

## ANALYSIS – The interaction between fiscal policy and monetary policy

Growing public debt in many countries highlights the interaction between fiscal and monetary policy. However, the situation varies considerably between countries. In countries with high debt, such as the United States, a continued increase in debt may lead to political pressure on the central bank to keep interest rates low in order to limit the government's interest costs. Sweden is not in this situation, partly because its public debt is low. Although fiscal policy does affect monetary policy, the risk that it will have implications for the monetary policy rule, i.e. inflation targeting, is currently low. At the same time, a more expansionary fiscal policy abroad could raise global interest rates and affect both the Swedish economy and monetary policy.

There is a global trend of countries increasing their public debt for both economic and political reasons. This development raises important questions, including how fiscal policy and monetary policy will affect each other going forward. The interaction between the two policy areas has also received growing attention in macroeconomic research in recent years.

Public debt is expected to continue rising in many countries that already have high levels of debt. In the United States, for example, the latest budget includes large unfunded tax cuts, that is, without corresponding cutbacks in public expenditure or increases in other taxes. This comes at a time when the United States is already running a significant budget deficit. Forecasts suggest that US federal debt could rise from around 100 to approximately 120 per cent of GDP over the next decade.<sup>28</sup> European countries are also moving towards a more expansionary fiscal policy, partly due to increased spending on defence and infrastructure. At the same time, several large economies, such as France and Italy, are already running significant budget deficits and have high levels of public debt.<sup>29</sup>

In Sweden, by contrast, public debt has been on a downward trend for some time, seen as a share of GDP. However, it is expected to rise in the coming years as Sweden increases defence spending and at the same time transitions from a surplus target to a balance target for general government net lending. This means that debt is

<sup>28</sup> See Committee for a Responsible Federal Budget (CRFB), "An August 2025 Budget Baseline", August 2025. The CRFB's forecast refers to the federal government's debt ratio. However, the total public sector debt ratio is higher and in 2023 was 24 percentage points the federal government's ratio.

<sup>29</sup> According to the IMF, public debt in France is projected to increase from the current 113 to 121 per cent of GDP by 2027. In Italy, debt is expected to increase from 135 to 138 per cent of GDP over the same period. The average public debt in the euro area as a whole is expected to rise from its current level of 88 to just under 93 per cent of GDP by 2030; see IMF "Euro Area Policies: 2025 Annual Consultation – Press Release; Staff Report; and Statement by the Executive Director for Member Countries", *IMF Country Report No. 25/174*, July 2025.

expected to increase from 34 to around 40 per cent of GDP over the next decade, according to estimates from the National Institute of Economic Research.<sup>30</sup>

However, it is difficult to predict how fiscal policy will evolve, as it is influenced by an uncertain development in the real economy and by political priorities that may change over time. The interaction between fiscal and monetary policy is important in this context. One question is whether the policy rules that have characterised the division of responsibilities between the two policy areas will change.

### How fiscal policy and monetary policy interact

According to the monetary policy rule, i.e. inflation targeting, the central bank sets the policy rate in relation to inflation and resource utilisation in the economy. Fiscal policy, by contrast, is governed by budgetary rules designed to ensure, among other things, that public debt does not become excessive.

When fiscal and monetary policy are conducted in line with their respective policy rules, there are interactions between them cause each to influence one another.<sup>31</sup> Monetary policy has a direct impact on public finances because government borrowing costs are largely determined by market rates, which in turn are affected by the policy rate. Interest costs account for a significant share of public expenditure. At the same time, public expenditure can influence monetary policy. If increased public expenditure is financed through increased borrowing rather than corresponding tax increases or other expenditure cuts, this can drive up economic activity and inflation.<sup>32</sup> This in turn contributes to higher interest rates, partly because the central bank then reacts to rising inflation.

How fiscal policy affects the economy depends partly on the extent of the fiscal policy changes and partly on the composition of increased public expenditure or tax cuts.<sup>33</sup> The effects of fiscal policy also depend on how the economy as a whole is functioning.<sup>34</sup> However, expectations and confidence in economic policy also play a significant role. For example, it is likely that interest rates on long-term government bonds, known as long rates, have risen over the past year because several countries have increased their debt and are planning to pursue a more expansionary fiscal policy. The rise in long rates likely reflects both expectations of future interest rate

<sup>30</sup> See the National Institute of Economic Research, "Offentligfinansiella scenarier för olika finansieringslösningar av en förstärkt försvarsuppbyggnad [Public finance scenarios for different financing solutions for a stronger defence]", March 2025. In Swedish only.

<sup>31</sup> See, for example, E. Leeper and C. Leith (2016), "Understanding Inflation as a Joint Monetary-Fiscal Phenomenon", in J.B. Taylor and H. Uhlig (eds), "Handbook of Macroeconomics", vol. 2, Elsevier Press and G. Kaplan (2025), "Implications of Fiscal-Monetary Interaction from HANK Models", Working Paper 34117, National Bureau of Economic Research.

<sup>32</sup> Experience shows that extensive and unfunded fiscal policy can drive inflation. During the pandemic, for example, the large fiscal support measures in the United States not only contributed to inflation rising, but also to it becoming more persistent. See F. Bianchi et al. (2023), "A Fiscal Theory of Persistent Inflation", *The Quarterly Journal of Economics*, vol. 183, No. 4, pp. 2127-2179.

<sup>33</sup> The combined effects of fiscal policy measures are usually described in terms of fiscal multipliers; see, for example, B. Lagerwall (2019), "Fiscal policy from a monetary policy perspective", Economic Commentary No 5, Sveriges Riksbank.

<sup>34</sup> For an overview of the relevant mechanisms, see M. Lindgren and C. Nilsson (2025), "Fiscal rules and debt in the 21st century: a brief overview", *Economic Review 2*, Sveriges Riksbank.

risks when fiscal policy becomes more expansionary and higher risk premiums that investors demand in order to purchase government securities.

In order to understand how, for example, fiscal policy affects monetary policy, it is also necessary to study how the policy areas act in relation to their policy rules.<sup>35</sup> If both fiscal and monetary policy follow their respective rules, a temporary expansionary fiscal policy that is later tightened need not have any major consequences for monetary policy.<sup>36</sup> However, if fiscal policy deviates from its policy rule, for example by allowing debt to increase persistently and significantly, problems may arise. Public finances that are perceived as unsustainable in the long term risk creating political pressure on the central bank to accept higher inflation in order to erode the debt. This, in turn, could lead to the policy rate being kept low to reduce the government's interest costs, which would prejudice the monetary policy rule. Such a development would allow fiscal policy to remain expansionary without the same requirements for future tightening. However, such expectations risk undermining monetary policy by causing economic agents to lose confidence in the central bank's ability to achieve the inflation target. Fiscal policy that limits government debt is therefore a prerequisite for monetary policy to be able to keep inflation low and stable. In summary, confidence in one policy area is dependent on confidence in the other.

### **How likely is it that fiscal policy will have consequences for the monetary policy rule?**

There is a risk that central banks will experience political pressure to adjust their monetary policy when debt levels increase. The United States, for example, risks moving in this direction, although there is considerable uncertainty. There is already political pressure on the Federal Reserve to keep the policy rate low and thus deviate from the monetary policy rule. Interest costs on federal debt are one possible explanation. Currently, they correspond to around 3 per cent of GDP and 13 per cent of federal budget expenditure.<sup>37</sup> However, if the debt rises from around 100 to 120 per cent of GDP over the next decade, interest costs are expected to increase to

<sup>35</sup> In technical terms, the question is whether a change in fiscal policy should be seen as a temporary deviation within the framework of a given stabilisation policy regime, or as an actual regime shift. In the research literature, a situation in which fiscal policy reacts weakly to debt and monetary policy reacts weakly to inflation is called *fiscal dominance*. The opposite, *monetary dominance*, describes a regime in which monetary policy reacts forcefully to inflation while fiscal policy stabilises debt. See E. Leeper (1991), "Equilibria under 'active' and 'passive' monetary and fiscal policies", *Journal of Monetary Economics*, vol. 27, No. 1, pp. 129-147.

<sup>36</sup> There are arguments that a more active fiscal policy could lead to a better mix of fiscal and monetary policy in certain situations. For a discussion of this interaction from a Swedish perspective, see, for example, L. Calmfors et al. (2022), *Samspel för stabilitet – en ESO-rapport om rollfördelningen mellan finans- och penningpolitik* [Interaction for stability – an ESO report on the division of roles between financial and monetary policy], report in Swedish to the Expert Group for Public Economic Studies 2022:3.

<sup>37</sup> Refers to the federal government's net interest expenditure for 2024 according to the Congressional Budget Office, "The Budget and Economic Outlook: 2025 to 2035", January 2025. According to the European Commission, which calculates interest expenditure in a comparable way for EU countries and the United States, among others, US public sector interest expenditure amounted to 4.6 per cent of GDP in 2024. See European Commission, "European Economic Forecast, Spring 2025", *Institutional paper 318*, May 2025.

around 4 per cent of GDP and 18 per cent of expenditure, assuming the current level of interest rates.<sup>38</sup>

In Sweden, the risk of fiscal policy having such far-reaching consequences for the monetary policy rule is considerably lower, not least thanks to low public debt. Interest costs for public debt currently correspond to 0.6 per cent of GDP.<sup>39</sup> The difference compared with the United States becomes even clearer when one considers that Sweden's public expenditure is actually higher than that of the United States as a share of GDP. In relation to total expenditure, Swedish interest costs are significantly lower – around 1.3 per cent, which is one tenth of the US level. If Swedish public debt were to increase from 34 to 40 per cent of GDP over the next decade, interest costs could therefore be expected to rise to around 1 per cent of GDP and around 2.5 per cent of public expenditure.<sup>40</sup> This means that public debt poses a significantly lower risk in Sweden than in the United States. However, this presupposes that the fiscal policy measures currently being implemented will, in the longer term, be financed by means other than through increased debt, thereby remaining consistent with the fiscal policy framework. Another important difference is that the Riksbank has a high degree of formal independence.<sup>41</sup> This further reduces the likelihood that an increase in debt will affect Swedish monetary policy.

However, even though fiscal policy in Sweden does not pose the same risk as in the United States, the Swedish economy, and thus also monetary policy, is affected by global developments. Both economic research and practical experience show that a more expansionary fiscal policy leads to increased economic activity, at least temporarily, to inflation being higher and interest rates rising. If fiscal policy in the United States and the euro area drives up global interest rates, Swedish interest rates may also rise rapidly, which would have consequences for Swedish growth and inflation.

The ECB also has strong formal independence, which limits the risk that debt developments in euro area countries will directly influence the direction of monetary policy. At the same time, conditions differ between countries. For example, France's interest costs next year are expected to amount to 2.8 per cent of GDP, while the corresponding figure for Germany is estimated at 1.1 per cent.<sup>42</sup> Since euro area countries share monetary policy but not fiscal policy, individual countries can increase

<sup>38</sup> The calculation of US interest expenditure is based on assumptions in CRFB (2025). The calculation of interest expenditure as a share of total expenditure in 2035 assumes that total expenditure as a share of GDP will remain unchanged from 2024.

<sup>39</sup> According to the European Commission (2025).

<sup>40</sup> The calculations are based on an average nominal borrowing rate of 3 per cent, annual nominal GDP growth of just under 4 per cent and an annual primary deficit of around 1 per cent of GDP. The increase in interest costs is partly explained by the fact that the expected borrowing rate is higher than previously. The calculations draw, among other things, on information from the National Institute of Economic Research. The calculations also assume that other factors do not affect debt developments.

<sup>41</sup> The Riksbank and the ECB are considered to have greater formal independence than the Federal Reserve, see N. Dincer and B. Eichengreen (2014), "Central Bank Transparency and Independence: Updates and New Measures", *International Journal of Central Banking*, Vol. 10, No. 1, pp. 189-253 and A. Garriga (2025), "Revisiting Central Bank Independence in the World: An Extended Dataset", *International Studies Quarterly*, Vol. 69, No. 2.

<sup>42</sup> See European Commission (2025).

their debt to a certain extent without having to bear the full consequences in the form of tighter monetary policy and higher interest costs.