Flash Economics

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Monetary credibility and fiscal credibility

Monetary credibility is strong if no one doubts the central bank's commitment to keeping inflation at or below its target (2% in most countries) over the medium term. Fiscal credibility is strong if no one doubts the government's commitment to pursuing a fiscal policy that stabilises the public debt ratio. We examine these two forms of credibility in the United States and France (and in the euro zone in the case of monetary credibility).

Monetary credibility remains strong in the United States and the euro zone, even though headline and core inflation have stood above 2% for several years. Fiscal credibility, by contrast, has weakened sharply in the United States and France, owing to the failure to rein in budget deficits and to stabilise the public debt ratio. It is therefore the weakening of fiscal credibility that accounts for the rise in long-term interest rates.

If monetary credibility were also to deteriorate – a prospect that is openly debated, particularly in the United States – the rise in long-term interest rates would be amplified.

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Monetary credibility still strong in the United States and the euro zone

For several years, **headline and core inflation have stood above both central banks' 2% inflation target, in the United States as well as in the euro zone** (**Charts 1A and 1B**).

Chart 1A
United States: Headline inflation and core inflation

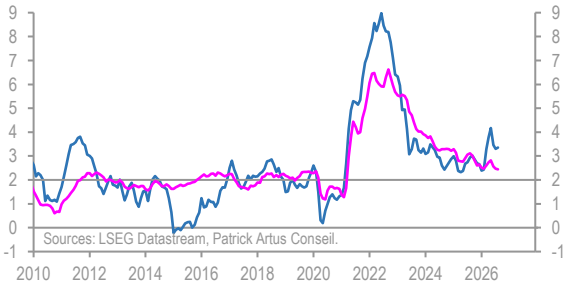
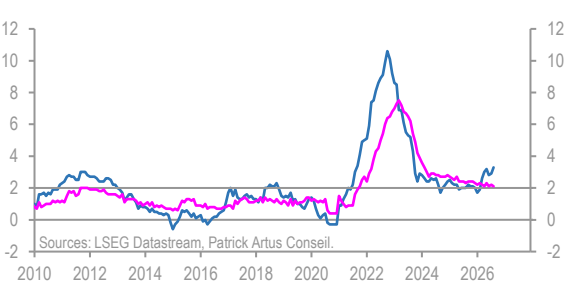
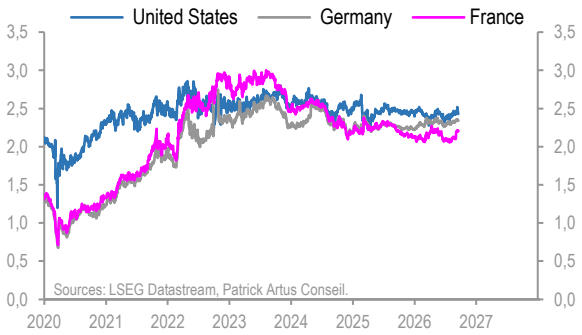


Chart 1B
Euro zone: Inflation and core inflation



A loss of monetary credibility at the Federal Reserve and the ECB could therefore be envisaged, and would be reflected in **a rise in long-term inflation expectations**. Yet **long-term inflation expectations,** as measured by the five-year, five-year forward inflation swap rate, **have not increased significantly since 2022** (**Chart 2**).

Chart 2
Five-year forward inflation-linked swap rate five years ahead (%)



For the time being, the monetary credibility of the Federal Reserve and the ECB has therefore remained strong.

A debate is admittedly under way in the United States over the stance that Kevin Warsh, Chair of the Board of Governors of the Federal Reserve System since May 2026, will take on inflation. Some observers are concerned about his close ties with Donald Trump, who is calling for a cut in the Federal Reserve's policy rates. For the time being, the credibility of the Federal Reserve, as measured by market-based inflation expectations, remains virtually intact.

Fiscal credibility sharply weakened in the United States and France

The United States is failing to reduce its budget deficit, which the Congressional Budget Office (CBO), in its August 2026 update, estimated at USD 2.1 trillion for fiscal year 2026 (**Chart 3**). **The situation is comparable in France** (**Chart 4**).

Chart 3
United States: General government deficit
(as % of GDP)

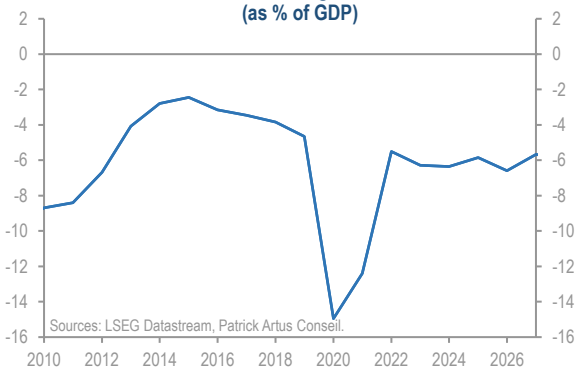
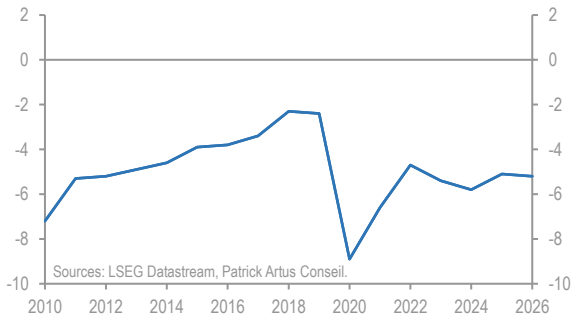


Chart 4
France: General government deficit
(as % of GDP)



In both countries, the deficit stems from rising defence spending, rising health spending and the growing interest burden on public debt.

This large deficit, which also corresponds to a substantial **primary deficit** – i.e. excluding the interest burden (**Chart 5**) – leads to **a continuous rise in the public debt ratio** (**Chart 6**).

Chart 5
General government primary fiscal deficit (as % of GDP)

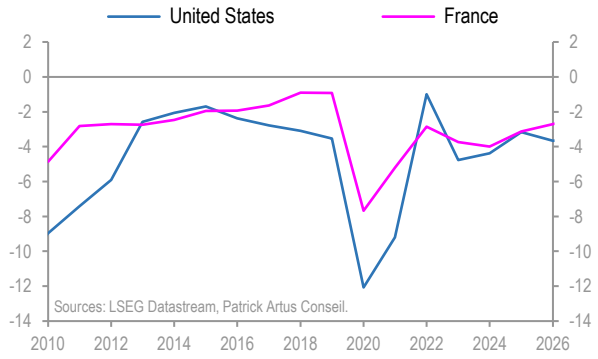
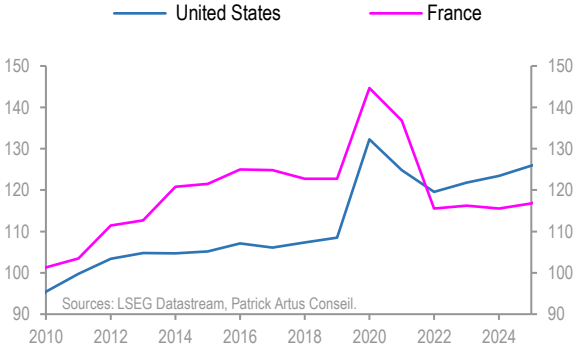


Chart 6
General government gross debt (as % of GDP)



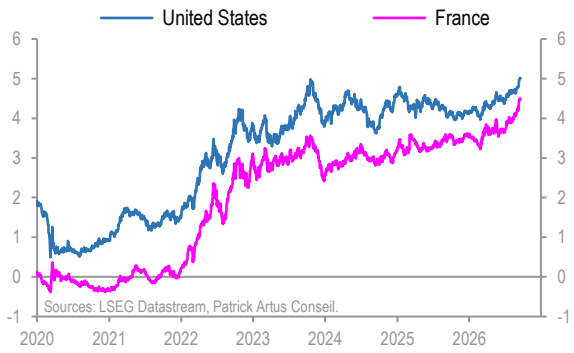
Fiscal solvency is therefore deteriorating continuously, which implies **a rise in the default risk premium**, pushing up long-term interest rates.

Summary: what accounts for the rise in long-term interest rates?

Long-term interest rates:

- have been on an upward trend in the United States since 2020, a trend that strengthened from 2023 to the summer of 2026;
- have been rising in France since 2021, with the increase gaining pace since the beginning of 2026 (**Chart 7**).

Chart 7
10-year interest rate on government bonds (as %)

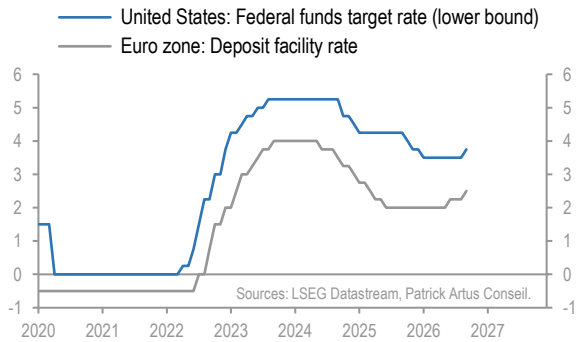


The rise in long-term interest rates may result from:

- mechanically, a rise in short-term interest rates;
- a loss of monetary credibility;
- a loss of fiscal credibility.

Short-term interest rates stopped rising in July 2023 in the United States and in October 2023 in the euro zone, and then began to fall in June 2024 in the euro zone and in September 2024 in the United States (**Chart 8**). Despite the 25 basis point increases in policy rates decided by the ECB in June 2026, and by the ECB and the Federal Reserve in September 2026, short-term interest rates remain well below their 2023 peaks.

Chart 8
Policy rates (%)



Since the end of 2023, the rise in long-term interest rates can only stem from a loss of monetary or fiscal credibility.

It follows from the above that, to date, the monetary credibility of central banks has been almost entirely preserved, and that the rise in long-term interest rates observed since the end of 2023 therefore results solely from the loss of fiscal credibility.

If monetary credibility were now to be eroded, particularly in the United States, the rise in long-term interest rates would be compounded by a rise in long-term inflation expectations.

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