

Working papers economics - Monetary Policy under Fiscal Risk

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Does the effectiveness of monetary policy depend solely on the decisions of the central bank? This paper examines how sovereign risk also influences the transmission of monetary policy actions. The findings show that greater fiscal stress reduces the central bank's stabilization capacity and increases the importance of a credible fiscal framework and an appropriate mix of policy instruments.

Publication Date: Friday, 9 of October 2026 **Approach**

The effectiveness of monetary policy does not depend solely on the decisions of the central bank. Fiscal conditions and perceptions of sovereign debt risk can also alter the way interest rates, foreign exchange intervention, and other policy instruments affect inflation, exchange rates, and economic activity.

This paper examines this interaction across a broad sample of advanced and emerging economies since the mid-1990s. In particular, we analyze whether a given policy action produces different effects depending on whether sovereign risk is low or high. To do so, we use sovereign credit default swap (CDS) spreads as a measure of fiscal stress and estimate policy responses that vary continuously with the level of sovereign risk.

Contribution

This paper broadens the discussion of fiscal-monetary interactions beyond extreme episodes of fiscal dominance. We show that fiscal constraints can matter even when the central bank retains formal independence.

Our main contribution is to examine, within a unified empirical framework, how sovereign risk shapes the transmission of three types of policy instruments: conventional monetary policy, foreign exchange intervention, and macroprudential and capital flow management measures. In addition, we complement the empirical evidence with a small open economy model that explicitly incorporates fiscal and financial channels, helping explain why policy transmission weakens as sovereign stress rises.

Results

We find that public debt levels alone do not adequately capture fiscal conditions. Emerging market economies face higher risk premia, a larger share of foreign currency-denominated debt, and a higher interest burden relative to government revenues, even when their debt levels are similar to or lower than those of advanced economies.

When sovereign risk is low, the various policy instruments generally produce the expected effects: higher policy rates reduce inflation and economic activity, while foreign reserve sales tend to appreciate the domestic currency. However, as sovereign risk rises, these effects weaken substantially and, in some cases, may even reverse.

In particular, a tighter monetary policy stance may increase public debt servicing costs, raise risk premia, and generate exchange rate and inflationary pressures that offset the conventional transmission channel. The key message is that greater fiscal stress reduces the central bank's capacity to stabilize the economy and increases the importance of a credible fiscal framework and an appropriate mix of policy instruments.

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