Between a Rock and a Hard Place:

Monetary Policy Under Fiscal Dominance

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Alarm Bells

“That’s called fiscal dominance, and we’re so far from that.”

Jerome Powell December 2024

“The preconditions for fiscal dominance are clearly strengthening.”

Janet Yellen January 2026

“The Fed is in a box.”

Eric Leeper July 2025

Sources: Powell (NYT DealBook Summit, 2024); Yellen (AEA, 2026); Leeper (MNI, 2025).

Three Questions

1. What exactly do we mean by fiscal dominance?
2. Is fiscal dominance already present in the United States, or merely a future possibility?
3. What can a central bank do when fiscal policy threatens its ability to maintain price stability?

Between a Rock and a Hard Place

Monetary vs. Fiscal Dominance

- Monetary and fiscal policy are linked through the consolidated government budget constraint (monetary policy has fiscal implications).
- The central issue is which authority adjusts to satisfy the government's intertemporal budget constraint.
- Monetary dominance arises when fiscal policy must accommodate monetary policy to ensure government solvency (the consensus assignment).
- Fiscal dominance arises when monetary policy must accommodate fiscal policy to ensure government solvency.

The Arithmetic of the Government Budget Constraint

Government flow budget constraint:

$$(g_t - \tau_t)P_t Y_t + (R_{t-1} - 1)D_{t-1} = D_t - D_{t-1} \tag{1}$$

Normalize by nominal GDP and impose stationarity:

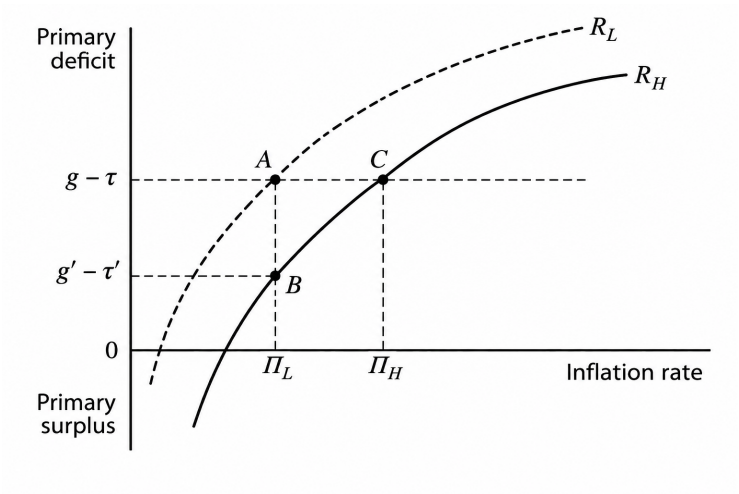
$$g - \tau = (1 - R/\mu)\,\theta \tag{2}$$

where: $\mu \equiv D_t/D_{t-1}$ and $\theta \equiv \frac{D_t}{P_t Y_t} \Rightarrow \mu = \Pi\gamma \equiv n$.

Use your favorite theory to determine θ; e.g., $\theta'(R/\Pi) > 0$. Laffer curve:

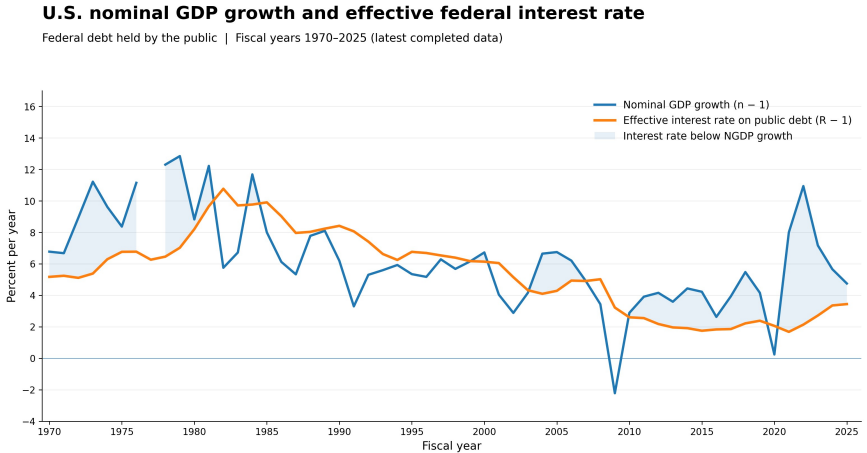
$$g - \tau = \left(1 - \frac{R}{\Pi\gamma}\right)\theta\left(\frac{R}{\Pi}\right) \tag{3}$$

Some Unpleasant Interest Rate Arithmetic



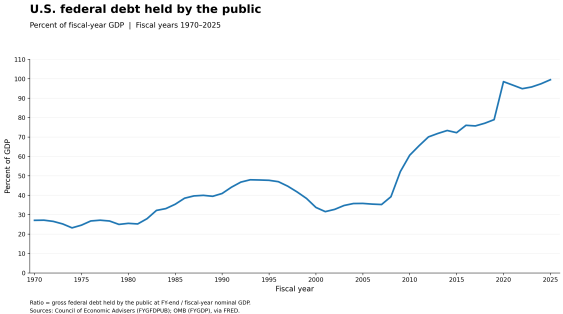
Interest Rates and Nominal GDP Growth: U.S., 1970–2025

- We've seen how fiscal commitments can constrain monetary policy.
- But how relevant is this predicament to the United States?



U.S. Government Debt: 1970–2025

- The effective interest rate on government debt has frequently been below nominal GDP growth; yet the U.S. debt-to-GDP ratio has increased dramatically.



If debt is relatively inexpensive to finance, why does the debt ratio keep rising?

The Arithmetic of Debt Accumulation

$$d_t \equiv g_t - \tau_t, \qquad n_t \equiv \Pi_t \gamma_t$$

Debt dynamics:

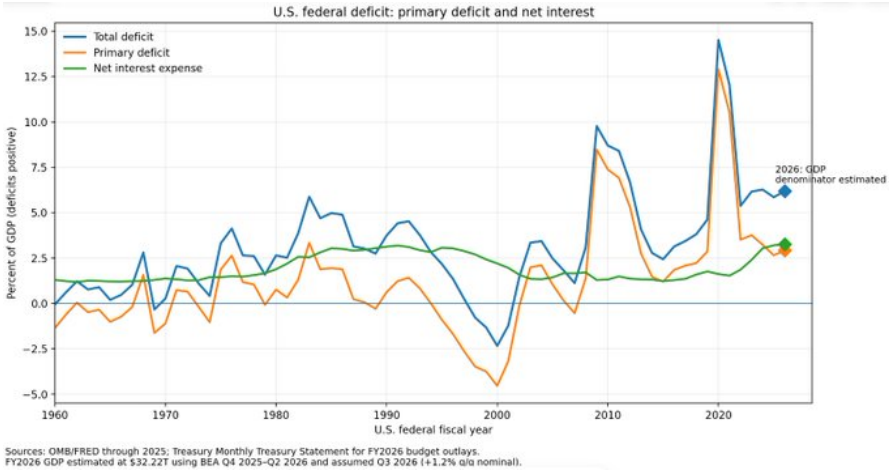
$$\boxed{\Delta\theta_t = d_t - \left(1 - \frac{R_{t-1}}{n_t}\right)\theta_{t-1}} \tag{5}$$

Debt-stabilizing primary deficit:

$$\boxed{d_t^* = \left(1 - \frac{R_{t-1}}{n_t}\right)\theta_{t-1}} \tag{6}$$

$$\boxed{\Delta\theta_t = d_t - d_t^*}$$

The Anatomy of U.S. Federal Deficits



Will fiscal policy adjust, or will monetary policy face increasing pressure to accommodate?

Monetary Policy: Stepping on a Rake?

Suppose fiscal dominance persists and inflation is above target.

Conventional central bank response: $\uparrow R$.

In short run (say, with inflation expectations fixed), $\theta'(R/E\Pi) > 0$ so that:

$$R \uparrow \implies \theta(R/\Pi^e) = \frac{D_t}{P_t Y_t} \uparrow \implies P_t \downarrow \text{(for given } D_t/Y_t)$$

But in long run (our steady-state analysis): $\uparrow R \Rightarrow \uparrow \Pi$.

Short-run disinflation, but **higher** steady-state inflation if no fiscal adjustment.

Temporary Inflation vs. Persistent Fiscal Dominance

A price-level adjustment need not imply a change in the monetary-fiscal regime.

$$\boxed{P_t = \frac{D_t}{\theta_t Y_t}}$$

Two potential sources of temporary inflation:

- Unfunded fiscal expansion: $D_t \uparrow \Rightarrow\ P_t \uparrow$
- Negative supply shock: $Y_t \downarrow \Rightarrow\ P_t \uparrow$

Both can generate a permanent price-level increase without permanently higher inflation.

Key question: Does fiscal policy constrain monetary policy after the shock?

Policy 1: Hedge Against Regime Uncertainty

Fiscal dominance is difficult to identify in real time.

Two competing risks:

- Insufficient tightening under monetary dominance.
- Excessive tightening under fiscal dominance.

Recommendation: Attenuate tightening as fiscal dominance becomes more likely or the costs of excessive tightening rise. Update beliefs as new evidence accumulates.

Policy 2: Speak Plainly About Fiscal Risks

The warning signs (FY2026):

- Federal deficit: $2.0 trillion (6.2% of GDP at full employment).
- Net interest: $1.05 trillion; primary deficit: $0.94 trillion.

The recommendation:

Explain how fiscal policy affects inflation, interest rates, and monetary policy—without prescribing fiscal choices.

Two precedents:

- Volcker (1982): publicly linked large deficits to high interest rates.
- Canada: a jointly agreed inflation target, with central bank operational independence.

Central bank independence does not require silence about fiscal policy.

Lessons from Latin America

1. Crises manifest in two ways: gradually, then suddenly.

   - Mexico (1982): rising global interest rates increased debt-service costs, exposing fiscal and external financing vulnerabilities.

2. Successful stabilization is possible.

   - Peru and Chile: fiscal stabilization and credible monetary institutions helped restore and sustain price stability.

3. The United States is different—not exempt.

   - Dollar-denominated debt reduces exposure to foreign-currency financing crises.
   - Rising debt-service costs nevertheless increase the need for fiscal adjustment.

The lesson: Monetary independence is more effective with credible fiscal backing.

Conclusions

Three questions, three answers:

1. Fiscal dominance arises when monetary policy must accommodate fiscal policy to maintain government solvency.
2. Whether the United States is fiscally dominant is difficult to determine in real time.
3. Central banks must conduct monetary policy while recognizing uncertainty about the regime.

Two policy recommendations:

- Hedge against regime uncertainty: attenuate interest-rate responses according to the likelihood and costs of policy errors.
- Speak plainly about the implications of fiscal policy for inflation and interest rates.