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FISCAL POLICY EFFECTIVENESS AND INFLATION DYNAMICS: EVIDENCE FROM EMERGING ASIAN ECONOMIES

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Abstract. *This study examines how effective fiscal policy is in shaping inflation dynamics across emerging Asian economies, focusing on the channels through which government spending, taxation, deficits, and public debt interact with prices. Using a comparative macroeconomic framework grounded in fiscal theory, Phillips-curve mechanisms, and open-economy transmission, the paper synthesizes evidence showing that fiscal expansions can raise inflation when demand is near capacity, when exchange-rate pass-through is strong, or when monetary policy credibility is weakened by fiscal stress ("fiscal dominance"). We highlight heterogeneity across emerging Asia based on institutions, debt structure, subsidy regimes, and inflation-targeting strength. The findings suggest that fiscal policy can stabilize growth in downturns, but its inflation impact depends on financing composition (domestic vs. external), the credibility of fiscal rules, and coordination with monetary policy. Policy implications emphasize medium-term fiscal frameworks, targeted subsidies, improved revenue mobilization, and debt management strategies to preserve price stability*

Keywords: *fiscal policy effectiveness, inflation dynamics, emerging Asia, fiscal dominance, public debt, structural VAR, exchange rate pass-through, policy coordination*

INTRODUCTION

Emerging Asian economies have repeatedly used fiscal policy—stimulus packages, subsidies, public investment, and tax adjustments—to manage growth shocks, energy-price spikes, and post-crisis recoveries. Yet inflation outcomes have varied widely. In some cases, fiscal expansion supported recovery with limited inflation, while in others it coincided with persistent price pressures. This divergence reflects differences in economic slack, supply constraints, import dependence, exchange-rate regimes, and—critically—how deficits are financed. When governments rely on inflationary financing mechanisms or when high debt constrains central banks, fiscal actions can amplify inflation dynamics through fiscal dominance channels. Recent empirical literature documents that fiscal adjustments can move inflation expectations in emerging markets more strongly than in advanced economies. At

the same time, country evidence from Asia shows that spending composition matters (e.g., wages/subsidies vs. productive investment), and that fiscal shocks can transmit to prices via exchange rates and output gaps. This paper builds a structured synthesis for emerging Asia, combining theory and evidence to clarify when fiscal policy stabilizes and when it risks de-anchoring inflation. The conceptual framework linking fiscal policy to inflation in emerging Asian economies is grounded in multiple transmission channels that interact with macroeconomic conditions and institutional credibility. Through the aggregate demand channel, deficit-financed public spending increases disposable income and consumption, shifting the demand curve outward. When economies operate close to full capacity—particularly in structurally supply-constrained environments common in emerging Asia—this additional demand translates into upward price pressures rather than higher output. The inflationary impact becomes stronger when fiscal expansions are persistent and financed through borrowing that raises concerns about sustainability. In contrast, when output gaps are wide during recessions, fiscal expansion may stimulate production with limited immediate inflationary effects, highlighting the state-dependent nature of fiscal multipliers. The cost and subsidy channel plays a distinct role in many Asian economies where governments intervene in energy and food markets. Subsidies can temporarily suppress headline inflation by keeping administered prices low. However, prolonged subsidy regimes widen fiscal deficits, accumulate arrears, and distort market signals. When subsidies become fiscally unsustainable and are eventually removed or reformed, the correction often results in sharp price adjustments, contributing to inflation volatility. Moreover, subsidy financing through domestic borrowing can crowd out private investment and exert indirect pressure on prices over time. Expectations form another crucial transmission mechanism. In emerging markets, inflation expectations are often more sensitive to fiscal developments because institutional credibility is still evolving. Announcements of credible fiscal consolidation—such as medium-term deficit reduction plans or revenue-enhancing reforms—can anchor expectations and reduce inflationary pressures even before actual adjustments materialize. Conversely, repeated fiscal slippages may unanchor expectations, raising inflation persistence. This dynamic underscores the importance of communication strategies and transparent fiscal rules in shaping macroeconomic stability. Fiscal dominance represents a structural risk when high public debt and financing needs constrain monetary independence. Under fiscal dominance, central banks may face implicit pressure to maintain accommodative conditions to contain debt-service costs, weakening anti-inflation credibility. This situation increases inflation persistence and complicates stabilization efforts. Evidence from Pakistan and several emerging Asian contexts suggests that when debt ratios rise significantly, inflation becomes more responsive to fiscal shocks and less sensitive to conventional monetary tightening. The open-economy channel is particularly relevant for emerging Asia due to high trade openness and reliance on imported energy and intermediate goods. Fiscal expansions can widen current account deficits, raise sovereign risk premia, and depreciate exchange rates. Given the relatively high exchange-rate pass-through in many emerging markets, currency depreciation quickly feeds into domestic prices. This mechanism amplifies inflationary effects, especially during global commodity price shocks. Empirical research in emerging Asia employs a variety of econometric approaches to identify these channels. Structural vector autoregression (SVAR) models are frequently used to disentangle exogenous spending and tax shocks and trace their dynamic effects on inflation through impulse response functions. These methods allow researchers to distinguish between demand-driven and cost-driven inflation responses and to assess the duration of fiscal shock impacts. Cointegration and vector error correction models (VECM) are used to examine long-run equilibrium relationships between fiscal variables and price levels, providing evidence on whether persistent government spending growth is associated with structural inflation trends. More recent empirical designs focus on

inflation expectations, using survey-based measures and fiscal adjustment episodes to assess how credibility influences price stability. These studies demonstrate that fiscal consolidations can lower inflation expectations in emerging markets, particularly when accompanied by institutional reforms. Additionally, a heterogeneity perspective is increasingly adopted, recognizing that the inflationary consequences of fiscal policy differ depending on debt maturity profiles, foreign currency exposure, inflation-targeting credibility, and the scale of subsidy programs. Such cross-country differences help explain why similar fiscal shocks can produce divergent inflation outcomes across Asia. Synthesized findings indicate that government spending shocks tend to raise inflation in the short run when output gaps are small or supply constraints are binding. The magnitude and persistence of the effect depend on financing methods and structural characteristics. Long-run analyses frequently reveal a positive association between sustained government expenditure growth and inflation, particularly in economies with weaker fiscal institutions. Under debt stress, fiscal dominance intensifies inflation persistence, reducing the effectiveness of monetary policy instruments. Spending composition also matters significantly. Transfers and generalized subsidies often stimulate consumption without enhancing productive capacity, increasing inflation risk. In contrast, public investment in infrastructure, technology, and human capital can expand supply potential, mitigating medium-term inflationary pressure by easing bottlenecks. This distinction emphasizes the importance of quality and efficiency in fiscal spending. Effective policy coordination can allow fiscal policy to stabilize output without fueling inflation. Rule-based fiscal frameworks, including credible medium-term expenditure ceilings and deficit targets, anchor expectations and reduce uncertainty. Targeted subsidies that protect vulnerable groups while preserving market price signals tend to be more fiscally sustainable and less distortionary than broad price controls. Strategic debt management—such as lengthening maturities and reducing foreign-currency liabilities—can lower fiscal stress and diminish exchange-rate-related inflation risks. Clear coordination between fiscal authorities and central banks is essential to prevent policy conflicts that undermine price stability. Looking forward, future research should develop harmonized cross-country quarterly datasets capturing spending composition, subsidy regimes, and debt structures across emerging Asian economies. State-dependent macroeconomic models can better capture differences between recessionary and expansionary periods. Further investigation into distributional inflation—particularly food versus core inflation—is crucial in import-dependent economies where fiscal interventions disproportionately affect essential goods. Finally, integrating climate and energy shocks into fiscal-inflation modeling frameworks will become increasingly important as governments expand green spending and respond to global commodity volatility. Institutional quality plays a foundational role in determining whether fiscal policy stabilizes or destabilizes prices in emerging Asian economies. Strong institutions—characterized by transparent budgeting, parliamentary oversight, independent fiscal councils, and credible fiscal responsibility laws—reduce policy uncertainty and enhance macroeconomic credibility. When fiscal rules are consistently enforced, markets are less likely to fear excessive deficit financing or debt monetization, which helps anchor inflation expectations. Conversely, weak governance structures, corruption, and the prevalence of contingent liabilities or off-budget expenditures create opacity around the true fiscal stance. Such uncertainty can elevate sovereign risk premia, depreciate exchange rates, and intensify inflationary pressures. Empirical comparisons across emerging Asia suggest that countries with stronger institutional frameworks and better public financial management systems experience lower inflation volatility even during fiscal expansions. Institutional credibility, therefore, acts as a moderating variable in the fiscal-inflation relationship. The structure of government revenue further shapes inflation outcomes. Economies heavily reliant on indirect taxation—such as value-added taxes, excise duties, and fuel levies—may experience more immediate price

effects when tax rates are adjusted. These taxes are often passed directly to consumers, contributing to cost-push inflation in the short term. In contrast, direct taxes on income and corporate profits typically have weaker immediate price effects, though they may influence investment and consumption decisions over time. Strengthening tax administration, reducing informality, and broadening the tax base enhance revenue stability and reduce dependence on borrowing. Higher revenue elasticity and tax buoyancy improve fiscal space, allowing governments to finance expenditures without resorting to inflationary financing mechanisms. In emerging Asian economies with narrow tax bases and large informal sectors, revenue reforms are particularly critical for maintaining price stability while pursuing development objectives. Debt sustainability and adherence to the intertemporal budget constraint are central to inflation dynamics. According to fiscal theory, if investors doubt a government's ability to generate future primary surpluses sufficient to service its debt, they may anticipate eventual monetization or restructuring. These expectations can raise current inflation even before any explicit monetary financing occurs. In emerging Asian contexts, high public debt—especially when denominated in foreign currency—exposes economies to exchange-rate risk. Currency depreciation increases the domestic burden of external debt, worsening fiscal balances and potentially triggering inflationary spirals through higher import prices. Intertemporal budget analysis helps assess whether fiscal trajectories are sustainable under realistic growth and interest-rate scenarios. Countries that maintain credible medium-term debt strategies and transparent debt reporting are better positioned to prevent inflation expectations from becoming unanchored. Political economy factors also significantly influence fiscal-inflation dynamics. In many emerging democracies, fiscal expansions are closely linked to electoral cycles. Governments may increase spending or introduce subsidies before elections to gain political support, leading to temporary economic stimulus followed by fiscal strain and inflationary pressures. Political fragmentation, coalition governance, and weak legislative oversight can undermine fiscal discipline, encouraging pro-cyclical policies that amplify macroeconomic volatility. Furthermore, short-term political incentives often conflict with long-term fiscal sustainability, delaying necessary consolidation measures. Incorporating political economy variables—such as election timing, governance quality indices, and fiscal transparency measures—into empirical models enhances understanding of how institutional and political incentives shape inflation outcomes in emerging Asian economies. Financial sector interactions significantly shape how fiscal deficits transmit into inflation in emerging Asian economies. When governments rely heavily on domestic banking systems to finance deficits, banks allocate a larger share of their balance sheets to sovereign securities. This “crowding-out” effect can restrict credit availability to the private sector, slowing productive investment while leaving aggregate demand supported by public spending. Such distortions weaken the traditional monetary transmission mechanism, as interest rate adjustments may not fully influence credit conditions if banks are heavily exposed to government debt. Moreover, the sovereign–bank nexus increases systemic vulnerability: fiscal stress can weaken bank balance sheets, while financial instability may compel governments to intervene, further widening deficits. In such environments, inflation volatility may rise because macroeconomic shocks quickly propagate through both fiscal and financial channels. Greater financial deepening, diversified capital markets, and reduced concentration of sovereign debt in banking portfolios can mitigate these risks and enhance macroeconomic stability. The exchange rate regime and monetary framework critically influence the inflationary impact of fiscal policy. Under fixed or tightly managed exchange-rate systems, expansionary fiscal policy may increase external imbalances, leading to reserve depletion and heightened pressure on the currency. If reserves fall to unsustainable levels, forced devaluations can occur, resulting in abrupt and often sharp inflation spikes due to high exchange-rate pass-through. In contrast, under flexible exchange-rate regimes combined with

credible inflation-targeting frameworks, central banks possess greater autonomy to offset fiscal shocks through interest-rate adjustments and communication strategies. However, the effectiveness of this response depends on institutional credibility and fiscal discipline. Comparative cross-country evidence suggests that economies with well-established inflation-targeting regimes and strong central bank independence experience more contained inflation responses to fiscal expansions than those with weaker monetary frameworks. Supply-side constraints represent a structural dimension of the fiscal-inflation relationship. Many emerging Asian economies face infrastructure deficits, energy shortages, logistics bottlenecks, and limited industrial diversification. In such contexts, fiscal expansion can quickly translate into price pressures because productive capacity cannot expand rapidly to meet rising demand. This demand–supply imbalance intensifies inflation sensitivity to fiscal shocks. Conversely, well-designed public investment aimed at easing structural bottlenecks—such as improving energy supply, transportation networks, or digital infrastructure—can expand potential output and reduce long-term inflationary pressures. Thus, the inflationary consequences of fiscal expansion depend not only on the size of spending but also on its composition and its alignment with productivity-enhancing reforms. Distributional and welfare effects add another important layer to the analysis. Inflation induced by fiscal expansion does not affect all households equally. Lower-income households allocate a larger proportion of their income to essential goods such as food, energy, and transportation, which are often more sensitive to fiscal and exchange-rate shocks. As a result, inflation can disproportionately erode real incomes among vulnerable groups, potentially offsetting the intended benefits of fiscal stimulus. Evaluating fiscal policy through a distributional lens helps policymakers balance short-term stabilization goals with long-term social equity. Integrating household-level survey data with macroeconomic models can provide deeper insights into how fiscal decisions influence poverty, inequality, and welfare outcomes alongside inflation. Global spillovers and external shocks further complicate fiscal-inflation dynamics in emerging Asia. These economies are deeply integrated into global trade and financial systems, making them sensitive to shifts in international interest rates, commodity prices, and capital flows. Expansionary fiscal policy implemented during periods of global monetary tightening may trigger capital outflows and currency depreciation, amplifying inflation through imported price pressures. Similarly, global commodity price shocks—particularly oil and food—can interact with domestic fiscal measures such as subsidies or tax adjustments, magnifying inflationary effects. Incorporating cross-border spillover models and global financial cycle indicators into empirical analysis strengthens understanding of how domestic fiscal actions interact with external conditions. Digitalization and fiscal transparency are emerging factors that influence inflation expectations and macroeconomic credibility. The adoption of digital public financial management systems, integrated financial information platforms, and real-time expenditure monitoring enhances accountability and reduces information asymmetry between governments, markets, and citizens. Improved transparency can lower uncertainty regarding fiscal sustainability, thereby stabilizing inflation expectations. Digital tax administration systems can also improve revenue collection efficiency, reducing reliance on deficit financing. In emerging Asian economies undergoing digital transformation, these reforms may gradually strengthen fiscal credibility and reduce the inflationary risks associated with expansionary policies. Future research should examine how digital governance innovations interact with macroeconomic performance indicators, including inflation stability and debt sustainability.

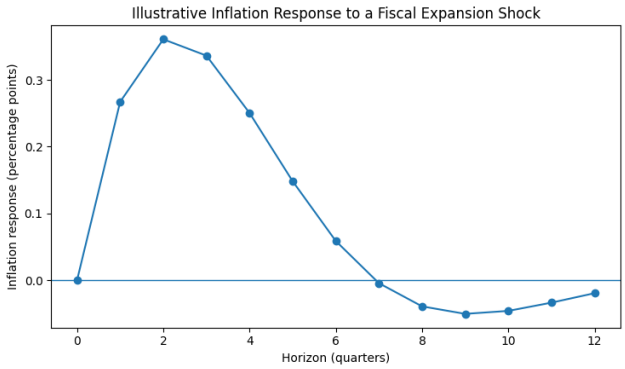
Naveed Rafaqat Ahmad highlights that the adoption of artificial intelligence in government institutions should be guided by clear regulatory structures. He argues that without well-defined governance frameworks, automated systems may introduce risks such as biased decision-making, lack of transparency, and reduced institutional accountability. Therefore, he

stresses the need for governments to develop policy mechanisms that ensure AI technologies operate within ethical and legal boundaries.

Yusoff et al. (2026) examined the factors that support sustainable growth of small and medium enterprises by focusing on entrepreneurial intention, organizational culture, and networking capabilities. The study explained that strong internal culture and effective business networks help SMEs build competitive advantages and maintain long-term development.

Salhab et al. (2025) explored the application of AI-based tools in improving production efficiency and quality management within 3D animation processes. The research highlighted that Cascadeur software assists in automation, reduces workflow difficulties, and enables professionals to achieve better productivity and creative performance.

Maruf et al. (2024) analyzed the role of robotic hand-in restaurant services in enhancing modern dining experiences in Kuala Lumpur. The authors found that AI-powered robotic systems improve service accuracy, reduce operational delays, and provide customers with innovative and technology-driven restaurant services.



Summary:

Overall, fiscal policy in emerging Asian economies is effective for stabilizing output during downturns, but its inflation consequences are highly state-dependent. Evidence suggests that deficit-financed spending can raise inflation, particularly where supply constraints, exchange-rate pass-through, and weak policy credibility coexist. Country studies using SVAR methods show inflationary pressure from government expenditure shocks, while long-run evidence using cointegration/VECM frequently links sustained spending growth to higher inflation. The risk intensifies when fiscal dominance emerges—high debt and financing needs limit monetary independence—making inflation more persistent and harder to control. Policy solutions center on credible medium-term fiscal frameworks, improved revenue mobilization, smarter and targeted subsidies, and debt strategies that protect central bank independence and inflation expectations.

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