define earlier.

First, we explore the correlation between the main variables (see Table 4 in appendix B). The correlation analysis shows that the monetary credibility variables are positively correlated with the backward-Phillips-style CMP by 24 percent. This implies variation in the values among the CMP measurement, although all have the same direction, which means that a higher CMP implies less credible monetary policy, and *vice versa*. For the fiscal cyclicality variables, we find that both regression and correlation approach measurements are strongly correlated. Finally, we examine the correlation between the financial stability variables, that is, detrended MSCI index and Bank Z-score. The correlation coefficient indicates that the Bank Z-score and MSCI index are weakly correlated. This suggests that it is difficult to define financial stability directly with one

measurement as there is a broad meaning of the system. Therefore, through this robustness test, we encompass the examination of a different approach that defines financial stability.

We employ ten estimations for a robustness test that combines various variable measurement approaches (see Table 5 and 6 in appendix B). Based on the rule of thumb for GMM estimator selection, we mostly use the System-GMM (see Table 7 and 8 in appendix B). Most robustness tests show that the role of monetary credibility in lowering inflation is empirically robust. We find that in estimations (1) and (3), the lower the CMP (i.e., credible monetary policy), the lower the inflation rates. The interaction term between monetary credibility and fiscal cyclicality is empirically insignificant, although we find it to be significant in estimation (2). Based on our robustness test results, we can conclude that most estimations indicate that fiscal cyclicality may not disrupt the advantage of monetary credibility in lowering inflation rates.

For the examination of financial stability, however, we find that both monetary credibility and the interaction term significantly affect financial stability measured only by the detrended MSCI index but not the Bank Z-score. Therefore, our robustness test estimation suggests that our findings are consistent as long as financial instability is measured by asset price alignment. On the contrary, the fact that our estimations are not consistent with other measurements implies the difficulty to find out a 'one-size fits all' measurement for the financial system stability, due to the broad dimension of the system.

4. Concluding Remarks

This study examines the role of monetary credibility and fiscal cyclicality in generating the tradeoff between inflation rates and financial stability. We systematically develop simple models to shape the rationalisation framework, which demonstrates the role of fiscal cyclicality behaviour in arousing a trade-off for the monetary policy to target low inflation rates and a stable financial system at once. On one hand, when the fiscal policy is procyclical, and the monetary authority decides to pursue its credibility, it causes low inflation but at the expense of financial stability. On the other hand, if the monetary authority decides to let its credibility deteriorate, it will effectively ensure financial stability but not lower inflation rates.

In this paper, we find that a credible monetary policy does not always generate financial instability, and it necessarily depends on fiscal policy. First, we find that a credible monetary policy may promote not only financial stability but also lower inflation rates as long as the fiscal policy is countercyclical. In contrast, the procyclical fiscal policy leaves the monetary policy facing a trade-off between inflation and financial stability. Table 3 shows the outcomes.

Table 3 is here

The pro-cyclical fiscal policy will initially deteriorate the credibility of monetary policy by generating a gap between targeted, actual, and expected inflation rates. Therefore, the monetary authority will try to attain its credibility by employing a negative money growth policy, which also significantly increases interest rates, to adjust the deviation between targeted, expected, and actual inflation rates. However, a significant increase in interest rate implies higher borrowing costs, reduced leverage, and increased financial risk, consequently exacerbating financial stability (Dell'Ariccia, Laeven, and Marquez, 2014). In contrast, if the fiscal policy is countercyclical, there are no reasons for the monetary authority to raise interest rates quickly or, at least, step by step. Furthermore, the countercyclical fiscal policy could restrain excessive booms and busts of business

cycles, thereby reducing the procyclicality of the financial sector, thus generating not only a stable inflation rate but also financial stability.

4.1. Suggestions for Further Research

There are several gaps in this paper. First, this paper excludes the role of macroprudential policy as one of the actors in a 'lean-against-the-wind' policy. Second, it implies that there could be a dynamic interaction between fiscal, monetary, and macroprudential policy in determining both inflation rates and financial stability regarding their cyclicality behaviour. These gaps could be satisfied with a more general construction, such as a game-theoretical framework, and so on.

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Operational Variables Measurement/Unit of Account Sources Description Author's Smoothed value of The Credibility calculation, $CMP = \frac{\left|\pi - \pi^{e}\right|}{\left(1 + \left|\pi - \pi^{e}\right|\right)} \times 100$ absolute deviation of Monetary Bank for between actual and Policy International expected inflation. Settlement $\hat{\sigma}_{12,t}^{2}(n) = \frac{1}{n-1} \sum_{t=0}^{n} (y_{1t} - \hat{\mu_{1t}}(n)) (y_{2t} - \hat{\mu_{2t}}(n));$ Correlation between cyclical components of $\hat{\rho}_{12,t}(n) = \frac{\hat{\sigma}_{12,t}^2(n)}{\hat{\sigma}_{1,t}^2(n) \times \hat{\sigma}_{2,t}^2(n)},$ government expenditure Cyclicality World Bank and real GDP. The rolling correlation coefficient (20 Behaviour of Data, Penn years window) **Fiscal Policy** World Table Regression between $\tau_t^c = \alpha_t + \beta y_t^c + \varepsilon_t;$ cyclical components of real GDP with respect to The rolling regression coefficient (20 cyclical components of years window) government expenditure. Bank for The annual growth rate Percentage change Inflation Rates International of CPI. (2010=100)Settlement World General government Public Debt Percentage of GDP Economic gross debt. Outlook Growth of Broad Money World Bank Money Growth Percentage change (M2) Data Exchange Real effective exchange Index IFS and (2010=100)FRED Rates rates (REER). Stock price volatility is Global the average of the 360-Financial Stock day volatility of the Development Index Volatility national stock market Dataset index. (GFDD) Morgan Stanley Capital MSCI Bloomberg International Index Index Global Default probability of Financial **Bank Z-score** Index Banking sector Development Indicators World Unemployment Unemployment to Percentage Economic Labour Force Ratio. Rate Outlook

Appendix A. Variables, Measurement, and Data Sources

Appendix B. Robustness Check

	CMP (HP- Filter)	CMP (Backward PC)	Fiscal Cyclicality (Rolling Regression)	Fiscal Cyclicality (Rolling Correlation)	MSCI Index (HP- Filter Detrended)	Bank Z- score
CMP (HP-Filter)	1.000					
CMP (Backward PC)	0.241	1.000				
Fiscal Cyclicality (Rolling Regression)	0.257	0.217	1.000			
Fiscal Cyclicality (Rolling Correlation)	0.218	0.259	0.778	1.000		
MSCI Index (HP- Filter Detrended)	0.163	0.462	-0.049	-0.084	1.000	
Bank Z-score	-0.238	-0.008	-0.123	-0.267	-0.087	1.000

Table 4Correlation Coefficients

 Table 5

 Robustness Checks (First Model Estimate)

	(1)	(2)	(3)
Inflation (-1)	.1151723 (.1080789)	.1661463 (.1136786)	.1930638* (.1164458)
Monetary Credibility (HP-Filter)	.1894311*** (.0717202)	.0481322 (.0597511)	
Monetary Credibility (Backward-Phillips)			.0384936*** (.0109615)
Monetary Credibility (HP-Filter) × Fiscal Cyclicality (Rolling Correlation)		.3615075** (.1655804)	
Monetary Credibility (Backward-Phillips) × Fiscal Cyclicality (Rolling Correlation)			025391* (.0145016)
Monetary Credibility (HP-Filter) × Fiscal Cyclicality (Rolling Regression)	.0727115 (.1309639)		
Money Growth	0012045*** (.0003174)	.0011093*** (.0003228)	.0012558*** (.0003439)
Real Effective Exchange Rates	0006311*** (.0001699)	0005635*** (.000156)	000612*** (.0001833)
Unemployment Rate	.0013861 (.0522805)	.0024956 (.0485775)	0054631 (.0430383)
Public Debt	0001462*** (.0000507)	0001291*** (.0000418)	000136** (.0000573)
Constant	.084406 (0196644)	.0761532 (.0178055)	.0828307 (.0204109)
Serial Correlation (<i>z</i> -Prob.)	0.233	0.321	0.236

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	(1)	(2)	(3)
Hansen Test (Chi-squared Prob.)	0.182	0.149	0.105
Wald-Stat (5)	160.35***	280.26***	135.89***
Number of Instruments	21	21	21
Number of Observation	341	341	341
Number of Group (Countries)	25	25	25
Estimator	System	System	System
Loumator	GMM	GMM	GMM

Notes: (1) and (2) represent the results of the first, second, and third model estimates, respectively. Stars denote statistical significance *, **, and *** at 10%, 5%, and 1%, respectively. Numbers in parentheses, (), represent the Windmeijer standard error. These two estimations show no serial correlation (represented by z-prob. of serial correlation) with valid instruments (insignificant chi-squared probability of the Hansen test).

Table 6
Robustness Checks (Second Model Estimate)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
MSCI (-1)	.156586*** (.0037014)	.2018108*** (.006666)	05802*** (.0026377)				
Bank Z-score (-1)				.3693287 (.2977206)	.4416043** (.2223191)	.4098119* (.2192062)	.41571* (.2163226)
Monetary Credibility (HP-Filter)	.0701031** (.0353772)	.1165757*** (.0364783)		-16.48531 (27.56051)	2.147489 (13.08129)		
Monetary Credibility (Backward- Phillips) Monetary Credibility			.159635*** (.0081241)			-2.365831 (2.768966)	-2.264424 (1.781357)
(HP-Filter) × Fiscal Cyclicality (Rolling Correlation) Monetary Credibility (Backward-		1987403** (.1009005)			-40.7567 (25.83604)		
Phillips) × Fiscal Cyclicality (Rolling Correlation) Monetary Credibility			17017*** (.0079215)				1.800333 (2.397058)
(HP-Filter) × Fiscal Cyclicality (Rolling Regression) Monetary	1312682 (.0967996)			-8.80234 (36.41416)			
Credibility (Backward- Phillips) × Fiscal						3.311493 (8.242095)	

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Cyclicality (Rolling Regression)							
Trade Openness	0095402 (.0096171)	0084825 (.0086766)	0002196 (.002315)	-5.516071 (4.611552)	-3.288141 (4.643107)	-5.804255 (3.816372)	-5.631753 (3.886811)
Real Effective Exchange Rates	0000298 (.0000351)	0000434 (.0000374)	. 0000779 (.0001005)	0275043 (.0371379)	0374014 (.038767)	0389234 (.0356007)	0376827 (.0358599)
Public Debt	0000556 (.0000549)	0000504 (.0000464)	-4.71E-07 (9.90E-06)	.026472 (.0439433)	.0135088 (.0408876)	.0227526 (.0427816)	.0221612 (.0420777)
Constant	.0130698 (.013255)	.0142077 (.0136327)	0102504 (.010027)	12.51702 (6.657739)	11.5169 (5.211145)	12.73614 (12.73614)	12.49747 (4.933419)
Serial Correlation (Z- Prob.)	0.318	0.318	0.313	0.079	0.060	0.072	0.074
Hansen Test (Chi-squared Prob.)	0.199	0.212	0.045	0.143	0.106	0.307	0.298
Wald-Stat (5)	28401.6***	23564.5***	89674.9***	25.66***	14.25**	14.85**	169.14***
Number of Instruments	20	20	20	19	19	19	19
Number of Observation	350	350	350	325	325	325	325
Number of Group (Countries)	25	25	25	25	25	25	25
Estimator	System GMM	System GMM	System GMM	System GMM	System GMM	System GMM	System GMM

Table 7
GMM Rule of Thumb for Robustness Checks (First Model Estimate)

Vari	able Combinations		δ_{PLS}	δ_{FE}	δ_{FD-GMM}	Estimator Selection
CMP	Fiscal Cyclicality (Rolling Regression)	Inflation	.5685337	.2965623	.1962958	System GMM
(HP-Filter)	Fiscal Cyclicality (Rolling Correlation)	Rates	.5715414	.3440067	.2510438	System GMM
CMP (Backward Phillips Curve)	Fiscal Cyclicality (Rolling Correlation)	Inflation Rates	.5660908	.2414336	.2180608	System GMM

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	Variable Combinations		δ_{PLS}	δ_{FE}	δ_{FD-GMM}	Estimator Selection
	Fiscal Cyclicality (Rolling	De-trended MSCI	.2108999	0506429	0496313	System GMM
CMP (HP-	Regression)	Bank Z-score	.9172721	.2880967	.3519971	System GMM
Filter) Fi	Fiscal Cyclicality (Rolling	De-trended MSCI	.5790135	0660833	065003	System GMM
	Correlation)	Bank Z-score	.9131476	.2904428	.3597646	System GMM
CMP	Fiscal Cyclicality (Rolling Regression)	Bank Z-score	.9237517	.2759005	.2759005	System GMM
(Backward Phillips Curve)	Fiscal Cyclicality (Rolling Correlation)	De-trended MSCI	.0045335	0508041	0498093	System GMM
		Bank Z-score	.9237792	.288805	.3200156	System GMM

 Table 8

 GMM Rule of Thumb for Robustness Checks (Second Model Estimate)

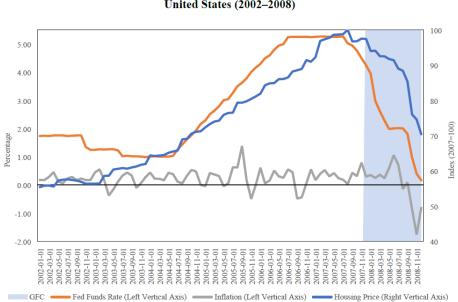
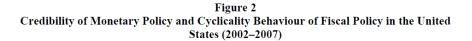
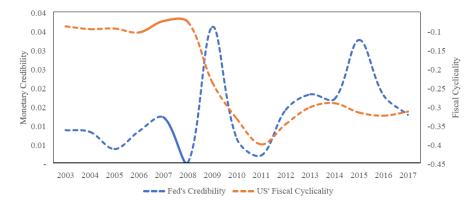


Figure 1 Inflation Rate, Fed Fund Rate, and Housing Price in the United States (2002–2008)

Source: Federal Reserves of Economic Data (FRED) and Green Street Advisor (GSA).

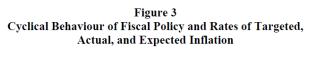


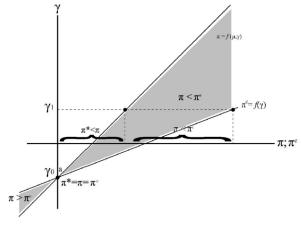


Source: Authors' calculations.

Notes: The cyclical behaviour of fiscal policy has been estimated using a 20-year rolling regression between cyclical components of government expenditure and real GDP. A positive (negative) correlation indicates procyclical (countercyclical) fiscal policy. The credibility of monetary policy has been estimated using the calculated value of absolute deviation between actual and expected inflation. A higher (lower) CMP indicates a more (less) credible monetary policy. The rate of expected inflation is generated from a backward-looking Phillips Curve, in which actual inflation responds to its lagged quarterly average and the Hodrick-Prescott detrended unemployment rate (Matteo, Marco, and Giuliana, 2013).

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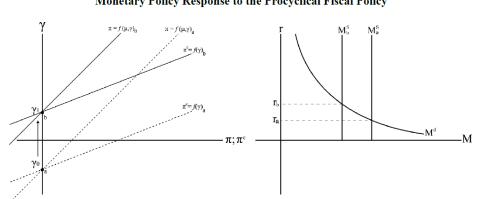
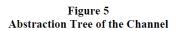
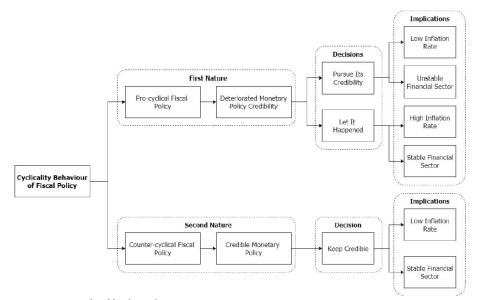


Figure 4 Monetary Policy Response to the Procyclical Fiscal Policy





Notes: conceptualised by the authors.

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:	Table 1 Estimated LDVs' Coefficient	
	First Model Estimate	Second Model Estimate
Pooled Least Square (δ_{PLS})	.5632988	.2108999
Fixed Effect (δ_{FE})	.3171388	0506429
Difference-GMM (δ_{FD-GMM}	.2214667	0496313
,	$\delta_{FD-GMM} < \delta_{FE} < \delta_{PLS}$	$\delta_{FE} \ll \delta_{FD-GMM} < \delta_{PLS}$

	Model E	stimates			
-	Inflation	Asset Price Misalignment			
Inflation (-1)	.1861313 (.1166045)	~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~			
Asset Price Misalignment (- 1)		0425327*** (.0049759)			
Monetary Credibility	.035003*** (.0100785)	.1335766*** (03608)			
Monetary credibility × Fiscal Cyclicality	0409745 (.0364007)	2727361*** (.094729)			
Trade Openness		.0060955 (.0040192)			
Money Growth	.0012769*** (.0003429)	()			
Real Effective Exchange Rates	0006093*** (.0001795)	.000091 (.0001035)			
Unemployment Rate	0018963 (.0441323)				
Public Debt	0001354** (.000054)	0000281 (.0000279)			
Constant	.0823579 (.0200451)	013234 (.0114176)			
Serial Correlation (z-Prob.)	0.256	0.314			
Hansen Test (Chi-squared Prob.)	0.108	0.229			
Wald-Stat (5)	148.44***	1283.44***			
Number of Instruments	21	20			
Number of Observation	341	350			
Number of Group (Countries)	25	25			
Estimator	System-GMM	System-GMM			

Table 2 Estimation Results

Notes: (1) and (2) represent the results of the first, second, and third model estimates, respectively. Stars denote statistical significance *, **, and *** at 10%, 5%, and 1%, respectively. Numbers in parentheses, (), represent the Windmeijer standard error. These two estimations show no serial correlation (represented by *z-prob.* of serial correlation) with valid instruments (insignificant chi-squared probability of the Hansen Test). We instrument all independent variables, as we assume that each model is with strictly exogenous independent variables.

Table 3 Fiscal Policy and Monetary Policy Credibility Outcomes Toward Inflation and Financial Stability

		Fiscal	l Policy
		Procyclical	Countercyclical
Monetary Policy	Credible	Low; Unstable	Low; Stable
	Non-Credible	High; Stable	

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Inflation and Financial Stability Tradeoff: Role of Monetary Policy Credibility and Fiscal Cyclicality

Authors

Akhmad Syakir Kurnia, Syahid Izzulhaq, Johan Beni Maharda, Agung Kunaedi

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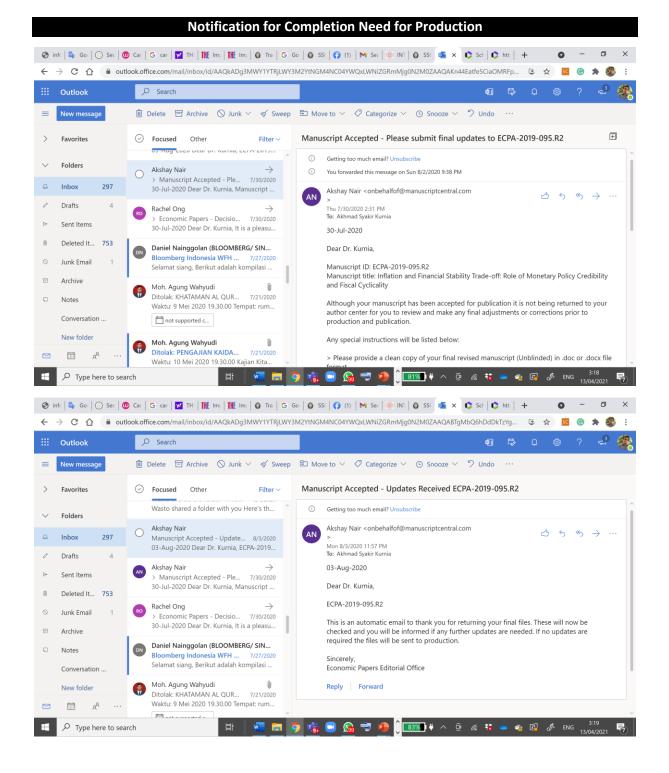
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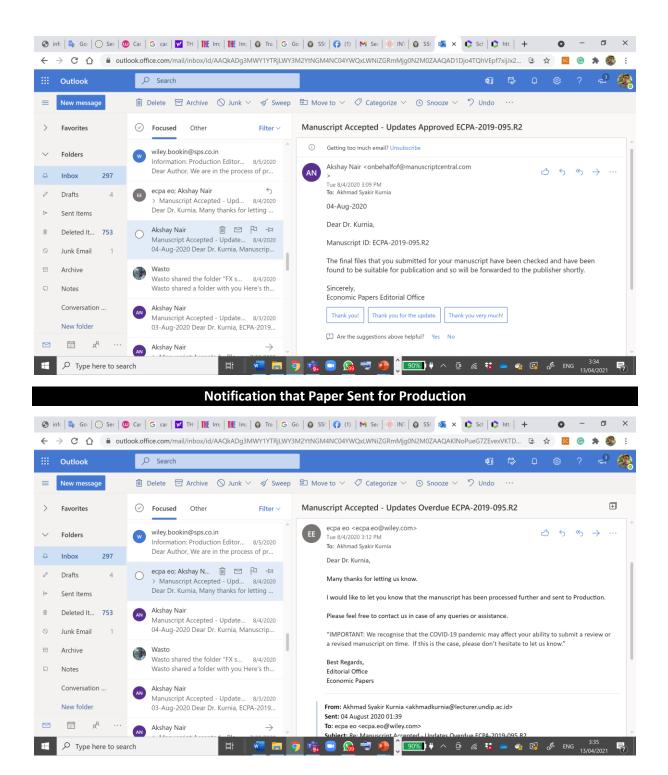
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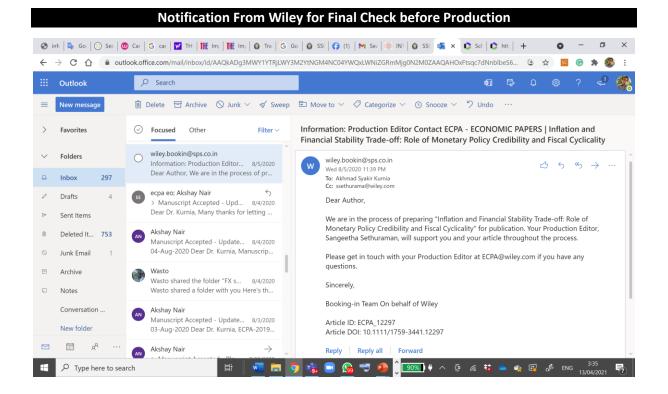
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Inflation and Financial Stability Trade-off: Role of Monetary Policy Credibility and Fiscal Cyclicality

Akhmad Syakir Kurnia 🝺 Syahid Izzulhaq 🝺 Johan Beni Maharda and Âgung Kunaedi

This paper examines the role of monetary credibility and fiscal cyclicality in generating the trade-off between inflation rates and financial stability. We systematically develop simple theoretical models to shape the rationalisation framework, which demonstrates the role of fiscal cyclicality behaviour in arousing a trade-off for the monetary policy to target low inflation rates and a stable financial system at the same time. By utilising the generalised method of moment (GMM), we find that a credible monetary policy generates a trade-off between inflation and financial stability as long as the fiscal policy is procyclical.

Keywords: credibility of monetary policy, procyclical fiscal policy, inflation and financial stability.

1. Introduction

The global financial crisis and the prolonged uncertainty of financial instability, together with a protracted economic recovery in their aftermath, have aroused hesitation regarding the role of monetary policy. This hesitation is not only on price stability goals but also on financial stability goals (Bordo & Siklos, 2015). However, ensuring low inflation and a stable financial sector at once is much more challenging for the monetary authority than merely focusing on a low and stable inflation rate. It becomes one of the monetary authority's significant concerns, as inflation and the financial sector frequently generate a severe trade-off.

Recent literature has pointed out the monetary policy dilemma of inflation and financial stability from several viewpoints. Geraats (2010) argues that whether price and financial stability are complementary or contradictory objectives depends on the type of economic shocks. In their characterisation of economic shocks, Jonsson and Moran (2014) also support these arguments. They argue that a trade-off between price and financial stability may arise if supply shocks drive economic fluctuations. Kim and Mehrotra (2015) suggest that-ex-post-there may have been a short-term policy trade-off for central banks with both financial and price stability objectives.

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Department of Economics, Faculty of Economics and Business, Diponegoro University Semarang, Indonesia. JEL classifications: E52, E58, E63

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There is a growing literature that focuses on risk-taking behaviour channels that generate a tradeoff between inflation and financial stability. Using the Taylor-style monetary policy rule in the possibility of reacting to banks' short-term liabilities, Shukayev and Ueberfeldt (2018) find that central banks need to accept higher levels of inflation and output volatility. In other words, there is still a policy trade-off between price and financial stability. Patnaik *et al.* (2019) examine the inflation–financial stability trade-off faced by monetary policy in the case of India. They find robust evidence of the trade-off between price and financial stability. This implies that the conduct of monetary policy may constrain the ability of a central bank to target financial stability with monetary policy instruments. Fouejieu *et al.* (2019) provide a framework to investigate trade-off between macroeconomic and financial stability when the central bank has a financial stability objective. Relying on a New Keynesian model with an endogenous financial bubble, their simulations suggest that a central bank attempting to "lean against the wind" may face trade-off between inflation/output stability, and financial stability.

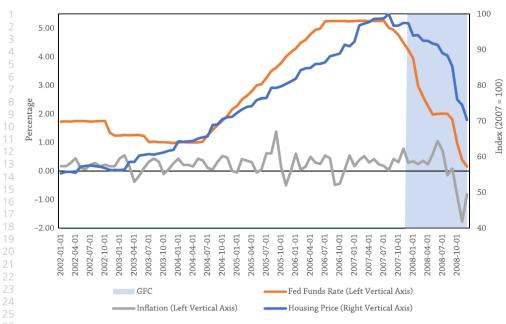
The proponents of this view also mention the role of credible monetary policy in defining what is characterised as the low-interest and inflation rate period in generating financial instability. According to the risk-taking channels Borio and Zhu (2012), maintaining low-interest rates for a protracted period increases financial risks through higher incentives to search for yields (Rajan, 2005). Jordà et al. (2015) use a large data set to document how loose monetary conditions have historically boosted real estate lending and house price bubbles, especially in the post-war period. For financial corporations, low-interest rates can increase interest margins, boost the firm's value and increase leverage, which ultimately translates into higher risk exposure (Adrian & Shin, 2010). Gambacorta (2009) also states that credible monetary policy has resulted in a protracted low-interest-rate episode that leads to an increase in banks' risk-taking behaviour, and accordingly promotes financial instability. Kim and Mehrotra (2015) assess the trade-off between financial stability and price stability by looking at the interaction between financial stability and actual-targeted inflation deviation-which can also be interpreted as monetary credibility (see Warjiyo & Juhro, 2019)-in Australia, Indonesia, Korea, New Zealand, Philippines and Thailand from 2000 to 2014. They find that about 12% of the observed country-years are characterised by the trade-off between monetary credibility and financial stability.

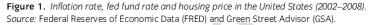
However, the way we see how the trade-off between inflation and financial instability occurs is slightly different. Looking at the US economy, a low inflation rate straightforwardly occurs with a gradual increase in interest rates (see Figure 1). Monetary policy is implemented in response to financial instability within inflation targeting. Thus, when using the interest rate as the policy instrument to achieve targeted inflation, the interest rate would have to be adjusted in response to an increased probability of financial default. The hike of asset price increases the value of collateral, boosts leverage, pushes both consumption and aggregate demand, and thus elevates inflation rates. To maintain a credible monetary policy with the inflation rate in order, the conduct of monetary policy will adjust interest rates upwards. Therefore, a credible monetary policy is not associated with a low-interest rate but with stable inflation.

Instead of charging the monetary authority with blame, we argue that there is also an important role of fiscal cyclicality behaviour. Figure 2 shows that before the bubble was about to burst in 2008, the Fed's monetary policy was more credible under the relatively more procyclical fiscal policy, which means that the US government tried to push the economy excessively, while the monetary authority persistently kept fighting against inflation. Therefore, under this circumstance, the economic policy was characterised by unharmonised coordination.

To shed light on the responsibility of an unharmonised economic policy, we develop a simple model to explain this situation. Our model demonstrates that in the initial condition, a procyclical fiscal policy distorts the credibility of monetary policy. Procyclical fiscal policy causes divergences in the targeted inflation rate, actual inflation rate and expected inflation rate. Afterwards, the monetary authority must decide whether to pursue its credibility or let it deteriorate. However, the monetary authority faces a dilemma related to the available options. On one hand, if the monetary authority decides to pursue its credibility, it causes low inflation and exacerbates financial instability. On the

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other hand, if the monetary authority decides to let its credibility deteriorate, it will effectively ensure financial stability but not lower inflation rates.

This paper elucidates the impact of the combination of monetary policy credibility and fiscal cyclicality on financial stability and inflation rates. Furthermore, we attempt to highlight the importance of policy coordination on the cyclical behaviour of fiscal policy, and the monetary policy to respond to it. For the empirical investigation, we employ the generalised method of moment (GMM) method involving 25 selected inflation-targeting framework (ITF) countries from 2003 to 2017.

To the best of our knowledge, there is one crucial point that differentiates this paper from previous research. This paper addresses the trade-off between inflation rates and financial stability considering the role of monetary credibility and fiscal cyclicality behaviour, while the existing literature has not yet addressed the role of fiscal cyclicality. Thus, we make every effort to significantly contribute to the development of literature related to the topics of monetary policy/ authority credibility, fiscal cyclicality and inflation–financial stability trade-off. Another motivation of this paper is to examine the role of monetary credibility and fiscal cyclicality in generating the trade-off between inflation rates and financial stability. We find robust evidence that suggests that a credible monetary policy generates a trade-off between inflation and financial stability if the fiscal policy is procyclical.

The rest of this paper is organised as follows. Section II elaborates on a theoretical foundation. Section III presents the empirical strategy regarding the definition of variables, the measurements and the devoted econometric method to estimate the parameters. Section IV presents the empirical findings and its discussion. Section V provides both remarks and policy recommendations.

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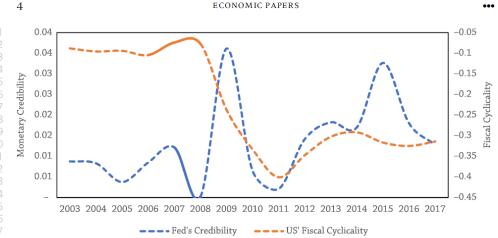


Figure 2. Credibility of monetary policy and cyclicality behaviour of fiscal policy in the United States (2002–2007). Source: Authors' calculations.

Notes: The cyclical behaviour of fiscal policy has been estimated using a 20-year rolling regression between cyclical components of government expenditure and real GDP. A positive (negative) correlation indicates procyclical (countercyclical) fiscal policy. The credibility of monetary policy has been estimated using the calculated value of absolute deviation between actual and expected inflation. A higher (lower) CMP indicates a more (less) credible monetary policy. The rate of expected inflation is generated from a backward-looking Phillips Curve, in which actual inflation responds to its lagged quarterly average and the Hodrick-Prescott detrended unemployment rate (Matteo, Marco, & Giuliana, 2013).

2. Simple Model

The set-up of the model aims to scrutinise the role of monetary policy credibility and fiscal cyclicality in shaping the nexus between inflation rates and financial instability. This section is organised as follows. The first section begins with the interdependency between the credibility of monetary policy and procyclical fiscal policy. The second section elucidates the financial instability model. Finally, the third section highlights the dilemma of credible monetary policy within procyclical fiscal policy.

2.1. Interdependency between Monetary Policy Credibility and Procyclical Fiscal Policy

We begin with the monetary policy credibility model developed by Barro and Gordon (1983), focusing on the role of the money growth policy. In this model, we augment the cyclicality of fiscal policy with the assumption that monetary policy transmission is imperfect. Thus, the model is expressed as follows:

$$\pi = \mu + \beta \cdot \gamma; \pi'(\gamma) > 0 \tag{1}$$

where π , μ , γ and β are inflation rates, money growth, degree of fiscal policy cyclicality behaviour and parameter of γ , respectively. Equation (1) describes a positive relationship between inflation rates and cyclical behaviour of fiscal policy $\pi'(\gamma) > 0$ indicates that if the fiscal policy is procyclical, then the constant money growth policy is more inflationary. Therefore, it also shows the imperfect transmission of monetary policy ($\pi \neq \mu$). Kaminsky et al. (2004), Mcmanus and Ozkan (2015), and Izzulhaq and Kurnia (n.d.) have revealed that the procyclical fiscal policy may affect the inflation rates by "turning sunny days into scorching infernos." That is, procyclical expansions in government expenditure excessively boost the aggregate demand, and set the economy into the "over-heated" circumstances, therefore causing the inflation rates to soar.

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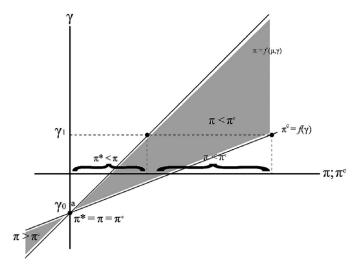


Figure 3. Cyclical behaviour of fiscal policy and rates of targeted, actual and expected inflation.

Targeting the inflation rate as the goal of monetary policy in ITF implies a sacrifice ratio to be borne in mind. There must be a cost of forgone output due to stable and low inflation rates. Consequently, a credible monetary policy is unavoidably characterised as countercyclical. Provided the trade-off between inflation and output, the central bank has the following single-period loss function to minimise:¹

$$L = a(\pi - \pi^*)^2 + (y - y^*)^2; y^* = k.y^n$$
(2)

where π^* , *y*, y^* , y^n and *k* are targeted inflation rates, output level, targeted output level, potential output and temptation parameter, respectively. Given the trade-off between inflation rates and output level, achieving low inflation rates implies that some of the output is sacrificed, *ceteris paribus*. Theoretically, it is represented by a Lucas supply shock:

$$y = y^n + b(\pi - \pi^e) \tag{3}$$

where π^{e} is the expected inflation rate.

Substituting equations (1) and (3) in equation (2) and taking the first-order condition, we obtain the optimal combination of fiscal policy cyclicality behaviour and the devoted variables that minimise the loss function as follows:

$$\gamma = -\frac{1}{\beta}\mu + \frac{b^2}{\beta(a+b^2)}\pi^e \tag{4}$$

Figure 3 depicts equations (1) and (6) in a way so that we can see the optimal policy. At γ_0 (i.e. countercyclical fiscal policy), the targeted inflation is parallel to the actual and expected inflation rates, *ceteris paribus*. In contrast, if the cyclical behaviour of fiscal policy occurs (at γ_1), then it creates a gap between targeted, actual and expected inflation rates.

¹Assuming that monetary policy is time consistent, k = 1, which implies targeted output equal to its potential, and the central bank sets the targeted inflation rates equals to zero (Blinder, 2000).

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Proof: *Equations* $\gamma = -\frac{1}{\beta}\mu + \frac{b^2}{\beta(a+b^2)}\pi^e$ and $\gamma = -\frac{1}{\beta}\mu + \frac{1}{\beta}\pi$ have different slopes, where $\frac{b^2}{\beta(a+b^2)}\pi^e < \frac{(a+b^2)}{\beta(a+b^2)}\pi^a > 0$. In other words, slope of $\pi = f(\gamma)$, $\frac{\partial \pi}{\partial \gamma}$, is steeper than slope of $\pi^e = f(\gamma)$, $\frac{\partial \pi}{\partial \gamma}$,

Proposition 1 *Procyclical fiscal policy generates a gap between targeted, actual and expected inflation rates. The more procyclical the fiscal policy, the larger the gap.*

Based on the above explanation, there are two conditions characterised by the degree of cyclical behaviour of fiscal policy. The first circumstance (i.e. procyclical fiscal policy) is indicated by a deviation in targeted, actual and expected inflation rates. In contrast, the second circumstance (i.e. countercyclical fiscal policy) is characterised by an equal rate of targeted, actual and expected inflation.

 L_a denotes the loss function within the first condition. The loss function equation is as follows:

$$L_a = a(\pi - \pi^*)^2 + [(1 - k)y^n + b(\pi - \pi^e)]^2; \pi \neq \pi^e \neq \pi^*; \gamma_1; k = 1$$
(5)

Equation (7) suggests that with procyclical fiscal policy, the credibility of monetary authority is undermined, and thus, value of the loss function L_a is larger than zero.

$$L_b = (\Delta \pi_{\text{tar}})^2 + \left[b \left(\Delta \pi_{\text{exp}} \right) \right]^2; L_b > 0$$
(6)

where $\Delta \pi_{tar} = (\pi - \pi^*)$ and $\Delta \pi_{exp} = (\pi - \pi^e)$.

On the contrary, the loss function (L_b) within the second condition, which assumes $\pi = \pi^e = \pi^*; \gamma_0; k = 1$, is as follows:

$$L_b = a(\pi - \pi^*)^2 + [(1 - k)y^n + b(\pi - \pi^e)]^2$$

$$L_b = 0$$
(7)

The value of the total loss (L_b) within the second condition equals zero ($L_b = 0$). This implies that with a countercyclical fiscal policy, the monetary policy achieves its optimal credibility, and hence, fiscal policy is complementary to the monetary policy.

Proposition 2 Procyclical fiscal policy malevolently exacerbates the credibility of monetary policy. On the contrary, the countercyclical fiscal policy helps monetary policy to attain its credibility.

When credibility is under pressure, the monetary authority is assumed to be able to regain its credibility via a tighter monetary policy (see Figure 2). The monetary authority will run a negative money growth policy and, therefore, significantly increase interest rates to adjust the deviation between targeted, expected and actual inflation rates. In this case, expansionary government spending results in the crowding-out effect by which the monetary authority will adjust the interest rate up to maintain the credibility of monetary policy. As can be seen in Figure 4 below, equations (1) and (6) will shift, resulting in a change in optimal point from point a to point b.

Proposition 3 Contractionary monetary policy could adjust the deteriorated monetary policy credibility by employing a negative money growth policy and significantly higher interest rates.

2.2. Financial Instability Model

The economy has witnessed several episodes of financial crises, from the 1930 Great Depression to the recent crises. A feature that is commonly found intrinsically in all episodes of the financial crises is the presence of asset price misalignment (Taipalus, 2012). Indeed, it is worth stressing that asset price misalignment is not merely a factor in deteriorating financial stability. Nevertheless, a massive

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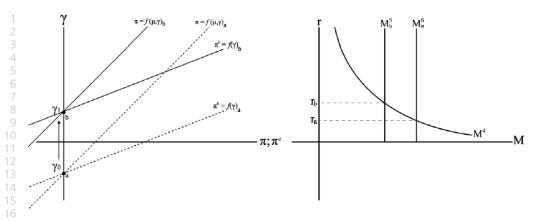


Figure 4. Monetary policy response to the procyclical fiscal policy.

swing in the asset price is often associated with strains in the financial sector and the real economy (Borio & Lowe, 2002). Therefore, we define financial instability as the build-up of asset price deviation from its fundamental value. Accordingly, we primarily simplify the endogenous asset price bubbles model *a la* Fouejieu, Popescu, and Villieu (2019), earlier found in Blanchard and Watson (1982):

 σ

$$= f(\sigma_{\varepsilon}, P_{\rm br}) + \varepsilon_{\sigma}$$

$$\frac{\partial \sigma}{\partial \sigma_{\sigma}} > 0; \frac{\partial \sigma}{\partial P_{\rm br}} < 0$$
(8)

where σ , $\sigma_{e^{r}} P_{\text{br}}$, $1-P_{\text{br}}$ and ϵ_{σ} are actual asset price deviation from its fundamental value, expected value of σ , probability of the bubble to persist, probability of the bubble to burst and exogenous shock, respectively.

In this model, therefore, there are two main drivers of the asset price misalignment: expectations and the probability of the bubble to persist. First, the expected value of σ is the expectation adaptive feature that captures the agent's expectation of future σ value based on their specific memory in the past. In other words, it suggests that the bubble is self-driven and may change without any connection to fundamental factors. For instance, the asset price bubble is self-fulfilling when $\partial \sigma_e > 1$, which characterises the over-optimistic market expectations (Fouejieu *et al.*, 2019). For the value of $P_{\rm br}$, we define $P_{\rm br}$ in a sigmoid pattern in which the probability of the bubble to persist is a function of *z*:

$$P_{\rm br} = f(z) \tag{9}$$

where z is defined as the log odds ratio between $P_{\rm br}$ and $1-P_{\rm br}$,

$$\ln\left(\frac{P_{\rm br}}{1-P_{\rm br}}\right) = z \tag{10}$$

Based on equation (10), it can be seen that larger the increase (decrease) in interest rates, larger (lower) the probability to default, $(1 - P_{br})$, and hence the lower (higher) the value of *z* will be. *z*, as the log ratio of the probability to persist to the probability to default, can be taken as an inquiry for risk-taking behaviour of economic agents, which is sensitive to the change in interest rate.

$$z = f(\Delta r); \frac{\partial z}{\partial (\Delta r)} < 0 \tag{11}$$

Equation (11) implies that tightening monetary policy (increased interest rate) leads to larger pessimism, and risk-averse behaviour reduces demand for credit, high loan loss provisions and a higher probability of the bubble to burst (Warjiyo & Juhro, 2019). In addition, higher interest rates imply

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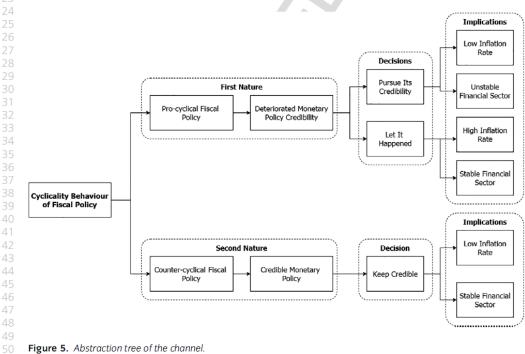
higher borrowing costs. Shrunk leverage increases financial risk and consequently exacerbates financial stability (Dell'Ariccia *et al.*, 2014). Since the deviation of the actual asset price from its fundamental value increases, the probability of the bubble to burst becomes larger.

Proposition 4 The higher increase in the interest rates (Δr) leads to reduced z. In turn, it escalates the probability of the bubble to burst $(1 - P_{br})$ and lowers the probability of the bubble to persist (P_{br}) . As $\partial \sigma / \partial P_{br} < 0$, the lower P_{br} thus induces asset price misalignment, σ .

2.3. Dilemma of the Credible Monetary Policy under the Procyclical Fiscal Policy

This channel can be explained by the combination of propositions formulated earlier. Figure 5 shows the channel through which the nature of the cyclical behaviour of fiscal policy transmits different outcomes in terms of inflation rates and the probability of a bubble to burst (or financial stability). We divide the channel into two types: procyclical fiscal policy (first nature) and countercyclical fiscal policy (second nature).

In the first type, the outcome depends on the decisions undertaken by the monetary authority in response to deteriorating credibility. This creates a monetary policy dilemma. Deteriorating credibility of the monetary policy originating from procyclical fiscal policy is indicated by the larger gap between targeted, actual and expected inflation rates (Propositions 1 and 2). Attempting to regain the credibility will imply negative money growth and higher interest rates (Proposition 3). As an outcome, the interest rate crawls up and boosts the probability of default via an asset price pass-through mechanism (Proposition 4). Therefore, maintaining a credible monetary policy costs financial instability.



Note: conceptualised by the authors.

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Hypothesis 1 Under the procyclical fiscal policy, a more credible monetary policy would generate a lower inflation rate, but with a more unstable financial sector.

What if the monetary authority does nothing to retain its credibility and lets the deterioration take place? Under these circumstances, the financial sector and the macroeconomy adversely generate a trade-off. Since the monetary authority does not lift the interest rate, the financial sector remains relatively stable (Proposition 4). However, it sacrifices the inflation rates, where an unreliable monetary policy lets the broadened gap between the actual and expected rates of inflation to persist (Proposition 2). In other words, the financial sector is stabilised at the expense of the inflation rate, which is costly for the economy.

Hypothesis 2 A less credible monetary policy under the procyclical fiscal policy would ensure financial stability, but at the expense of the inflation rate.

On the contrary, under the second type, the monetary authority would not face a dilemma. The countercyclical fiscal policy ensures lower output gaps. Therefore, it becomes a benevolent complement to monetary policy (Proposition 2). Thus, under this circumstance, monetary authority attains and chooses to maintain its credibility. Thus, monetary authority has no reason to increase interest rates significantly, which in turn lowers the probability of the bubble to burst (Proposition 4). As a result, the economy is characterised by a low inflation rate and a low probability of the bubble burst.

Hypothesis 3 *Credible monetary policy and countercyclical fiscal policy promote both stable financial sectors and low inflation rates.*

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3. Empirical Strategy

3.1. Data

We construct a data set covering 25 selected ITF countries² (i.e. Argentina³, Australia, Brazil, Canada, Chile, Colombia, Ghana, Iceland, India⁴, Indonesia, Israel, Japan (See Hong *et al.* (2019)), Mexico, New Zealand, Norway, Peru, Philippines, Poland, Republic of Korea, Romania, South Africa, Sweden, Turkey, the United Kingdom and the United States⁵) from 2003 until 2017 from various data sources (see Appendix A).

3.2. Identifying the Technical Definition of Variables

3.2.1. Credibility of Monetary Policy

A growing body of literature suggests numerous technical approaches to define the extent of credible monetary policy. Warjiyo and Juhro (2019) define monetary policy credibility as the deviation of actual and targeted inflation. The larger the deviation of actual inflation from the target, the less

²See Hammond (2012) for Australia, Brazil, Canada, Chile, Colombia, Ghana, Iceland, Indonesia, Israel, Mexico, New Zealand, Norway, Peru, Philippines, Poland, Republic of Korea, Romania, South Africa, Sweden, Turkey and United Kingdom.

³See Argentina's inflation targeting regime Press Conference on 26 September 2016 (https://www.bcra.gob.ar/ Noticias/Regimen_de_Metas_de_Inflacion_en_Argentina_i.asp).

⁴See Reserve Bank of India Act, 1934 (As amended by the Finance, No. 2, Act, 2019), Chapter IIIF Monetary Policy, Point 45ZA.

⁵See FOMC meeting minutes on 25 January 2012: The Federal Reserve (the Fed) officially reached a broad agreement on the following principles regarding its longer-run goals and monetary policy strategy: promoting maximum employment, stable prices and moderate long-term interest rates. The Fed also formally set the medium-term inflation rates at 2 per cent.

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credible the monetary policy. Fritsche *et al.* (2009) and Kabundi and Mlachila (2018) define the credibility of monetary policy using disagreement among inflation forecasters. Less disagreement implies higher monetary policy credibility. In other words, the credibility of monetary policy increases when inflation becomes more predictable. Meanwhile, Zeng (2018) identifies the extent of a credible monetary policy using the inflation persistence approach reflecting public responsiveness to the monetary policy. Higher persistence of the inflation rate indicates lesser responsiveness of the public to the monetary policy.

Although the definitions vary, there is a core value of the credibility hypothesis (CH) in those definitions. In verbatim, CH is articulated as the foregone output costs of a disinflationary episode that will be smaller if the public correctly believes that the attempt will not be abandoned (see Fellner (1979)). This implies that a credible monetary policy is the outcome of harmonised interaction between public and monetary authority, as indicated by the successful measures of the monetary authority to set the actual and expected inflation precisely at the same level.

We measure the credibility of the monetary policy using the following formula:

$$CMP = \frac{|\pi - \pi^{e}|}{(1 + |\pi - \pi^{e}|)} \times 100$$
(12)

where CMP, π and π^e are the credibility of monetary policy, actual inflation rates and expected inflation rate, respectively. In measuring the expected rate of inflation, we forecast it from a backward-looking Phillips curve in which actual inflation responds to its lagged quarterly average and to the Hodrick–Prescott detrended unemployment rate (Matteo *et al.*, 2013).

3.2.2. Cyclical Behaviour of Fiscal Policy

The cyclical behaviour of fiscal policy is related to how fiscal policy (e.g. tax, spending and deficit/surplus budget policy) responds to business cycles. Fiscal policy is said to be procyclical when fiscal authority responds to economic expansion through an expansionary fiscal policy and responds to economic recession by a contractionary fiscal policy (Kaminsky *et al.*, 2004).

There are several approaches to identifying fiscal policy cyclicality behaviour, given devoted variables and measurement techniques. Tornell and Lane (1999), Talvi and Végh (2005), Ilzetzki (2011), Park (2012), and Frankel *et al.* (2013) have used government spending, whereas Kaminsky *et al.* (2004) and Camous and Gimber (2018) have used tax revenue as the fiscal instrument proxy. This shows that government spending is frequently applied to identify fiscal policy cyclicality behaviour instead of tax revenue. Park (2012) argues that using tax revenue as the variable leads to biased estimation because tax revenue inherently correlates with business cycle determinants, which are tax rates. In contrast, many papers frequently employ a regression approach to identify the fiscal policy cyclicality behaviour. In contrast, this paper utilises fiscal cyclicality behaviour as an independent variable.

This paper uses a 20-year window rolling regression for the cyclical component of both government spending and gross domestic product (GDP) to obtain cyclicality coefficients for each individual and time observation (Frankel *et al.*, 2013; Mcmanus & Ozkan, 2015). Furthermore, a positive correlation indicates that fiscal policy is procyclical and *vice versa*. Specifically, the measurement of fiscal cyclicality behaviour is categorised as follows:

$$\hat{\rho}_{12,t} \begin{cases} 1 \ge \hat{\rho}_{12,t} > 0, \text{ for procyclical fiscal policy} \\ -1 \le \hat{\rho}_{12,t} < 0, \text{ for countercyclical fiscal policy} \end{cases}$$
(13)

where *n* is the rolling window and $\hat{\rho}_{12,t}$ is the rolling regression coefficient between the two cyclical components of government spending and GDP.

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3.2.3. Financial Instability

Each episode of crisis generates a growing body of literature exponentially, leading to the wide-ranging definitions of financial instability. Nevertheless, the broad literature converges to the identical core meaning, that is the system-wide episode in which the financial system fails to function (World Bank, 2015). Unfortunately, it is difficult to find out the "one-size fits all" meaning due to the broad dimension of the system. Hence, the measure of financial stability is usually proxied by its symptoms.

As discussed earlier, financial instability is characterised by an increased deviation of asset price away from its fundamental value (i.e. asset price misalignments). Nevertheless, the question is which indicator best approximately reflects the asset price misalignment. The severe worldwide history of crises (e.g. the tulip crisis, the south sea bubbles, the 2008 global financial crisis) has captured asset price misalignment occurrence, which is identical to the downturn of the stock market (Johannessen, 2017). Meanwhile, similar to Johannessen (2017), Taipalus (2012) developed the asset price misalignment indicators using stock-market-based data. Their results show that the indicators can locate the periods that are quoted as severe boom or bust periods in asset prices. Likewise, Vila (2000), Okina *et al.* (2001), Malkiel (2010), and Fouejieu *et al.* (2019) use stock-market-based indicators, specifically the Morgan Stanley Capital International (MSCI) stock index as a measure of asset price bubbles. This suggests that the stock market may approximately reflect asset price misalignment. For the asset price misalignment measure, we adopt the detrended MSCI index, estimated using an absolute gap between the actual MSCI index and its fundamental value.⁶ Therefore, in this regard, a period of excessive asset price misalignment is identified by a widened detrended MSCI index.

3.3. Model Specification

The objective of this paper was to explain the malevolent effects of credible monetary policy under the procyclical fiscal policy on the inflation rate and financial stability. The models scrutinise the effect of a credible monetary policy on inflation rates and financial stability conditional on the cyclical behaviour of fiscal policy.

Furthermore, the model estimates contain the interaction term variable of monetary credibility (CMP) and fiscal cyclicality (FCB). We technically use the term of primary effect for the coefficient of CMP and the augmented effect for the interaction term coefficient. The interaction term variable facilitates the analysis of the consequences of each kind of fiscal cyclicality behaviour towards the impact of the credible monetary authority on inflation rates, economic growth and financial stability.

We start with the first model estimate, aiming to examine the impact of a credible monetary policy on inflation rates under a procyclical fiscal policy. This estimate follows the standard determination model of inflation, which includes the money growth rate, exchange rates, unemployment rates and public debt as controlled variables (see, e.g., Woodford, 1994; Totonchi, 2011; Alisa, 2015). The model is as follows:

 $\pi_{i,t} = \alpha_0 + \delta_1 \pi_{i,t-1} + \alpha_1 \text{CMP}_{i,t} + \alpha_2 (\text{CMP}_{i,t} \times \text{FCB}_{i,t}) + \gamma Z_{i,t} + u_{i,t}$ $\pi_{i,t} = \alpha_0 + \delta_1 \pi_{i,t-1} + (\alpha_1 + \alpha_2 \text{FCB}_{i,t}) \text{CMP}_{i,t} + \gamma Z_{i,t} + u_{i,t}$ (14)

where π , CMP, FCB and γZ are inflation rate, monetary policy credibility, cyclicality character of fiscal policy and vector of parameter and controlled variables, respectively. α_1 and α_2 FCB_{*i*,*t*} denote the primary effect and augmented effect of monetary policy credibility, respectively.

Lastly, we proceed to the second model estimate, aiming to analyse the aftermath of monetary policy credibility on financial stability conditional on the cyclical behaviour of fiscal policy. Specifically, the model also involves several control variables such as trade openness, exchange rates and debt-to-GDP ratio (e.g. see Fouejieu *et al.*, 2019). The model is as follows:

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⁶Fundamental values of MSCI are estimated using the Hodrick–Prescott filter.

	First model estimate	Second model estimate
Pooled least square (δ_{PLS})	0.5632988	0.2108999
Fixed effect $(\delta_{\rm FE})$	0.3171388	-0.0506429
Difference GMM ($\delta_{\text{FD-GMM}}$)	0.2214667	-0.0496313
	$\delta_{ ext{FD-GMM}}{<}\delta_{ ext{FE}}{<}\delta_{ ext{PLS}}$	$\delta_{ ext{FE}} \!\ll\! \delta_{ ext{FD-GMM}} \!<\! \delta_{ ext{PLS}}$

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 $\rho_{i,t} = \alpha_8 + \delta_3 \rho_{i,t-1} + \alpha_9 \text{CMP}_{i,t} + \alpha_{10} (\text{CMP}_{i,t} \times \text{FCB}_{i,t}) + \tau Q_{i,t} + u_{i,t}$ $\rho_{i,t} = \alpha_8 + \delta_3 \rho_{i,t-1} + (\alpha_9 + \alpha_{10} \text{FCB}_{i,t}) \text{CMP}_{i,t} + \tau Q_{i,t} + u_{i,t}$ (15)

5 where ρ , τQ and $(\alpha_9 + \alpha_{10}\text{FCB}_{i,t})$ are stock volatility, the vector of parameters and control variables, 6 and the net effect of monetary policy credibility on stock volatility, respectively.

As we are dealing with the inclusion of lagged dependent variables in the model, the standard panel data regression would lead to biased and inconsistent estimation because the lagged dependent variables (LDVs) would be correlated with the composite error term (CET) by construction (Baltagi, 2005). Thus, we employ the generalised method of moment (GMM). However, in deciding between the differenced GMM and system GMM to be employed, we follow the standard procedure developed by Stephen bond (Roodman, 2009). The rules of thumb critically decide the selection between difference GMM and system GMM, which utilises the first-order LDV coefficient of difference GMM (δ_{FD-GMM}), pooled least square (δ_{PLS}) and fixed effect (δ_{FE}). The estimated δ_{PLS} is considered to be biased upwards, while the estimated value of δ_{FE} is considered to be biased downward (Bond, 2002). When the estimated value of δ_{FD-GMM} lies below or closer to δ_{FE} than to δ_{PLS} , System GMM is suitable for estimation and *vice versa* (Roodman, 2009).

From Table 1, we obtained the estimated values of $\delta_{\text{FD-GMM}}$, δ_{PLS} and δ_{FE} for the first and second model estimates. For the first model estimate, we see that $\delta_{\text{FD-GMM}}$ lies below δ_{FE} and δ_{PLS} ($\delta_{\text{FD-GMM}} < \delta_{\sigma_{\text{FE}}} < \delta_{\text{PLS}}$). Therefore, System GMM is suitable for estimating the first model. For the second model, the estimated value of $\delta_{\text{FD-GMM}}$ is greater than δ_{FE} and relatively far below δ_{PLS} . Therefore, estimation using System GMM is more suitable for the second model.

4. Results

This section elucidates the estimation results and discusses them. It begins with statistical inferences followed by the construe of the meaning of empirical findings within the theoretical framework discussed earlier.

4.1. Estimation Result

Table 2 shows the estimation results. We begin by exploring the empirical relationship between inflation rates and monetary policy credibility under the procyclical fiscal policy (model 1). The results show a positive net effect of monetary policy credibility on inflation rates, formed by significant positive primary effect and insignificant augmented effect. This implies that the cyclical behaviour of fiscal policy does not affect the outcomes of monetary credibility on the inflation rate reduction. In other words, it suggests that inflation remains low along with a more credible monetary policy, irrespective of the cyclical behaviour of fiscal policy. However, we also found that actual inflation is not driven by one-year lagged inflation. This indicates the flexibility of price changes.

A significant effect of money growth on the inflation rate with a positive sign indicates that higher the growth of money, higher the inflation rates. The result is parallel to the classical theory of money or the monetarist view (see Friedman (1968)). A significant effect of exchange rates with a negative sign on the parameter suggests that currency depreciation leads to higher inflation. The result provides evidence to the exchange rates pass-through hypothesis (see Taylor

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2		Model estimates				
4 5		Inflation	Asset price misalignment			
6	Inflation (-1)	0.1861313 (0.1166045)				
7	Asset price misalignment (-1)		-0.0425327^{***} (0.0049759)			
8	Monetary credibility	0.035003*** (0.0100785)	0.1335766*** (03608)			
9	Monetary credibility \times fiscal cyclicality	-0.0409745 (0.0364007)	-0.2727361^{***} (0.094729)			
10	Trade openness		0.0060955 (0.0040192)			
11	Money growth	0.0012769*** (0.0003429)				
12	Real effective exchange rates	-0.0006093*** (0.0001795)	0.000091 (0.0001035)			
13	Unemployment rate	-0.0018963 (0.0441323)				
14	Public debt	-0.0001354** (0.000054)	-0.0000281 (0.0000279)			
15	Constant	0.0823579 (0.0200451)	-0.013234 (0.0114176)			
16	Serial Correlation (z-Prob.)	0.256	0.314			
17	Hansen test (Chi-squared Prob.)	0.108	0.229			
18	Wald-Stat (5)	148.44***	1283.44***			
19	Number of instruments	21	20			
20	Number of observation	341	350			
21	Number of group (Countries)	25	25			
22	Estimator	System GMM	System GMM			

Note: (1) and (2) represent the results of the first, second and third model estimates, respectively. Stars denote statistical significance *, ** and *** at 10%, 5% and 1%, respectively. Numbers in parentheses, (), represent the Windmeijer standard error. These two estimations show no serial correlation (represented by *z-prob*, of serial correlation) with valid instruments (insignificant chi-squared probability of the Hansen test). We instrument all independent variables, as we assume that each model is with strictly exogenous independent variables.

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(2000)). A significant effect of public debt on the inflation rate with a negative sign on the parameter indicates that an increase in public debt irregularly reduces inflation rates. Higher public debt potentially reduces the incentive to accumulate more public debt, and prioritises fiscal sustainability instead (Park, 2012).

Finally, we wrap up the estimations by scrutinising the empirical relationship between monetary policy credibility and financial stability under the procyclical fiscal policy. The estimation output shows that a credible monetary policy generates higher asset price misalignment under a procyclical fiscal policy. Technically, it is indicated by a negatively significant net effect under the procyclical fiscal policy. In contrast, under the countercyclical fiscal policy, the credible monetary policy maintains a stable financial system, which is indicated by a positive net effect. The remaining variables of the model estimate show a significantly negative effect of the first lagged asset price misalignment on its actual value. This finding contradicts our theoretical foundation. However, it is consistent with the Minsky Instability Hypothesis, which states that a stable condition may actually induce instability in the future (Angerma, 2013).

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44 4.2. Robustness Checks

To ensure robust estimations, we employ estimation consistency checks with different variable measurements. First, the expected inflation, which is a component of monetary credibility (CMP) measurement, is estimated using the Hodrick–Prescott filter (HP filter). Correia, Neves, and Rebelo (1995) explain that the backward–forward model estimation of HP filter performs well in measuring the approximate value of expected inflation rates. The second strategy to afford robust findings and rationalisations is that we not only employ a rolling regression for the cyclical behaviour of fiscal policy measurement, but also a rolling correlation with a 20-year window ($\hat{\tau}_{,t}$). It measures the correlation between the cyclical component of real GDP and government expenditure. Therefore, the

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measurement of fiscal cyclicality behaviour is interpreted as follows:

$$\hat{\tau}_{,t} \begin{cases} 1 \ge \hat{\tau}_t > 0, \text{ for procyclical fiscal policy} \\ \hat{\tau}_t = 0, \text{ for acyclical fiscal policy} \\ -1 \le \hat{\tau}_t < 0, \text{ for countercyclical fiscal policy} \end{cases}$$

For the last robustness check, we strive to scrutinise the consistency estimation for the financial system stability variable, as it is problematic to find out a "one-size fits all" measurement due to the broad dimension of the system. Hence, we also operate the Bank Z-score as the financial system stability variable. Bank Z-score is frequently used and becomes a popular indicator of financial system stability because of its ability to capture the banking system's risk-taking behaviour (Li & Malone, 2016). This strategy is essential because it implies that our robustness check on financial system stability comprises not only a test for measurement consistency but also a consistency test to check whether the assumption of financial stability is different from what we define earlier.

First, we explore the correlation between the main variables (see Table B1 in Appendix B). The correlation analysis shows that the monetary credibility variables are positively correlated with the backward-Phillips-style CMP by 24 per cent. This implies variation in the values among the CMP measurement, although all have the same direction, which means that a higher CMP implies less credible monetary policy and *vice versa*. For the fiscal cyclicality variables, we find that both regression and correlation approach measurements are strongly correlated. Finally, we examine the correlation coefficient indicates that the Bank Z-score and MSCI index are weakly correlated. This suggests that it is difficult to define financial stability directly with one measurement as there is a broad meaning of the system. Therefore, through this robustness test, we encompass the examination of a different approach that defines financial stability.

We employ ten estimations for a robustness test that combines various variable measurement approaches (see Tables B2 and B3 in Appendix B). Based on the rule of thumb for GMM estimator selection, we mostly use the System GMM (see Tables B4 and B5 in Appendix B). Most robustness tests show that the role of monetary credibility in lowering inflation is empirically robust. We find that in estimations (1) and (3), the lower the CMP (i.e. credible monetary policy), the lower the inflation rates. The interaction term between monetary credibility and fiscal cyclicality is empirically insignificant, although we find it to be significant in estimation (2). Based on our robustness test results, we can conclude that most estimations indicate that fiscal cyclicality may not disrupt the advantage of monetary credibility in lowering inflation rates.

For the examination of financial stability, however, we find that both monetary credibility and the interaction term significantly affect financial stability measured only by the detrended MSCI index but not the Bank Z-score. Therefore, our robustness test estimation suggests that our findings are consistent as long as financial instability is measured by asset price alignment. On the contrary, the fact that our estimations are not consistent with other measurements implies the difficulty to find out a "one-size fits all" measurement for the financial system stability, due to the broad dimension of the system.

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5. Concluding Remarks

This study examines the role of monetary credibility and fiscal cyclicality in generating the trade-off between inflation rates and financial stability. We systematically develop simple models to shape the rationalisation framework, which demonstrates the role of fiscal cyclicality behaviour in arousing a trade-off for the monetary policy to target low inflation rates and a stable financial system at once. On one hand, when the fiscal policy is procyclical, and the monetary authority decides to pursue its credibility, it causes low inflation but at the expense of financial stability. On the other hand, if the monetary authority decides to let its credibility deteriorate, it will effectively ensure financial stability but not lower inflation rates.

In this paper, we find that a credible monetary policy does not always generate financial instability, and it necessarily depends on fiscal policy. First, we find that a credible monetary policy may promote

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Table 3.	Fiscal Policy and Monetary	Policy Credibility Outcomes	Towards Inflation and Financial Stability
----------	----------------------------	-----------------------------	---

3	Fis	cal policy
4	Procyclical	Countercyclical
6 Monetary policy 7 Credible 8 Non-credible	Low; Unstable High; Stable	Low; Stable

not only financial stability but also lower inflation rates as long as the fiscal policy is countercyclical. In contrast, the procyclical fiscal policy leaves the monetary policy facing a trade-off between inflation and financial stability. Table 3 shows the outcomes.

The procyclical fiscal policy will initially deteriorate the credibility of monetary policy by generating a gap between targeted, actual and expected inflation rates. Therefore, the monetary authority will try to attain its credibility by employing a negative money growth policy, which also significantly increases interest rates, to adjust the deviation between targeted, expected and actual inflation rates. However, a significant increase in interest rate implies higher borrowing costs, reduced leverage and increased financial risk, consequently exacerbating financial stability (Dell'Ariccia et al., 2014). In contrast, if the fiscal policy is countercyclical, there are no reasons for the monetary authority to raise interest rates quickly or, at least, step by step. Furthermore, the countercyclical fiscal policy could restrain excessive booms and busts of business cycles, thereby reducing the procyclicality of the financial sector, thus generating not only a stable inflation rate but also financial stability.

5.1. Suggestions for Further Research

There are several gaps in this paper. First, this paper excludes the role of macroprudential policy as one of the actors in a "lean-against-the-wind" policy. Second, it implies that there could be a dynamic interaction between fiscal, monetary and macroprudential policy in determining both inflation rates and financial stability regarding their cyclicality behaviour. These gaps could be satisfied with a more general construction, such as a game-theoretical framework.

Conflict of Interest

The Statement of No Conflict of Interest.

The Statement of Authorship

Akhmad Syakir Kurnia conceived and designed the study, collected data, analysed and interpreted 38 the data, drafted the manuscript and/or critically revised the manuscript, and approved the final version of the manuscript. Syahid Izzulhaq conceived and designed the study, collected data, analysed and interpreted the data, drafted the manuscript and/or critically revised the manuscript. Johan Beni Maharda conceived and designed the study, collected data, and analysed and interpreted the data.

Agung Kunaedi collected data, and analysed and interpreted the data.

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Appendix A.

Variables, Measurement and Data Sources

	Variables	Operational description	Measurement/unit of account	Sources
1	The credibility of monetary policy	Smoothed value of absolute deviation between actual and expected inflation.	$CMP = \frac{ \pi - \pi^{e} }{(1 + \pi - \pi^{e})} \times 100$	Author's calculation, Bank for International Settlement
(Cyclicality behaviour of fiscal policy	Correlation between cyclical components of government expenditure and real GDP.	$ \hat{\sigma}_{12,t}^{2}(n) = \frac{1}{n-1} \sum_{i=0}^{n} (y_{1t} - \hat{\mu}_{1t}(n))(y_{2t} - \hat{\mu}_{2t}(n)); $ $ \hat{\rho}_{12,t}(n) = \frac{\hat{\sigma}_{12,t}^{2}(n)}{\hat{\sigma}_{1,t}^{2}(n) \times \hat{\sigma}_{2,t}^{2}(n)}; $	World Bank Data, Penn World Table
		Regression between cyclical components of real GDP with respect to cyclical components of government expenditure.	The rolling correlation coefficient (20- year window) $\tau_t^c = \alpha_t + \beta y_t^c + \varepsilon_t$; The rolling regression coefficient (20- year window)	

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Appendix A. (Continued)

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Variables	Operational description	Measurement/unit of account	Sources
Inflation rates	The annual growth rate of CPI.	Percentage change $(2010 = 100)$	Bank for International Settlement
Public debt	General government gross debt.	Percentage of GDP	World Economic Outlook
Money growth	Growth of broad money (M2)	Percentage change	World Bank Data
Exchange rates	Real effective exchange rates (REER).	Index (2010 = 100)	IFS and FRED
Stock volatility	Stock price volatility is the average of the 360-day volatility of the national stock market index.	Index	Global Financial Development Dataset (GFDD)
MSCI	Morgan Stanley Capital International Index	Index	Bloomberg
Bank Z-score	Default probability of banking sector	Index	Global Financial Development Indicators
Unemployment rate	Unemployment-to-labour force ratio.	Percentage	World Economic Outlook

Appendix B.

30 Table B1. Correlation Coefficients

Appendix B. Robustness Ch	eck		K			
Table B1. Correlatio	n Coefficie	nts				
	CMP (HP Filter)	CMP (Backward PC)	Fiscal cyclicality (Rolling Regression)	Fiscal cyclicality (Rolling Correlation)	MSCI index (HP Filter Detrended)	Ba Z
CMP (HP Filter)	1.000					
CMP (Backward PC)	0.241	1.000				
Fiscal Cyclicality (Rolling Regression)	0.257	0.217	1.000			
Fiscal Cyclicality (Rolling Correlation)	0.218	0.259	0.778	1.000		
MSCI Index (HP Filter Detrended)	0.163	0.462	-0.049	-0.084	1.000	
Bank Z-score	-0.238	-0.008	-0.123	-0.267	-0.087	1.0

Table B2. Robustness Checks (First Model Estimate)

	(1)	(2)	(3)
Inflation (-1)	0.1151723	0.1661463	0.1930638*
	(0.1080789)	(0.1136786)	(0.1164458)
Monetary Credibility (HP Filter)	0.1894311***	0.0481322	
	(0.0717202)	(0.0597511)	
Monetary Credibility (Backward Phillips)			0.0384936***
			(0.0109615)
Monetary Credibility (HP Filter) \times Fiscal Cyclicality		0.3615075**	
(Rolling Correlation)		(0.1655804)	
Monetary Credibility (Backward Phillips) × Fiscal			-0.025391*
Cyclicality (Rolling Correlation)			(0.0145016)
Monetary Credibility (HP Filter) \times Fiscal Cyclicality	0.0727115		
(Rolling Regression)	(0.1309639)		
Money Growth	0012045***	0.0011093***	0.0012558***
	(0.0003174)	(0.0003228)	(0.0003439)
Real Effective Exchange Rates	-0.0006311***	-0.0005635***	-0.000612***
	(0.0001699)	(0.000156)	(0.0001833)
Unemployment Rate	0.0013861	0.0024956	-0.0054631
	(0.0522805)	(0.0485775)	(0.0430383)
Public Debt	-0.0001462^{***}	-0.0001291***	-0.000136**
	(0.0000507)	(0.0000418)	(0.0000573)
Constant	0.084406	0.0761532	0.0828307
	(0196644)	(0.0178055)	(0.0204109)
Serial Correlation (z-Prob.)	0.233	0.321	0.236
Hansen Test (Chi-squared Prob.)	0.182	0.149	0.105
Wald-Stat (5)	160.35***	280.26***	135.89***
Number of Instruments	21	21	21
Number of Observation	341	341	341
Number of Group (Countries)	25	25	25
Estimator	System	System	System
	GMM	GMM	GMM

Note: (1) and (2) represent the results of the first, second and third model estimates, respectively. Stars denote statistical significance *, ** and *** at 10%, 5% and 1%, respectively. Numbers in parentheses, (), represent the Windmeijer standard error. These two estimations show no serial correlation (represented by *z*-prob. of serial correlation) with valid instruments (insignificant chi-squared probability of the Hansen test).

	(1)	(2)	(3)	(4)	(5)	(9)	(2)
MSCI (-1)	0.156586*** (0.0037014)	0.2018108*** (0.006666)	-0.05802^{***} (0.0026377)				
Bank Z-score (–1)				0.3693287	0.4416043**	0.4098119*	0.41571*
Monetary Credibility	0.0701031**	0.1165757***		-16.48531	2.147489	(2002/12:0)	077017:01
(HP Filter) Monstary Credibility (Bachward	(0.0353772)	(0.0364783)	0 150635***	(27.56051)	(13.08129)	7 365821	
Phillips)			(0.0081241)			(2.768966)	(1.781357)
Monetary Credibility (HP Filter) × Fiscal		-0.1987403^{**}			-40.7567		
Cyclicality (Rolling Correlation)		(0.1009005)			(25.83604)		
Monetary Credibility (Backward			-0.17017^{***}				1.800333
Phillips) × Fiscal Cyclicality (Rolling			(0.0079215)				(2.397058)
Correlation)							
Monetary Credibility (HP Filter) × Fiscal	-0.1312682			-8.80234			
Cyclicality (Rolling Regression)	(0.0967996)			(36.41416)			
Monetary Credibility (Backward						3.311493	
Phillips) × Fiscal Cyclicality (Rolling						(8.242095)	
Regression)							
Trade Openness	-0.0095402	-0.0084825	-0.0002196	-5.516071	-3.288141	-5.804255	-5.631753
	(0.0096171)	(0.0086766)	(0.002315)	(4.611552)	(4.643107)	(3.816372)	(3.886811)
Real Effective Exchange Rates	-0.0000298	-0.0000434	0.0000779	-0.0275043	-0.0374014	-0.0389234	-0.0376827

•••

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Note: (1) and (2) represent the results of the first, second and third model estimates, respectively. Stars denote statistical significance *, ** and *** at 10%, 5% and 1%, respectively. Numbers in parentheses, (), represent the Windmeijer standard error. These two estimations show no serial correlation (represented by z-prob. of serial correlation) with valid instruments (insignificant chi-squared probability of the Hansen test). (0.0420777)(4.933419)0.0221612 169.14^{***} 12.49747 6 GMM 0.298 System 0.074325 25 19 (0.0427816)12.73614 (12.73614) 0.0227526 9 14.85^{**} System GMM 0.072 0.307 19 325 25 (0.0408876)11.5169 (5.211145) 0.0135088 (2) 14.25^{**} System GMM 0.060 0.106 325 25 19 (0.0439433)12.51702 (6.657739) 0.026472 25.66*** (4)GMM System 0.143 0.079 325 19 25 -0.0102504(0.010027) (9.90E-06) 89674.9*** -4.71E-07 $\widehat{\mathfrak{S}}$ 25 System GMM 0.313 0.045 20 350 0.0142077(0.0136327)(0.0000464)-0.000050423564.5*** (7)

0.318 0.212

0.0130698 (0.013255) (0.0000549)-0.0000556

Ξ

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Table B3. (Continued)

Public Debt

Constant

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System GMM

> GMM System

350 25 20

20 350 25

Number of Group (Countries)

Estimator

Number of Instruments Number of Observation

Wald-Stat (5)

 28401.6^{***}

0.199 0.318

Hansen Test (Chi-squared Prob.)

Serial Correlation (z-Prob.)

1 Table B4. GMM Rule of Thumb for Robustness Checks (First Model Estimate)

Variable combinations		$\delta_{ m PLS}$	$\delta_{ m FE}$	$\delta_{ m FD-GMM}$	Estimator
CMP (HP Filter)					
Fiscal cyclicality (Rolling Regression)	Inflation	0.5685337	0.2965623	0.1962958	System GMM
Fiscal cyclicality (Rolling	rates	0.5715414	0.3440067	0.2510438	System GMM
Correlation)					
CMP (Backward Phillips Curve)					
Fiscal cyclicality (Rolling	Inflation	0.5660908	0.2414336	0.2180608	System GMM
Correlation)	rates				·

 Table B5. GMM Rule of Thumb for Robustness Checks (Second Model Estimate)

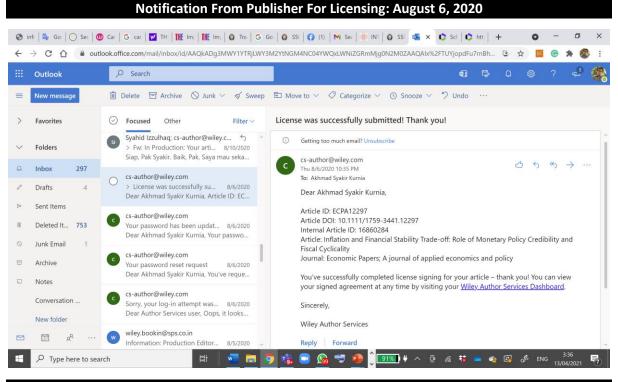
Variable combinations		$\delta_{ ext{PLS}}$	$\delta_{ m FE}$	$\delta_{ ext{FD-GMM}}$	Estimator selection
CMP (HP Filter)					
Fiscal cyclicality (Rolling Regression)	Detrended MSCI	0.2108999	-0.0506429	-0.0496313	System GMM
	Bank Z-score	0.9172721	0.2880967	0.3519971	System GMN
Fiscal cyclicality (Rolling Correlation)	Detrended MSCI	0.5790135	-0.0660833	-0.065003	System GMN
	Bank Z-score	0.9131476	0.2904428	0.3597646	System GMM
CMP (Backward Phillips Curve)					
Fiscal cyclicality (Rolling Regression)	Bank Z-score	0.9237517	0.2759005	0.2759005	System GMM
Fiscal cyclicality (Rolling Correlation)	Detrended MSCI	0.0045335	-0.0508041	-0.0498093	System GMM
	Bank Z-score	0.9237792	0.288805	0.3200156	System GMN

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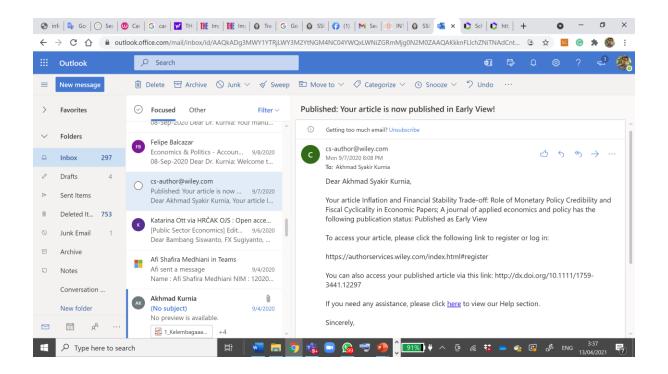
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