Fiscal Dominance – The Market is Testing the Central Bank Put

Executive Summary

Markets are shifting into a regime of fiscal dominance. Inflation expectations remain broadly anchored, but long-end yields continue to rise as investors demand compensation for fiscal risk. Central banks are being tested on whether they will tolerate higher yields or step in to cap them. This note explains the fiscal dominance model, recalls historical precedents, and narrates the current situation as a story of markets probing the limits of the central bank put.

1. The Story Unfolds

In the post-Covid world, central banks fought inflation aggressively, raising rates at the fastest pace in decades and beginning to shrink their balance sheets. Inflation expectations fell back toward target, and for a moment it seemed that monetary dominance had been restored. Yet governments emerged from the pandemic with unprecedented debt burdens: the US above 120% of GDP, the Eurozone with Italy above 140%, and Japan with more than 250%. The key question today is whether central banks are constrained more by inflation, or by sovereign debt sustainability.

2. The Fiscal Dominance Model Explained

At its heart, the fiscal dominance model links the government's budget needs to inflation and money creation. The consolidated budget identity is:

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

On the left: fiscal needs – primary deficit, debt rollover costs when $r>g$, and the cost of remunerating reserves. On the right: resources available from the inflation tax – applied to currency in circulation (H) and, partially, to reserves (R). If fiscal needs exceed this seigniorage capacity, monetary tightening can only postpone, not eliminate, inflation. This is the essence of Sargent & Wallace's 'unpleasant arithmetic': less inflation today leads to more debt accumulation, hence more inflation tomorrow.

Expectations and Cagan Dynamics

When money demand falls as expected inflation rises, the system behaves like a Cagan model: $(H/Y + \lambda R/Y) = k * \exp(-\alpha E[\pi])$. This creates a Laffer curve of seigniorage: beyond some threshold, higher inflation yields lower revenues as agents abandon money balances. This illustrates the limits of using inflation to finance persistent fiscal gaps.

3. Lessons from History

- US 1940s: Yield curve control kept financing cheap, but credibility was lost. Independence restored only with the 1951 Accord. - US late 1980s: Inflation expectations remained anchored, but fiscal deficits pushed long yields higher. The solution was fiscal consolidation. - Eurozone 2010–12: Inflation stable, but spreads exploded. Draghi's conditional 'whatever it takes' was enough to restore order. - UK 2022: An unfunded fiscal package triggered a gilt crisis; the BoE calmed markets with targeted, temporary purchases.

4. Today's Situation (2025)

Today, inflation expectations are anchored – 5y5y swaps hover around 2.3–2.5%. But long-end yields keep rising. This reflects not inflation fears, but fiscal concerns: massive issuance, high deficits, and doubts about governments' ability to sustain high real rates. This is the Treasury trap: if the Fed cuts rates, the Treasury increases reliance on short-term debt, raising rollover risk. If the Fed holds rates high, debt service costs balloon. In both cases, the temptation grows for central banks to intervene at the long end, implicitly or explicitly.

The same dynamics apply in Europe, where the ECB is watched whenever BTP–Bund spreads widen, and in Japan, where the BoJ already caps the 10Y near 2%. Everywhere, markets are probing the credibility of the central bank put.

5. Thresholds to Watch

- UST 30Y > 5%: Fed credibility tested. - BTP–Bund spread > 250bp: ECB's anti-fragmentation backstop in play. - MOVE Index > 150: bond market volatility shock. - Gold > $2,700/oz: safe-haven demand surging as fiscal dominance priced.

6. Conclusion – The Market's Narrative

We are in a rare equilibrium: inflation credibility remains intact, but fiscal credibility is under strain. Markets will keep testing until central banks draw red lines. History suggests that conditional, targeted interventions can calm volatility without destroying credibility. But if interventions become permanent, markets will price fiscal dominance: inflation expectations drift higher, FX weakens, and safe-haven demand accelerates. The story of 2025 is not about inflation fears, but about governments' fiscal anchors – or lack thereof – and how long central banks can pretend to ignore them.