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Bank of Japan

**The Importance of Fiscal Sustainability:
Preconditions for Stability in the Financial System and in Prices**

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Relationship between Fiscal Sustainability and Central Banks

The mission of a central bank is to contribute to sustained growth of the economy by maintaining public confidence in money, and price stability and financial system stability are two facets of this mission. Fiscal sustainability is an important element that has a fundamental impact on both. According to conventional wisdom, when the government loses its credibility with respect to the sustainability of government debt and does not make enough effort to regain it, this ultimately leads to either inflation or a default on the debt. To put this differently, it is often said that a central bank comes to face a tradeoff between price stability and financial system stability. However, since both are essential preconditions for sustained economic growth, it is not at all meaningful to consider which of the two we should choose. What is crucially important is to prevent the economy from getting into such a tradeoff in the first place; for that reason, fiscal sustainability itself is an essential precondition for the proper functioning of a central bank. Let me now elaborate on this point.

In normal times, government bonds are traded in large volumes in financial markets and used as collateral, reflecting their characteristics as safe assets. They are also held by financial institutions as liquidity buffers and investment assets. As such, a heightened risk for government debt default is likely to lead to instability in the financial system, through an increase in the liquidity risk and the capital loss of financial institutions. In such a situation, a central bank may be called into action as a "lender of last resort" by providing liquidity in order to maintain the stability in financial markets and the financial system, and such operations are expected to be effective at least in the short term. Taking an example from Europe, the ECB's Long-Term Refinancing Operations (LTROs) have helped to restore calm in financial markets. We are fully aware of the importance of such operations, but one has to also keep in mind that they can only be used to "buy time."

A central bank's operations to "buy time" may help the government to garner time to build a public consensus on the need for fiscal consolidation and gain the credibility of market participants for a consolidation plan. However, the side effects of such operations become significant when the government's commitment to fiscal reforms is weak and the plan for fiscal consolidation is less effective. Specifically, a temporary lull in financial markets due

to a decline in government bond yields is likely to dilute the sense of urgency among the government and the public, and thus weaken the momentum for progress toward fiscal reforms. If the government continues to run fiscal deficits, a possibility arises in which the central bank is forced to supply an unlimited amount of liquidity -- in the form of either liquidity provision against government bonds as collateral or an outright purchase of government bonds -- in order to get around a re-emergence of financial system instability. Historically, the consequence of such a large-scale supply of money is uncontrollable inflation. If market participants and the public, which have the knowledge of this history, were to anticipate a regime shift at some point, the credibility with respect to government bonds and money would be lost abruptly, and a process leading to uncontrollable inflation would begin.

After all, without solid progress toward fiscal consolidation, we cannot avoid significantly adverse impacts on economic activity and the standard of living.

The Case of Japan

Now I would like to take up the case of Japan, which attracts frequent questions. As is well known, the ratio of gross government debt to GDP in Japan is the highest among developed countries. In spite of such unfavorable fiscal conditions, the government bond yields remain low and stable, and policy discussions are focused on mild deflation instead of concerns regarding inflation, as evidenced by the fact that the consumer price index has fallen by 3.4 percent in cumulative terms since 1998, which can be translated to 0.2 percent annually. The low level of the government bond yields is consistent with the growth rate of the economy and the inflation rate, and at issue is the interpretation of the premium that could arise from worsening fiscal situations.

It seems difficult to explain the case of Japan in light of the conventional wisdom. One frequently offered explanation is that the ample domestic savings in Japan have absorbed the issuances of Japanese Government Bonds (JGBs) and the share of JGBs held by foreign investors is very small. But a more fundamental explanation is that the stability in the government bond yields reflects market participants' expectations that fiscal soundness will be restored through structural reforms in both the economic and fiscal areas. At the

moment, such expectations are not firmly backed by concrete reform plans; the public therefore restrains spending on concerns over future fiscal developments, and this constitutes one factor behind sluggish economic growth and mild deflation. If this is indeed the case, the experience of Japan indicates a possibility that a cumulative increase in government debt, combined with weak growth expectations, might generate deflationary pressures as long as the government retains its credibility with respect to eventual fiscal consolidation. In other words, this is the situation before the loss of fiscal sustainability leads to either inflation or a default on the debt.

Behind the decline in growth expectations and the cumulative increase in government debt are the aging of the population and the failure of the Japanese economy to adjust to it in a flexible manner. There is a limitation, at least in the short run, to changing the demographic trend itself. Therefore, given that the rapid aging of the population is likely to continue, strengthening the growth potential through productivity improvements and making the fiscal structure sustainable in the situation of an aging population are the most important challenges for Japan in terms of maintaining macroeconomic stability over the medium to long term.