Fiscal Dominance – Testing the Central Bank Put

Executive Summary

Markets are shifting into a regime of fiscal dominance, where sovereign debt sustainability rather than inflation dynamics increasingly constrains monetary policy. Inflation expectations remain broadly anchored, but term premia are rising as investors demand compensation for fiscal risks. This note explains the fiscal dominance model step by step, illustrates historical precedents, and applies the framework to today's context across the US, Eurozone, and Japan.

1. The Fiscal Dominance Model

The core of fiscal dominance lies in the intertemporal budget constraint of the sovereign, combined with monetary dynamics. In its simplest form, inflation (π) is related to money growth (μ), velocity (ν), and real growth (g): $\pi = \mu + \nu - g$. With stable velocity, $\pi \approx \mu - g$.

Seigniorage (revenues from money creation) as a share of GDP can be expressed as: $s/Y = \mu / V$. In a stationary setting, the government budget constraint is: $d + (r - g)b = s/Y$, where d is the primary deficit, b is the debt-to-GDP ratio, r the real interest rate, and g growth. This leads to a simple identity: $\pi = V [d + (r - g)b] - g$.

In the post-2008 world of Quantitative Easing (QE), reserves (R) expanded dramatically. Many reserves are remunerated (iR), reducing their role as an inflation tax. Introducing λ as the share of reserves effectively taxed by inflation, the consolidated budget constraint becomes:

$$d + (r - g)b + (iR - \pi)(R/Y) = (\pi + g)(H/Y + \lambda R/Y)$$

where H is non-remunerated base money, R bank reserves, and iR the interest paid on reserves. If fiscal needs on the left-hand side exceed the seigniorage capacity on the right-hand side, inflation cannot be durably anchored by monetary policy alone. Inflation is thus displaced over time: less today implies more debt accumulation and more tomorrow (Sargent & Wallace, 1981).

2. Expectations and the Cagan Money Demand

When money demand declines with expected inflation, a Cagan-type formulation applies: $(H/Y + \lambda R/Y) = k * \exp(- \alpha E[\pi])$. Plugged into the budget constraint, this produces a seigniorage Laffer curve: beyond a threshold, higher inflation yields less revenue as agents flee money balances. This is critical in understanding the limits of using inflation to close fiscal gaps.

3. Historical Precedents

- US 1940s: Yield curve control capped financing costs, but credibility eroded, ending with the 1951 Accord. - US late 1980s: inflation expectations anchored, but fiscal deficits lifted long rates; resolved via consolidation. - Eurozone 2010–12: inflation stable, but spreads exploded; Draghi's conditional "whatever it takes" restored order. - UK 2022: gilt crisis from fiscal slippage; BoE stabilized with targeted, temporary bond purchases.

4. Today's Situation (2025)

United States: Debt >120% GDP, primary deficit ~5%. Seigniorage capacity is small (<1% GDP). Equation cannot balance without higher inflation or fiscal adjustment. Likely outcome: medium-term inflation 2.5–3%, persistent term premia, curve steepeners.

Eurozone: Average debt ~90% GDP (Italy >140%). ECB constrained by fragmentation. Outcome: inflation forwards 2.3–2.6%, Bund yields 2.5–3.5%, volatile spreads.

Japan: Debt ~260% GDP, chronic deficits. BoJ is a structural buyer, implicitly capping the 10Y near 2%. Inflation expectations ~2.3–2.6%, with long rates 1.5–3%.

5. Market Implications – Testing the Central Bank Put

Inflation expectations remain anchored around 2–2.5%, but fiscal credibility is under pressure. Yield curves steepen as term premia rise. This creates a Treasury trap: cutting short rates raises rollover risks, keeping them high inflates debt service costs. Either way, markets anticipate implicit or explicit curve interventions (Yield Curve Control).

6. Thresholds to Watch

- UST 30Y > 5% → Fed credibility tested. - BTP–Bund spread > 250bp → ECB anti-fragmentation put tested. - MOVE Index > 150 → volatility shock requiring intervention. - Gold > $2,700/oz → safe-haven demand accelerates under fiscal dominance fears.

7. Conclusion

We are in a rare configuration: inflation credibility intact, but fiscal credibility strained. Markets will continue to test central banks until clear red lines are defined. Conditional, targeted interventions can preserve short-term stability, but long-term sustainability requires fiscal consolidation. Otherwise, the central bank put becomes untenable.