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Fiscal Dominance and Asset Price Redistribution

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Abstract

This paper studies the distributional consequences of fiscal dominance through asset prices. When public debt constrains monetary policy, interest rates may decline as debt increases. Lower discount rates raise asset valuations, generating capital gains for asset holders. In a simple framework combining public debt dynamics, fiscal reaction functions, and a debt-sensitive interest rate rule, we derive a formal condition under which fiscal dominance generates redistribution toward asset-owning households through the asset price channel, and show that the wealth share of asset holders is increasing in public debt.

1. Introduction

Public debt has reached historically high levels in many advanced and emerging economies. At the same time, the global environment of ultra-low interest rates that prevailed during much of the past two decades appears to be fading. As borrowing costs increase, concerns about debt sustainability and the interaction between fiscal and monetary policy have re-emerged. In particular, recent policy discussions have revived interest in the possibility of *fiscal dominance*, a regime in which monetary policy becomes constrained by the need to maintain government debt sustainability.

Under fiscal dominance, interest rate policy may respond not only to macroeconomic stabilization objectives but also to the fiscal position of the government. When public debt is high, increases in interest rates raise debt servicing costs and can threaten fiscal sustainability. In such circumstances, monetary authorities may face pressure to keep interest rates lower than would otherwise be implied by conventional policy rules. While this mechanism may help stabilize public finances in the short run, it may also generate important distributional effects.

This paper highlights a simple but largely overlooked channel through which fiscal dominance can affect the distribution of wealth. If higher public debt leads to lower equilibrium interest rates, discount rates decline and asset prices increase. Because ownership of financial assets is typically concentrated among a subset of households, this asset price channel can generate redistribution toward asset holders. In this sense, fiscal adjustment through interest rate suppression may operate not through inflation or taxation, but through changes in asset valuations.

The analysis contributes to three strands of literature. First, it relates to the literature on fiscal dominance and monetary–fiscal interactions (Sargent and Wallace, 1981; Leeper, 1991; Bianchi and Melosi, 2019). Second, it connects to the macroeconomic debate on public debt sustainability in low interest rate environments (Blanchard, 2019; Dabla-Norris et al., 2023; Eggertsson, Mehrotra, and Robbins, 2019). Third, it relates to the asset-pricing literature emphasizing the role of discount-rate movements in asset valuation (Campbell and Shiller, 1988; Cochrane, 2011). Greenwald, Leombroni, Lustig, and Van Nieuwerburgh (2024) show empirically that declining interest rates generate capital gains on long-duration assets that increase financial wealth inequality—a channel closely related to the mechanism formalized here. Recent work on public sector balance sheets also highlights the importance of low government funding costs in high-debt environments (Chien, Cole, and Lustig, 2024). The practical relevance of these concerns is underscored by the OECD Global Debt Report (OECD, 2025), which documents record sovereign bond issuance and rising interest-payment-to-GDP ratios across member countries, conditions under which fiscal dominance becomes an increasingly plausible policy regime.

To illustrate the mechanism, we develop a simple framework combining public debt dynamics, a fiscal reaction function, and a debt-sensitive interest rate rule reflecting fiscal dominance. The model shows that when interest rates decline as government debt increases, asset prices rise mechanically through the discounting channel. If only a fraction of households owns these assets, the resulting valuation gains increase wealth concentration.

The remainder of the paper is organized as follows. Section 2 presents the theoretical framework. Section 3 derives the main results. Section 4 discusses the distributional implications and policy interpretation.

2. Model

Consider a simple economy in discrete time. Government debt evolves according to

$$D_{t+1} = (1 + r_t - g)D_t - PB_t \tag{1}$$

where D_t denotes public debt, r_t the real interest rate, g the growth rate of the economy, and PB_t the primary balance.

Fiscal policy responds imperfectly to public debt according to

$$PB_t = \alpha + \psi D_t \tag{2}$$

where $\psi \geq 0$ measures the responsiveness of the primary balance to debt. A low value of ψ reflects limited fiscal adjustment capacity.

Under fiscal dominance, monetary policy becomes sensitive to the fiscal position of the government. We capture this mechanism through a debt-sensitive interest rate rule

$$r_t = r^* - \phi D_t \tag{3}$$

where r^* denotes the benchmark interest rate and $\phi > 0$ measures the strength of monetary accommodation induced by debt pressure. This reduced-form rule captures the implicit response of a monetary authority facing a debt-sustainability constraint. When public debt is high, raising the policy rate increases debt-service costs and threatens fiscal solvency, creating pressure to accommodate below the benchmark rate. Bianchi and Melosi (2019) provide theoretical foundations for this mechanism, showing that lack of monetary–fiscal coordination generates systematically lower rates in high-debt regimes. Empirically, the rule is consistent with the Bank of Japan's yield curve control after 2013 and the ECB's implicit spread management during 2012–2022.

A simple extension introduces a debt threshold $\bar{D}$ such that fiscal pressures affect interest rates only when debt exceeds a prudential level,

$$r_t = r^* - \phi \max(D_t - \bar{D},\ 0),$$

capturing the idea that fiscal dominance becomes relevant only once debt surpasses a critical level. This formulation maps naturally onto the empirical literature on nonlinear fiscal reaction functions and debt limits.

There exists a financial asset paying a constant dividend $A > 0$. The asset price follows a perpetuity discounting relation

$$P_t = \frac{A}{r_t} \tag{4}$$

This is the simplest possible discounting structure. A richer Gordon growth specification, $P_t = A/(r_t - g_A)$, would not alter the directional result of Proposition 1—only the magnitude of $\partial P_t/\partial D_t$—and would connect naturally to the $r - g$ debt-sustainability framework of Blanchard (2019).

Substituting equation (3) into (4) yields

$$P_t = \frac{A}{r^* - \phi D_t} \tag{5}$$

Finally, suppose only a fraction $\lambda \in (0, 1)$ of households owns the asset. Aggregate wealth of asset holders is

$$W_t = \lambda P_t \tag{6}$$

3. Results

The relationship between public debt and asset prices follows directly from equation (5).

Proposition 1. *Suppose $A > 0$, $\phi > 0$, and $r^* - \phi D_t > 0$. Then asset prices satisfy*

$$\frac{\partial P_t}{\partial D_t} = \frac{A\phi}{(r^* - \phi D_t)^2} > 0.$$

Thus, under fiscal dominance, an increase in public debt raises asset prices through the discount-rate channel.

Proof.
From equation (5),

$$P_t = A(r^* - \phi D_t)^{-1}.$$

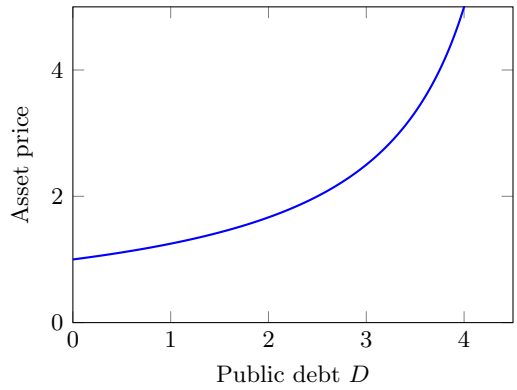
Differentiating with respect to D_t gives

$$\frac{\partial P_t}{\partial D_t} = \frac{A\phi}{(r^* - \phi D_t)^2}.$$

Since $A > 0$, $\phi > 0$, and $r^* - \phi D_t > 0$, the derivative is strictly positive. □

Figure 1 illustrates the mechanism. The left panel shows the convex relationship between public debt and asset prices. The right panel shows that the marginal effect $\partial P_t / \partial D_t$ is itself increasing in D_t: the impact of fiscal dominance on asset valuations accelerates as debt rises.

(a) Asset price $P(D) = A/(r^* - \phi D)$



(b) Marginal effect $\partial P/\partial D = A\phi/(r^* - \phi D)^2$

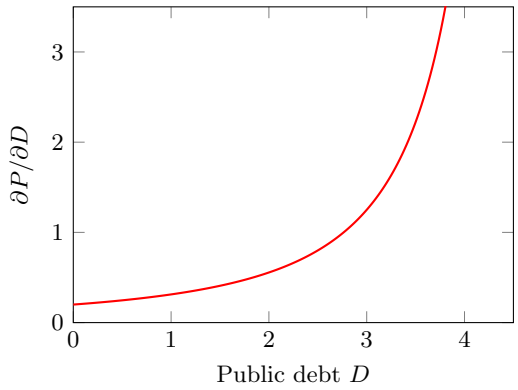


Figure 1: Asset price and its marginal debt sensitivity under fiscal dominance. Parameters: $A = 1$, $r^* = 1$, $\phi = 0.2$.

The distributional consequence follows formally from Proposition 1.

Proposition 2. *Under the conditions of Proposition 1, the wealth of asset-holding households satisfies*

$$\frac{\partial W_t}{\partial D_t} = \frac{\lambda A \phi}{(r^* - \phi D_t)^2} > 0.$$

Furthermore, let $\bar{W}$ denote the wealth of non-asset-holding households, assumed invariant to the discount-rate channel. Define the wealth share of asset holders as $\sigma_t = W_t/(W_t + \bar{W})$. Then $\partial \sigma_t / \partial D_t > 0$: fiscal dominance increases the wealth share of asset-holding households.

Proof.
From equation (6) and Proposition 1,

$$\frac{\partial W_t}{\partial D_t} = \lambda \frac{\partial P_t}{\partial D_t} = \frac{\lambda A \phi}{(r^* - \phi D_t)^2} > 0.$$

For the wealth share: since $\bar{W} > 0$ is independent of D_t,

$$\frac{\partial \sigma_t}{\partial D_t} = \frac{\bar{W}}{(W_t + \bar{W})^2} \cdot \frac{\partial W_t}{\partial D_t} > 0.$$

□

4. Distributional Implications and Policy Interpretation

The model highlights a simple redistribution channel operating through asset prices in high-debt environments. When fiscal pressures induce monetary accommodation, lower interest rates increase asset valuations through the discount-rate channel. Because ownership of financial assets is typically concentrated among a subset of households, these valuation gains accrue disproportionately to asset holders, as established in Proposition 2.

This mechanism complements existing discussions of high public debt, which often emphasize inflation, taxation, or fiscal consolidation as adjustment margins. The analysis suggests that changes in asset prices may also play an important role in shaping the distributional consequences of high-debt regimes. In this sense, fiscal adjustment through interest rate suppression operates not through explicit redistribution, but through changes in asset valuations that benefit households with existing financial wealth.

An important determinant of the strength of fiscal dominance is demographic structure. In aging economies, rising old-age dependency ratios increase pension and health expenditures, driving debt accumulation and raising the effective value of ϕ. Simultaneously, demographic shifts may depress the natural rate of interest r^* through changes in aggregate saving behavior (Eggertsson, Mehrotra, and Robbins, 2019). These forces are particularly relevant for middle-income economies undergoing rapid fertility decline, where fiscal adjustment capacity is limited and the demographic transition may compress the timeline over which fiscal dominance becomes binding.

The assumption that non-asset-holder wealth $\bar{W}$ is invariant to the discount-rate channel is a simplification. If public transfers to non-asset-holding households are themselves constrained by the debt dynamics that generate fiscal dominance, the redistributive effect identified in Proposition 2 is amplified. Quantification of these interactions, and of the redistribution magnitude more broadly, requires micro data on asset ownership and a calibrated overlapping-generations framework—a natural direction for subsequent research, particularly for emerging economies where such data remain scarce.

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