Flash Economics

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Fiscal dominance will be present in the United States and in the euro area

Fiscal dominance is a situation in which the government fails to ensure the sustainability of public debt and maintains a particularly high primary fiscal deficit (excluding interest payments on public debt). We believe that the projected path of the public deficit in the United States, along with recent changes to fiscal rules in Europe, will indeed lead to a situation where primary budget deficits remain persistently high. In such a context, the central bank faces significant challenges. Sustained large public deficits put upward pressure on inflation, and the normal response of monetary policy would be to become more restrictive. However, a restrictive monetary policy accelerates the accumulation of public debt and can trigger a debt crisis.

As a result, fiscal dominance is generally expected to lead the central bank to adopt an expansionary monetary policy in order to avoid a public debt crisis, and to tolerate higher inflation than its target.

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The definition of fiscal dominance

"Fiscal dominance" is a situation in which fiscal authorities do not ensure the sustainability of public debt (the primary budget deficit remains high), and the central bank is forced to conduct expansionary monetary policy in order to stabilize the public debt ratio. This may involve maintaining very low interest rates or implementing irreversible Quantitative Easing (in which the central bank permanently purchases public debt — effectively equivalent to canceling the purchased debt, since the central bank returns its profits to the state, meaning the interest paid by the state to the central bank is returned by the central bank to the state).

Under fiscal dominance, the central bank can no longer pursue its traditional objectives (such as low inflation) but must instead focus on restoring the sustainability of public debt.

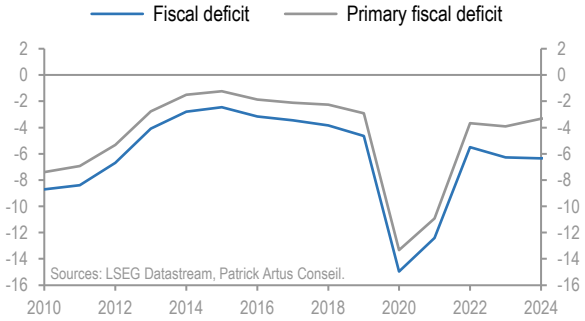
The situation of fiscal dominance is very different from the normal situation of "monetary dominance," where fiscal policy ensures the sustainability of public debt (there is a sufficient primary budget surplus to prevent the debt ratio from rising), and monetary policy can pursue its traditional objectives (low inflation, financial stability, etc..).

The shift to fiscal dominance is likely in the United States and the euro area

1. United States

The public deficit and the primary budget deficit (Chart 1) are expected to remain very high;

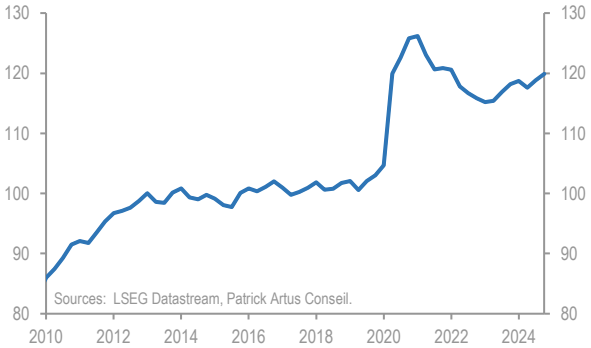
Chart 1
United States: Fiscal deficit and primary fiscal deficit
(as % of nominal GDP)



For the 2025 fiscal year, based on the public deficit observed from October 2024 to April 2025 ($1.9 trillion), the public deficit will likely be close to 7% of GDP. The Congressional Budget Office estimates that **the federal budget deficit** will remain around 7% of GDP from 2026 to 2034, bringing the U.S. federal debt-to-GDP ratio to at least 122.4% in 2034, compared to 100% in 2024.

If total public debt is considered — including the debt of local governments — the current figure reaches 120% of GDP (Chart 2).

Chart 2
United States: Public debt (as % of nominal GDP)



It is likely that, after the end of Federal Reserve Chair Jerome Powell's term in May 2026, Donald Trump will appoint his successor by choosing someone willing to pursue **a more expansionary monetary policy** (**Chart 3**), in order to depreciate the dollar and stabilize the public debt ratio. **This would mark a shift to a regime of fiscal dominance**, meaning that the Federal Reserve would abandon its goal of bringing core inflation back down to 2% (**Chart 4**).

Chart 3
United States: Federal Funds target rate (as %)

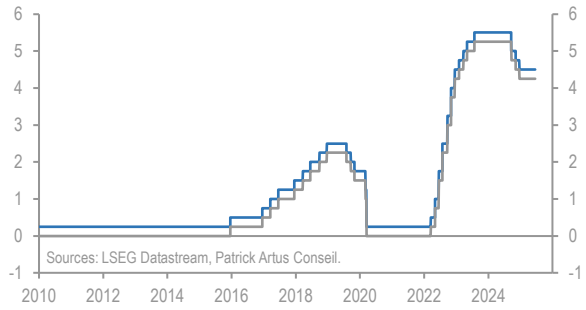


Chart 4
United States: Headline inflation and core inflation (as %)



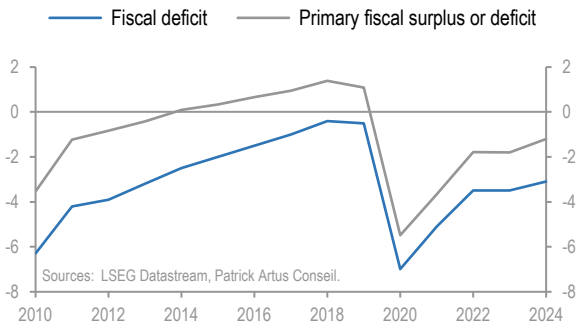
2. Europe / Euro Area

In the recent period:

- The European Commission has agreed not to include the increase in military spending in the public deficit limited to 3% of GDP;
- Germany has announced a €500 billion infrastructure investment plan;
- The Draghi Report has proposed increasing Europe's (public and private) investment rate by 5 percentage points of GDP, including investments in the energy transition, breakthrough innovation funding, and the digital sector.

It is therefore very likely that, starting in 2025–2026, the euro area's public deficit will exceed the previously projected level of 3.2% of GDP — a projection made before these changes to fiscal rules — and that the euro area will continue to run a primary public deficit (excluding interest payments on public debt, **Chart 5**).

Chart 5
Euro zone: Fiscal deficit and primary fiscal surplus or deficit (as % of nominal GDP)



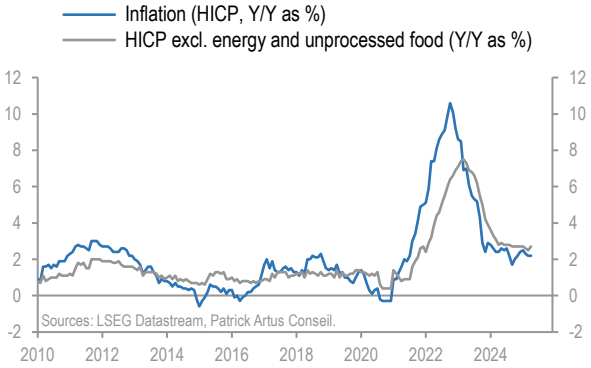
It is likely that the ECB will support this more expansionary fiscal policy with an equally expansionary monetary policy. It will not want monetary policy to hinder the increase in public investments or military spending, but it will aim to limit the accumulation of public debt (**Chart 6**).

Chart 6
Euro zone: Public debt (as % of nominal GDP)



This implies that it will abandon the goal of bringing core inflation back down to 2% (Chart 7), thereby **clearly entering a regime of fiscal dominance.**

Chart 7
Euro zone: Inflation and core inflation



Summary: what to expect if the United States and Europe enter a regime of fiscal dominance?

If public deficits remain high in the euro area and the United States, it is likely that these two countries (or regions) will enter a regime of fiscal dominance, where expansionary monetary policy ensures the stability of the public debt ratio. This development aligns with Donald Trump's desire for the Federal Reserve to lower interest rates, as well as Europe's growing recognition that additional public spending (such as investments recommended by the Draghi Report and increased military expenditures) is both inevitable and justified.

If the United States and the euro area enter a regime of fiscal dominance, inflation will remain above the inflation target in both the United States and the euro area.

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