Flash Economics

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Could central banks be tempted by "fiscal dominance"? What would be the consequences for financial markets?

Public debt ratios are rising in the United States, the United Kingdom, France, and, from 2025 onward, in Germany. It is unlikely that they can be stabilised given the need for higher military spending, demographic aging, and pressure from populist movements. We wonder whether central banks (the Federal Reserve, the ECB, and the Bank of England) might be tempted to shift toward a highly expansionary monetary policy, involving purchases of government debt, with the objective of pushing long-term interest rates below nominal growth. This would amount to using "fiscal dominance" (monetary policy offsetting the fact that fiscal policy remains structurally expansionary) to stabilise public debt ratios.

In the short term, it appears highly unlikely that the ECB or the Bank of England could adopt a very expansionary monetary policy while disregarding inflation; however, the question may arise with respect to the Federal Reserve. Moreover, over the medium term, all central banks will face the challenge of stabilising public debt ratios.

If "fiscal dominance" were to be adopted, involving lower short-term interest rates and a return to quantitative easing, inflation would be supported. This future rise in inflation is not yet priced in by the inflation swap market, but it likely helps to explain the sharp increase in the price of gold.

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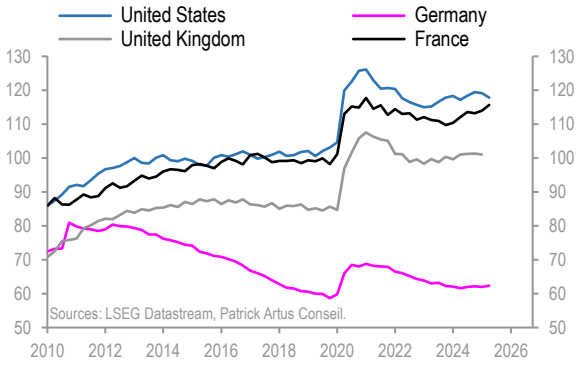
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Relentless rise in public debt ratios in major OECD countries

In the United States, the United Kingdom, Germany from 2025 onward, and France, **public debt ratios are clearly on an upward trajectory** (**Chart 1**).

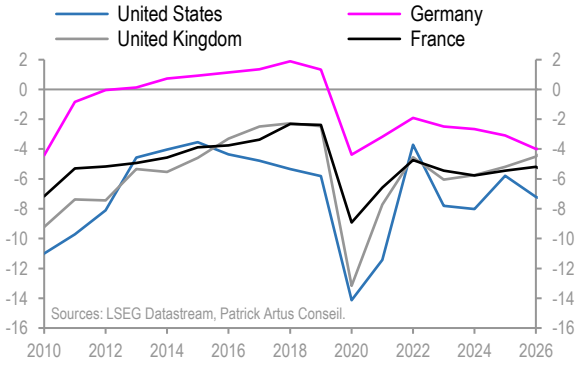
Chart 1
Public debt (as % of nominal GDP)



This reflects the inability to reduce public deficits sufficiently (**Chart 2**) in the face of:

- rising military spending;
- demographic aging, which is driving higher public spending on pensions and healthcare (especially in continental Europe);
- weak economic growth in Europe;
- pressure from populist parties, whether already in power (United States) or approaching power (United Kingdom, Germany, France), which seek to support consumption and reject curbs on growth.

Chart 2
Fiscal surplus or deficit (as % of nominal GDP)



The temptation of "fiscal dominance"

"Fiscal dominance" refers to a situation in which **monetary policy becomes responsible for stabilising the public debt ratio**, while fiscal policy remains expansionary.

If such a configuration were to emerge, the central bank would sharply reduce its short-term interest rate and specifically rely on quantitative easing (the purchase of government debt securities) to push down long-term interest rates.

In the United States, the Federal Reserve will continue to cut short-term interest rates while having reactivated its Treasury purchase programme (T-Bills) in early December 2025. **There is therefore a clear move toward the implementation of fiscal dominance**, following a period (2022–November 2025) during which the reduction in the size of the Federal Reserve's balance sheet (**Chart 3**) exerted upward pressure on long-term interest rates.

Chart 3
United States: Monetary base (USD bn)



For the time being, the Bank of England and the ECB are, on the one hand, keeping interest rates close to the inflation rate (**Charts 4A/B**) and, on the other hand, extending quantitative tightening (the reduction of their balance sheets, **Charts 5A/B**).

Chart 4A
United Kingdom: Base rate and inflation

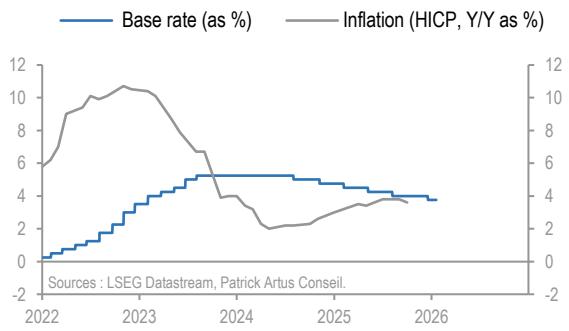


Chart 4B
Euro zone: ECB Deposit rate and inflation

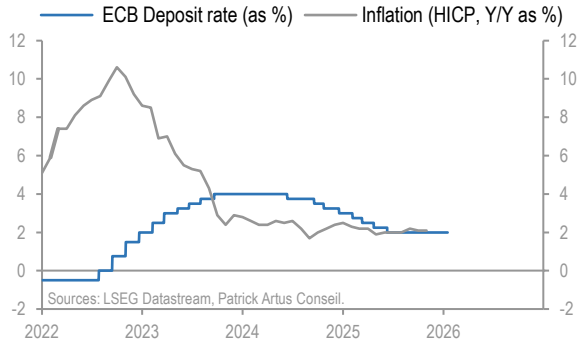


Chart 5A
United Kingdom : Holdings of Gilts by the Bank of England (GBP bn)



Chart 5B
Euro zone: Monetary base (EUR bn)



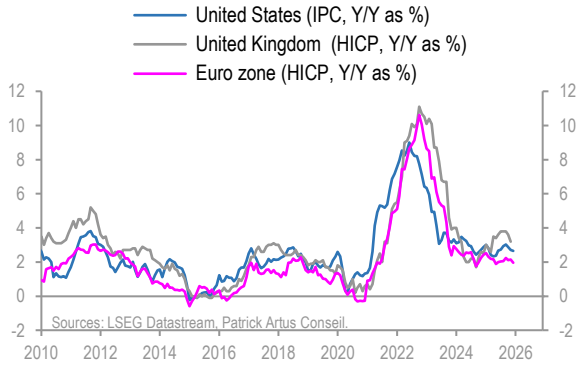
However, over time, **it is difficult to imagine that these two central banks could further disregard the rise in public debt ratios**, which will automatically continue under the unavoidable maintenance of an expansionary fiscal policy.

We therefore believe that **central banks will have to adopt fiscal dominance, as of now in the United States and later in Europe.**

Summary: consequences of the adoption of fiscal dominance

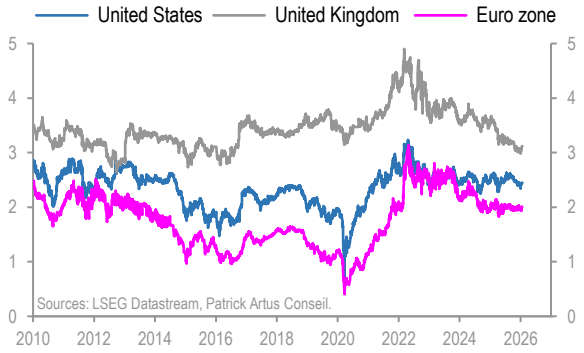
If central banks, in the United States immediately and later in the United Kingdom and the euro area, shift to fiscal dominance (with central banks taking responsibility for stabilising public debt ratios), one can expect support for the demand for goods and services, and **a situation of excess demand driven by the simultaneous presence of expansionary fiscal and monetary policies**. This implies that **a reacceleration of inflation should be anticipated** (**Chart 6**).

Chart 6
Inflation



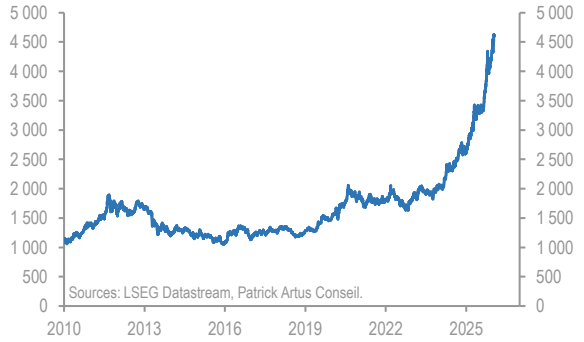
The fact that inflation is set to reaccelerate is not reflected in **inflation swaps**, which traditionally forecast a return of future inflation toward its long-term average (**Chart 7**).

Chart 7
10-year inflation swaps (as %)



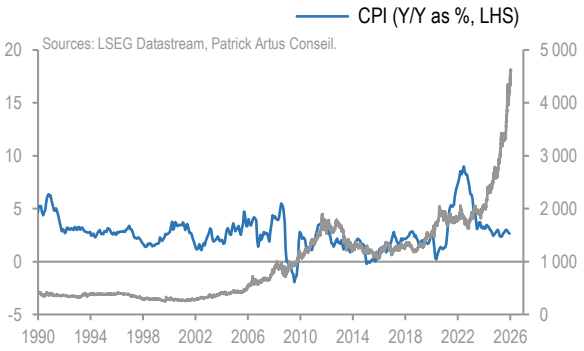
However, this foreseeable acceleration in inflation is fully consistent with **the rise in the price of gold** (**Chart 8**), which serves as a safe haven when expected inflation increases.

Chart 8
Gold price (USD per Troy Ounce)



It therefore appears that fiscal irresponsibility will lead to monetary irresponsibility, encouraging investors to turn toward assets that have historically provided protection against inflation (as is the case with gold, as shown by the comparison between the price of gold and inflation in the United States, **Chart 9**).

Chart 9
United States: Inflation and gold price



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