

Fiscal Dominance

The U.S. faces unsustainable debt dynamics characterized by mounting debt levels and rapidly increasing debt service costs. At the same time, the Fed's independence is under attack and there is speculation that the new Fed Chair might subordinate monetary policy to fiscal or political considerations. This quarter's special topic examines the risks of eroding central bank independence and illustrates how monetary policy operated during a previous period of fiscal dominance.

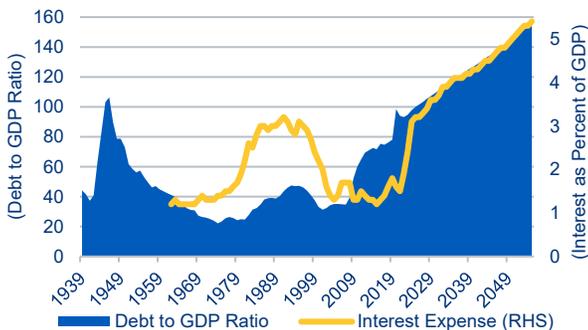
Fiscal Dominance During WWII

Government debt can become unsustainable as a result of large and persistent fiscal deficits and debt service costs that exceed the rate of nominal GDP growth. A policy of fiscal dominance can appear attractive when debt dynamics become unsustainable.

Under fiscal dominance, the central bank is compelled to reorient policy to containing debt service costs. We often hear that this is achieved by inflating away the debt, but that image is incomplete and potentially misleading. If the yield on U.S. Treasuries is not controlled, higher inflation will merely lead to rising yields and higher debt service costs as debt is rolled over. If allowed to persist, such a dynamic ultimately culminates in a doom loop of hyperinflation.

When the average maturity of the debt is short, as it is today, inflating away the debt is especially ineffective. To be effective, there must be a hard ceiling on interest rates, as the Fed imposed during WWII.

Exhibit 1
Unsustainable Debt Dynamics During WWII and Now
Source: CBO. Federal debt and net interest payments in percent of GDP. Projections as of March 2025 (before impact of BBB and tariffs).

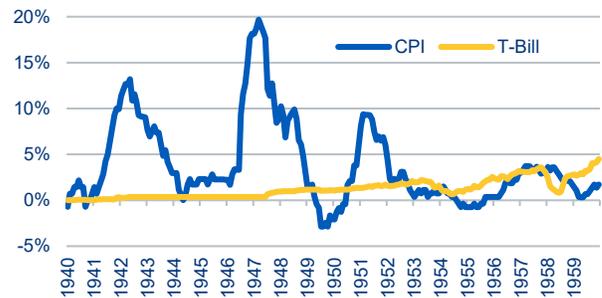


The costs of WWII led to a rapid accumulation of debt exceeding 100% of GDP (Exhibit 1). To avoid a situation in which persistent deficits and rising debt service costs resulted in explosive debt growth, U.S. monetary policy was reoriented toward pegging U.S. Treasury yields across the yield curve. To achieve this, the Fed purchased U.S. Treasuries whenever yields threatened to breach predetermined ceilings. In this precursor to QE, the Fed expanded its balance sheet to achieve fiscal, not monetary ends.

Thanks to Fed intervention, from 1940-1951 the yield on T-bills averaged 0.6% and U.S. 10-year bond yields never exceeded 2.5%, well below the rate of inflation, which was high and volatile and averaged 5.5% (Exhibit 2). With the Fed effectively eliminating the price risk of holding longer duration Treasuries, the market gravitated toward higher yielding long-term bonds, leaving the Fed to absorb mainly lower yielding T-bills.

Exhibit 2
Fiscal Dominance During WWII

Sources: BLS and FRED. YoY change in CPI and 90-day T-bill yield in percent. Low inflation during 1944-1946 reflects price controls.



This policy of debt monetization resulted in yields that were deeply negative in real terms. This, combined with rapid economic growth following the war, contributed to a steep decline in the debt ratio and allowed the return to an independent monetary policy in 1951.

Today's Unsustainable Debt Dynamics

The debt ratio currently exceeds its previous peak during WWII and is projected to increase rapidly (see Exhibit 1). This increase reflects many years of high fiscal deficits that are currently running at 6% of GDP despite strong economic growth. Fiscal deficits are forecast to remain high. In addition, debt service costs are on a steep upward trajectory, crowding out other spending. This combination creates the risk of explosive debt dynamics, making it tempting to once again subordinate monetary policy to the budget. Whether a return to fiscal dominance would be successful in today's highly integrated global capital markets is an open question. Successful or not, a strategy of fiscal dominance would entail grave risks.

A return to a policy of fiscal dominance would result in higher and more volatile inflation. Confidence in the Fed, the reserve currency status of the U.S. dollar, and the safe haven role of U.S. Treasuries would be undermined. The Fed would not be able to engage in countercyclical policies and its ability to respond to crises would be impaired. Repairing the credibility of the Fed would be difficult, and the economic costs of ultimately restoring price stability high.

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