Sunday, 6 September 2026

The Editorial

The price of monetary independence

Academic terminology from research into market commentary happens occasionally, but not all is well understood across all participants. Today, we discuss one of those "buzzwords", fiscal dominance, with the specific angle of monetary policy impact in case of fiscal dominance. The background to addressing this is not only a natural extension of last week's Editorial on US yields and the drivers thereof, but also that some commentaries have reemerged in the discussion of it.

Furthermore, the timing is particularly interesting as we are entering a phase where central banks are once again having to think about how far they will and can tighten policy. Next week, the ECB is set to deliver yet another rate hike, and the following week the Fed will meet, where a c.60% probability of a rate hike is currently priced in by markets. The obvious question is therefore whether monetary policy is becoming constrained by fiscal policy and, more importantly, what the latest research actually tells us about it. Importantly though, on Wednesday 9 September, we will see Scott Bessent's recent announcement in action when the US Treasury will increase buybacks (read financial repression by operation twist in action), and the market reaction to that is not straightforward.

The meaning of fiscal dominance

Before digging into fiscal dominance, it important to establish the optimal segregation between fiscal and monetary policy, with the textbook example being the so-called Ricardian fiscal regime. Here, the central bank has the job of determining inflation and price stability, while fiscal policy takes the interest rate and monetary policy stance as a given and adjusts taxes or spending accordingly. The government's intertemporal budget constraint is therefore respected: public debt remains ultimately backed by future fiscal surpluses. In other words, monetary policy determines the price level, while fiscal policy adjusts to ensure the debt is sustainable.

Now, to the fiscal dominance. Fiscal dominance is not something that suddenly appears simply because government debt is high. At its core, fiscal dominance is about the extent to which fiscal policy limits the freedom of monetary policy - how far rates can be raised, for how long, and how much volatility policymakers are ultimately willing to tolerate in the government bond market when they meet their mandate.

In the extreme example, which we haven't just seen briefly in modern times in developed markets, the interaction can become rather uncomfortable. The practical examples that come to mind are, for example, the BoE's de facto suspension of its inflation mandate to mitigate the Lizz Truss budget announcements or during the European sovereign debt crisis where had it not been for the ECB and the monetary union, the outcome to that may have been vastly different. Luckily, those countries managed to regain market trust via hard-fought fiscal discipline and ultimately a solid growth outlook.

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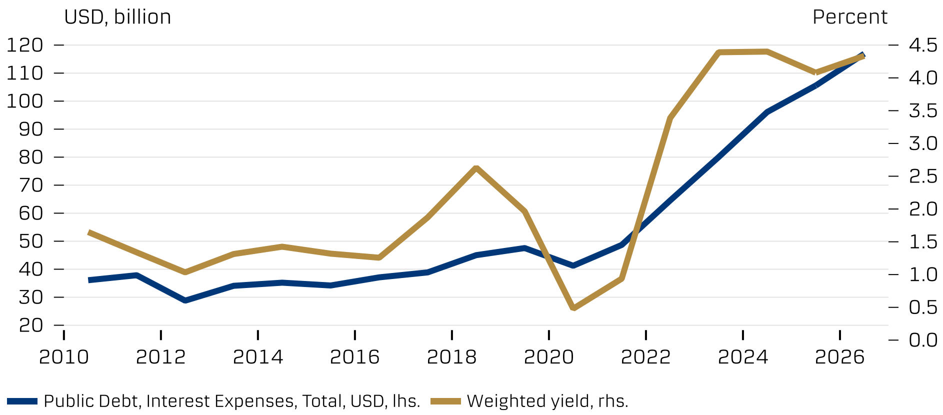
Now, the mechanics of a central bank that hikes rates is to weaken demand in order to bring inflation down. The flipside of this is that it also increases the government's interest bill. And with a large stock of outstanding debt, the fiscal impact can become substantial, even if only newly issued debt is immediately repriced at higher rates. If fiscal policy does not respond by tightening its own stance, the bond market may eventually have to do the adjustment – and ultimately monetary policy - to absorb the consequences.

The chart below illustrates one part of this story and the point that when we operate in a high yield environment, it makes the discussion about fiscal dominance more prevalent. The chart shows the average yield on outstanding US government debt alongside government interest expenditure. There are nuances between them, not least that not all debt is rolled over at once, but it's clear that we have moved significantly higher since COVID.

Volume weighted market yield of outstanding US treasuries vs US interest expenses



Source: Bloomberg, Macrobond, Danske Bank

There is, of course, no magical debt-to-GDP ratio or interest-cost threshold at which point we can suddenly declare that we are in a situation of fiscal dominance or that we have a debt crisis, but we do provide a few numbers later. From a market perspective, it is ultimately the bond market that serves as the "relief valve" between the interaction of deficits, debt servicing costs, interest rates and the willingness of investors to finance the government. Again, this is what we saw during the Lizz Truss moment and the sovereign debt crisis.

Two pieces to highlight from this year

However, the experience of the past few years also provides an important counterargument to the fiscal-dominance narrative. When inflation surged after COVID, central banks tightened decisively despite already elevated debt levels and rising interest costs. The Fed raised rates by 5.25pp, while the ECB hiked its policy rate by 4.5pp. And, as recently as earlier this year, monetary policy was still being tightened despite the challenging fiscal backdrop.

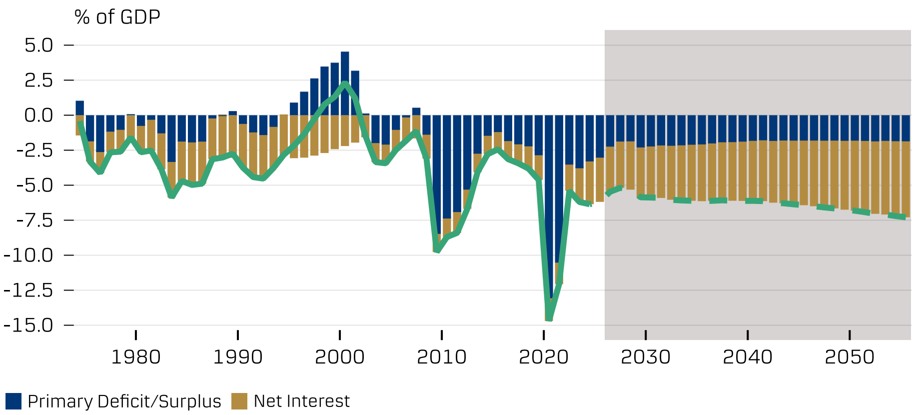
That is fairly strong evidence against the idea that fiscal dominance is already preventing at least two of the world's most important central banks from acting independently. Monetary policy has clearly operated independently. This was also what the ECB's *Schnabel* described as credible evidence of monetary dominance in recent years. Looking ahead, a recent *BIS* research piece highlighted that the next question following the rising debt is the fiscal cost of fighting inflation, which has increased and could create an endogenous ceiling in respect of how far rates can be raised. While this does not point to us being at this point yet, the fact that such a piece has been written is interesting in itself. In summary, the fact that central banks managed to tighten aggressively in the last cycle has demonstrated that there was monetary policy headroom, but it doesn't necessarily demonstrate that the headroom is unlimited.

The US case – let's put some numbers to it

To be more practical, let's take the US as an example. With debt projected at 126% of GDP this year, a sustained increase in interest rates has a very different fiscal significance than it would have with a debt ratio of e.g. 63% as in Germany. If we assume a 1pp permanent increase to the US interest rate, it would add 1.2% of GDP to annual interest expenditure, all else being equal, or in USD terms, about USD400bn, but only after the full debt is rolled, which for the US is after about 6 years (average maturity of US debt), which in simple terms means that it would "only" add 0.2% of GDP of cost every year.

0.2% of GDP is of course manageable in itself, but if this happens every year, it may become a problem as the same rate hike can be contractionary for the private sector while simultaneously expansionary for the fiscal position. And as projected by the CBO, the interest rate expenditure is set to be an even larger driver US public deficits going forward – without the presumed 1pp hike.

US, Public Deficits, % of GDP + CBO Forecast



Source: Bloomberg, Macrobond, Danske Bank

The bond market is the relief valve

This is where we think the bond market deserves more attention in the fiscal-dominance debate. If fiscal policy responds to higher interest costs by tightening the primary balance, the system can remain broadly Ricardian, and it's all good from the market perspective, and we get the usual flattening of the yield curve. However, recent US administration and deficit problems beg the question: what if fiscal policy does not adjust? Could we end up in a situation where the US yield curve steepens when the Fed hikes? After all, something has to absorb the difference, and that something is ultimately the bond market; the case being that more borrowing requires more government bonds to be absorbed by investors.

If investors become less comfortable with the fiscal trajectory, they will demand compensation/term premiums, leading to higher real yields and a weaker currency.

Monetary policy still works, but it comes with a cost

It would be outright wrong to say that debt above a certain level means monetary policy no longer works. It does. The question is rather how much collateral damage is created by using it.

Here a *Fed* research paper provides an interesting perspective. While not directly focused on fiscal dominance, when applying the framework to a 1pp increase in the expected US debt-to-GDP ratio, it illustrates that the longer-run neutral interest rate is raised by around 1–2bp and the 10-year Treasury term premium by roughly 2–3bp. While the numbers look small, just keep in mind the "direction" and the fact that US debt/ GDP is projected to increase by 2.3pp per year, according to the CBO; so, after 10 years, the neutral rate level may be 23-46bp higher and term premiums 46-69bp higher, if estimates are taken literally.

This means that fiscal deterioration does not simply sit passively on the government's balance sheet. It can feed back into the price of government borrowing through the bond market, raising the cost of debt service and potentially creating a further deterioration in the fiscal position. This is precisely the feedback loop that matters when thinking about fiscal dominance: higher debt can raise the cost of borrowing, which raises interest expenditure, which creates more debt, which in turn puts further pressure on yields.

From monetary r* to fiscal r*

Years ago, the IMF introduced the concept of fiscal r* (also called r**), which is the real interest rate that would stabilise the debt-to-GDP ratio (ensure financial stability) given a particular path for primary balances, growth and inflation. Put simply, if monetary r* is above fiscal r*, the central bank can in principle set rates at a level that is entirely appropriate for inflation, while simultaneously putting the public debt ratio on an upward trajectory given the assumed fiscal policy.

The resulting gap is not evidence that monetary policy is "wrong" but it is evidence of a tension between two otherwise reasonable objectives: price stability and debt stability.

And here fiscal dominance becomes more than a theoretical concept. The US provides a striking example. According to the IMF, the US is projected to run a cyclically adjusted primary deficit of 3.5% of GDP in 2026 while carrying public debt of 126% of GDP, as also noted above. At the same time, real growth is projected at 2.3%. Combining the three implies a fiscal r* of roughly minus 0.5%.

That result does not mean the US Treasury cannot borrow at positive real rates. It means something more subtle. If the US were to maintain today's fiscal stance indefinitely, the real effective interest rate on government debt would need to average about minus 0.5% to prevent the debt ratio from rising over time.

The arithmetic becomes uncomfortable surprisingly quickly. Suppose the real effective interest rate rises to 1%, still well below what most economists would consider restrictive. The debt dynamics equation then implies debt would rise by roughly 1.9 percentage points of GDP per year before any stock-flow adjustments. In other words, debt accumulation would become the default outcome unless fiscal policy tightened materially.

That observation highlights a growing tension across advanced economies. Monetary r* and fiscal r* are no longer the same thing. The Federal Reserve may believe that a real policy rate of around 1% to 1.5% is broadly neutral for inflation and economic activity, yet the fiscal arithmetic suggests debt stabilisation would require considerably lower borrowing costs if current deficits persist.

The table below offers some indications of what levels monetary and fiscal r* is. Of particular interest is that Italy has a positive development with a negative gap, which is due to the primary budget balance surplus.

Monetary r* and fiscal r* in advanced economies

Economy	Monetary r*	Fiscal r*	Gap (Monetary - Fiscal)
United States	1.0-1.5%	-0.5%	1.5-2.0 pp
Euro Area	0.5-1.0%	-0.5%	1.0-1.5 pp
Germany	0.5-1.0%	-2.9%	3.4-3.9 pp
France	0.5-1.0%	-1.3%	1.8-2.3 pp
Italy	0.5-1.0%	1.1%	-0.6 to -0.1 pp
United Kingdom	1.0-1.5%	0.2%	0.8-1.3 pp
Japan	0.0-0.5%	-0.2%	0.2-0.7 pp

Note: Fiscal r estimated as structural growth + cyclically adjusted primary balance / Debt to GDP.*
Source: IMF, HLW styled frameworks to estimate monetary r, Danske Bank*

And then there is financial repression

Fiscal dominance does not necessarily arrive with a bang and there are a more subtle routes through which fiscal pressures can influence financial conditions: financial repression. Instead of the central bank simply being forced to keep rates low, governments can create an environment in which the state can borrow more cheaply than it otherwise would. Banks and other domestic investors can be encouraged — or effectively required — to hold government bonds, while regulation, capital controls or central-bank balance sheets can help create a captive demand for sovereign debt. Or as in August 2026, try to increase buybacks via an operation twist as Bessent has announced.

The economic effect is potentially similar: the government's effective cost of borrowing is kept below what an unconstrained market might otherwise demand. The adjustment is simply pushed onto savers, banks and private borrowers rather than appearing directly in the government budget.

This is not just a theoretical possibility. New *IMF* research covering 17 advanced economies and more than a century of data finds that financial repression has been a persistent feature of modern history. It was particularly important in the post-war period, when governments were dealing with very high debt burdens, and the authors find evidence that it has once again generated fiscal savings since the GFC.

That does not mean that a new era of financial repression is inevitable. But it is a useful reminder that governments have historically found more than one way of dealing with uncomfortable debt dynamics.

And it highlights an important distinction. Fiscal dominance is about the fiscal position constraining monetary policy. Financial repression is about changing the financial environment to ease the fiscal constraint. They are not the same thing, but under sufficiently high debt burdens, the one thing can lead to the other.

So, are we heading for fiscal dominance?

Not necessarily. The relevant question is not whether a debt ratio of 100%, 120% or 150% automatically triggers fiscal dominance. There is no such threshold. The real question is what happens when the central bank tightens and the fiscal consequences become large enough to matter for the bond market. Here, the risk is that term premiums matter more, and monetary policy becomes less effective, if higher bond issuance and fiscal stimuli (money flowing from government into the private sector/bond holder) mitigate the central-bank assessed required demand destruction. One prime example is the Lizz Truss moment, as highlighted above, where the market disciplined the government, and the central bank had to step in to ensure financial stability before thinking of its primary mandate. Even though it was for a brief moment, it highlights that the risk and reaction function is real.

In conclusion

Historically, monetary constraint has dominated. Governments have carried moderate debt burdens and central banks could focus almost exclusively on inflation and (employment) growth. Today, many advanced economies operate with debt ratios above 100% of GDP, and critically, structurally weak fiscal positions. In that world, fiscal r* becomes increasingly relevant. The question is no longer merely where central banks want rates to be, and thus we can't rule out the 2010s debate about monetary policy being replaced in the 2030s with fiscal r*, which ultimately may dictate where monetary r* can settle. In other words, it does not mean that monetary policy stops working, but it means that the fiscal feedback becomes increasingly important, particularly as a bond market theme.

Thus, what will ultimately decide whether we enter a fiscal dominant regime, where monetary policy is restricted, is the bond market. For now, it is pricing term premiums higher, and that shouldn't go unnoticed.

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Report completed: 04 September 2026 at 18:01 CET
Report disseminated: 06 September 2026 at 07:00 CET