Restoring Fiscal Soundness and Its Influences on Monetary Policy - With a Focus on the Advanced Countries -

<Summary>

The active operation of fiscal policy since the Lehman Brothers' collapse is seen as having greatly contributed to the overcoming of the financial crisis, but it gave rise to the problem of a deterioration of fiscal soundness. Fiscal soundness being a nation's overall debt servicing capacity, once impaired, its restoration involves a considerable length of time and sustained economic costs in addition to which there is a heightened risk of the excessive volatility of macro-economic indicators such as prices and interest rates.

The new post-crisis economic paradigm is expected to bring about considerable changes in the macro-economic environment surrounding the public finances in the future. A great expansion of government debt in the course of addressing a financial crisis and a narrowing of the tax base in line with the trend of low growth are likely to act to weaken the restoration of fiscal soundness. If debt stabilization is delayed due to growing burden of principal and interest payments on public debt, the markets' risk assessment becomes stricter, thus resulting in a reassessment of the vulnerability of private sector debt. Growing demand for government bonds in line with a preference for safe assets may cause a fall in the level of interest rates, thus resulting in a reduced debt burden. On the other hand, sovereign debt may increase due to the weakening of the government's will to accomplish fiscal consolidation.

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In addition, with a country's fiscal scope having been reduced, the fiscal pressures stemming from demographic changes such as population ageing are likely to mount.

The problem of elevated fiscal burden has no little influence on the environment for the conduct of monetary policy, and changes may be expected in its countercyclical function and implementation conditions and in the inflation climate. To deal with these changes, it is first necessary to reinforce the channels of monetary policy transmission and to expand policy toolkit to strengthen monetary policy effectiveness. The macro-prudential policy function should be strengthened to enable a preemptive response to any possibility of financial unrest arising from fiscal fragility. Another important task is that of managing expected inflation in a stable manner by addressing the inflationary pressures arising from the decline in fiscal soundness.