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Monetary policy in times of high public debt

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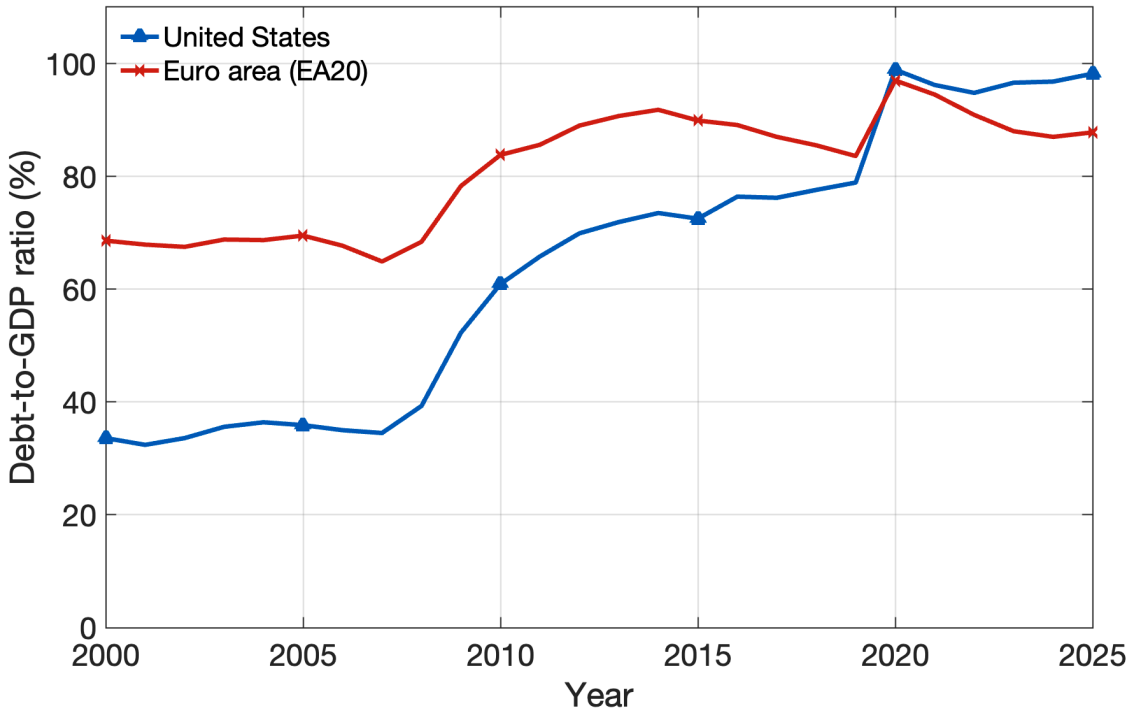
High public debt around the globe has revived concerns that it could undo central banks' ability to control inflation. Central banks can still control inflation when public debt is high, but must then take into account that higher public debt increases the level of interest rates consistent with price stability.

Public debt has climbed sharply on both sides of the Atlantic since the global financial crisis (see Chart 1). Meanwhile, financing needs are expanding owing to the green transition and higher defence spending. This has revived an old concern: can high public debt fuel inflation? When the euro area was first pieced together, the Maastricht Treaty[2] imposed limits of 3% on fiscal deficits and 60% on debt-to-GDP ratios. This reflected concerns that looser national fiscal policies could strain the seams of the monetary union by weakening the central bank's grip on inflation. And surveys suggest that households also associate high debt with higher inflation (see Andrade et al. 2025). By contrast, Milton Friedman's dictum that "inflation is always and everywhere a monetary phenomenon" suggests that, as long as the central bank is independent and the government does not interfere, monetary policy can keep a firm grip on inflation.

Chart 1

General government debt-to-GDP ratios for the United States and the euro area



Sources: “Federal debt held by the public” from Federal Reserve Economic Data (FRED) and Eurostat’s “General government gross debt (EA20)”.

An issue that divides economists

So, which is it: can we always expect the central bank to keep inflation hemmed in, or can fiscal policy weaken the central bank’s ability to deliver price stability? Among economists there is surprisingly little consensus on this.[3] On the one hand, most monetary models follow the Friedman view according to which monetary policy always controls inflation. On the other hand, the fiscal theory of the price level argues that unless current public debt is backed by future fiscal surpluses then fiscal policy, rather than monetary policy, can determine inflation (Leeper, 1991; Sims, 1994; and Woodford,1995).[4]

The range of views has only widened in recent years. Blanchard (2019) highlighted that when interest rates on government bonds are below the economy’s growth rate, debt does not need to be backed by future surpluses. In this situation, a government may be able to keep rolling its debt over without having to raise taxes later to repay it – though Blanchard cautioned that this would not necessarily be a good idea. Conversely, the fiscal response to the pandemic made another intuition hard to ignore: if you give households extra money and they spend some of it, but the supply of goods remains limited, then prices rise (see for example Angeletos, Lian and Wolf, 2024).

Both arguments rely on the assumption that households are not fully “Ricardian”. Households are said to be Ricardian when they save all of any debt-financed transfer they receive in anticipation of higher future taxes and the level of public debt makes no difference to their spending. In contrast, non-

Ricardian households spend some of the extra money transferred. This is because some people may realise they won't live to see the future tax increases, while others may be unable to borrow and prefer spending more today even though they expect higher taxes tomorrow. The empirical evidence suggests actual household behaviour doesn't fit the Ricardian pattern: Borusyak, Jaravel and Spiess (2024) found that US households spent 8-11% of their 2008 tax rebates on non-durable goods in the same quarter in which they received their rebates.

How high can debt be without causing price stability to unravel?

In Dupraz and Rogantini Picco (2025), we take a fresh look at how fiscal policy could put serious strain on price stability. While rising public debt is inflationary when households are not Ricardian, we note that this does not necessarily mean the central bank loses control over inflation. Public debt translates into wealth for households, and greater wealth tends to raise spending, putting inflationary pressure on the economy. But the central bank can normally lean against that extra demand by increasing interest rates – just as it can counter the inflationary effects of other kinds of shocks.

Nevertheless, this only works up to a point. When households are not Ricardian, public debt can become so high that even very high interest rates cannot rein in households' desire to spend. In fact, higher rates can even encourage spending, because higher rates on a household's savings mean it needs less savings to maintain high consumption in the future. However, we find the implied limit on public debt to be quite high – our main estimate puts it at about 5.4 times annual GDP, far above current advanced-economy debt ratios.

How can monetary policy prevent high debt raising inflation?

A more immediate difficulty arises well before that limit is reached. A standard prescription for monetary policy is to hike policy rates as inflation rises. But when households are non-Ricardian, this can backfire. Higher rates curb spending today, but they also increase future debt, adding inflationary pressure tomorrow. Inflation becomes more persistent, so when the central bank tightens more strongly cumulative inflation may fall very little – or even rise.

There is, however, a way for monetary policy to stay in close control of inflation. Rather than waiting for higher debt to generate inflation, the central bank can tighten interest rates directly in response to an increase in the level of public debt. This restores the ability of monetary policy to prevent fiscal shocks from increasing inflation.

Public debt alters the natural rate of interest

To explain this, it helps to consider the natural rate of interest: the rate that keeps demand in line with what the economy can produce and therefore keeps inflation on target. The natural rate depends on all the factors that determine households' desire to save rather than spend, such as demographics, productivity and risk preferences (see Marx, Mojon and Velde, 2021).

But the natural rate depends not only on households' demand for assets in which to invest their savings; it also depends on the supply of these assets. Government debt is an important source of asset supply, and therefore helps shape the natural rate (see for example Auclert et al., 2025). For the

United States, estimates suggest that a 1 percentage point increase in debt relative to GDP raises long-term interest rates by about 3 basis points (see for example Plante, Richter and Zubairy, 2025).

How the central bank can stay in control of inflation

To track the natural rate, central banks in our analysis therefore need to keep an eye on public debt. Given that the natural rate increases with the level of public debt, they need to raise interest rates when public debt increases – and not wait to respond to the inflation that higher debt can generate. That can be institutionally uncomfortable: central banks do not want to appear to react to fiscal decisions. But monitoring the level of public debt is not the same as conducting fiscal policy; it is part of understanding how to implement monetary policy in a way that suits the economy it needs to stabilise.

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2.

The “Maastricht Treaty” refers to the Treaty on European Union, signed in Maastricht on 7 February 1992 and later amended by the Treaty of Lisbon. Since 1997, the EU’s framework for coordinating fiscal policies has commonly been referred to as the Stability and Growth Pact.

3.

For a review of the literature on the linkages between fiscal and monetary policy, with a focus on the potential risks to price stability in times of high public debt, see Checherita-Westphal et al. (2024).

4.

Woodford’s (2026) tribute to Chris Sims discusses how the role of fiscal policy in determining inflation was an increasingly recurrent theme in Sims’ later work.

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