

POLICY COORDINATION FOR FRACTURED TIMES

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Unstable geopolitics complicates effective coordination of fiscal and monetary policy

Advanced economies are grappling with a pernicious mix of high and rising public debt and persistent inflation. The textbook remedy for this twin challenge is a mix of monetary and fiscal policies: central bank commitment to lower inflation backed by credible fiscal adjustment to stabilize debt. But geopolitical fragmentation today augurs a world where rising risks of supply disturbances threaten stagflation pressures and demands on fiscal policy exacerbate outstanding imbalances. The new global equilibrium is not yet defined, but fiscal sustainability and macroeconomic stability during a rocky transition will likely require policymakers across advanced and emerging market economies to accept moderate—if temporary—higher-than-desired inflation.

After the global financial crisis, the monetary-fiscal policy mix was the key to preventing a more severe and persistent downturn. Two conditions determined its success. First, both policies pushed in the same direction, stimulating aggregate

demand without destabilizing the fiscal outlook, while countering deflationary pressure. Second, international relations still largely echoed the postwar cooperation of Bretton Woods. This may no longer be true (Corsetti 2025). The policy mix model doesn't work as well given today's frequent and large supply disturbances, which stem from, or are amplified by, policy decisions that deepen trade fragmentation and geopolitical imbalances and challenge the postwar global economic and monetary order.

In such an environment, monetary-fiscal coordination may weaken central bank independence and thus threaten macroeconomic stability. Counteracting this risk requires geopolitical stability upheld by enhanced international cooperation, widespread adherence to accepted legal norms, and effective international institutions. An integrated policy framework, capable of containing the disruption of economic fragmentation and rising geopolitical tension, will lay the foundation of fiscal sustainability alongside stable control of inflation

fluctuations. When geopolitical tensions escalate without backstops, supply disruptions and adverse supply shocks put fiscal and monetary policy into conflict.

Fiscal sustainability

Why should we expect inflation to play a significant role in fiscal sustainability? Theoretically, all monetary models embed, if only implicitly, coordination of monetary and fiscal policies. The argument is straightforward: When a central bank tightens policy to reduce inflation, real interest rates rise and growth slows. This widens the primary deficit (the deficit excluding interest payments on debt) and raises the real burden of debt. Unless the government cuts spending or hikes taxes to balance the books, rising interest on government bonds will give households more money, feeding aggregate demand. Inflation then rises until the real value of outstanding nominal debt aligns with expected future taxation or spending reductions. Correcting the imbalance without fiscal consolidation thus directly opposes the central bank's goal of controlling inflation. If central banks try to enforce price stability without a credible fiscal framework, an uncontrolled inflationary spiral may arise: Aggressive tightening raises debt-service costs, intensifying inflation pressure, and further tightening and worse fiscal imbalances ensue (Bianchi and Melosi 2019).

The success of a monetary contraction in reducing inflation depends on government's commitment to adjusting primary surpluses—known as *fiscal backing*. But there's more. A key and often underappreciated point is that the effectiveness of monetary-fiscal coordination historically rests on a relatively stable geopolitical environment and a widely accepted international order.

Historical evidence

Academics and policymakers increasingly recognize that fiscal imbalances are typically resolved through a combination of fiscal adjustment and inflation surprises. Bianchi, Faccini, and Melosi (2023) show that US policymakers have long relied on monetary-fiscal coordination to stabilize government debt and inflation, albeit to varying degrees. In the 1970s, this coordination collided with disruptions in oil markets, sparking a period of heightened inflation. Yet in the following decades and through the 2010 years of below-target inflation, monetary-fiscal coordination offset persistent deflationary forces without unmooring inflation expectations. Globalization and international cooperation contributed to the geopolitical stability that ensured the success of monetary-fiscal coordination.

After the pandemic, however, unprecedented coordination of monetary and fiscal policies to support economic recovery contributed to persistently high inflation because it occurred against a backdrop of disruptions to global supply chains and Russia's invasion of Ukraine.

As Smets and Wouters (2024) have shown, supply disruptions complicate monetary-fiscal coordination: Fiscal backing weakens more in response to supply shocks than to demand shocks. This asymmetry helps explain why monetary-fiscal coordination tends to be more successful during demand-driven expansions accompanied by favorable supply conditions—as in the 2010s—than when large fiscal imbalances coincide with persistent adverse supply shocks. In the former scenario, moderate fiscally induced inflation can protect against deflationary pressure without undermining the inflation target, even when the interest rate is stuck at zero. In the latter case, however, central banks confront a difficult dilemma. Do they tighten policy to defend price stability risks at the cost of a deeper recession and worse fiscal position? Or do they accommodate the inflationary consequences of supply disruptions to mitigate the downturn and ease the fiscal burden, at the cost of abandoning price stability?

Controlled inflation

Today, geopolitical tensions, rising defense spending, trade fragmentation, and weaker growth prospects are eroding fiscal positions across advanced economies. This comes atop population aging, low productivity growth, and heightened exposure to climate and geopolitical risks. In this environment, fiscal backing is inherently weaker, increasing the risk of persistent and sizable inflationary pressures. Debt is already high, so fiscal adjustment must be gradual—and *sustainable* adjustment will likely require pragmatic tolerance for some *controlled* inflation. Such “fiscal inflation” works when temporary and moderate and without causing a disruptive and ultimately counterproductive loss of inflation-fighting credibility.

If government bonds are not indexed to inflation, the central bank can smooth or delay price adjustment. The rationale rests on the possibility of significant fiscal corrections in the future and on markets' continuous revision of their fiscal outlook. For instance, markets may expect an AI-driven productivity boom to raise growth enough to reduce the debt burden at lower tax rates. In this case, smoothing price adjustment amounts to a gamble on price and fiscal stability: The central bank buys time, keeping inflation relatively stable today vis-à-vis rising debt, in the hope that raising it substan-

tially won't be necessary in the future if growth fails to accelerate (Corsetti and Maćkowiak 2024). Success calls for effective communication. Authorities must assure the public of their ability to stabilize public debt—via reforms and policies to contain supply-side disturbances—while delivering plausible broad-based productivity gains.

Broader approach

How might this sustainable adjustment play out across the world? Historical experience suggests that countries such as the US and the UK have mechanisms that stabilize debt, in part through inflation. Much of this ability is rooted in a mix of explicit rules and unwritten guidelines structuring the institutional balance of power. Institutional equilibrium is more complex, however, in the euro area, which lacks a meaningful federal budget and debt.

Stabilizing forces may originate in anticipation of productivity growth from new technologies and improved public spending: Both could boost growth and strengthen long-term fiscal sustainability. Governments now face the challenge of scaling up defense outlays while also investing in R&D and innovation—priorities sharply different from those of the globalization era—but some types of defense spending could also feed expectations of growth-enhancing innovations.

Yet with high debt, successful unconventional policy collaboration may not be achievable. In response to the disruption of geopolitical fragmentation and the dismantling of economic networks, governments may give in to the temptation to raise revenue by taxing trade or embrace financial repression—in the form of tighter regulation and capital controls—in the hope of lower borrowing costs. Adding to trade tensions, these measures are likely to raise vulnerability to stagflationary shocks, spurring disruptive two-way feedback between domestic and uncoordinated international policies. Extended unconventional collaboration that integrates a wide range of internal and cross-border policies would stave off this risk by helping keep the world economy on a path to sustainable fiscal adjustment.

Emerging markets face particular challenges as geopolitical developments send shock waves through financial and real markets. These could redefine the magnitude and geography of global imbalances and the costs and benefits of exported policies, capital account liberalization, and exchange rate arrangements with limited flexibility. Many governments will have to defend the hard-won credibility of policy regimes that allowed them to develop significant markets for local-cur-

rency-denominated debt. While this enhances the potential contribution of controlled inflation to address fiscal imbalances, it also raises the temptation to respond to shocks by engineering large inflation surprises—at the risk of undermining prior progress.

A global public good

Large fiscal imbalances, adverse demographic trends, and geopolitical developments require closer coordination between monetary and fiscal authorities. Enhanced coordination is not necessarily undesirable and may, in fact, help boost the credibility of fiscal stabilization, but it calls for a balancing act. Across advanced and emerging market economies, governments may overestimate the scope for reasonable fiscal inflation, downplay the benefits of a credible inflation-targeting regime, and exaggerate the advantages of lack of cooperation in international economic relations. Had advanced economies been able to neutralize the geopolitical forces underlying the oil shocks—most notably the Organization of the Petroleum Exporting Countries' leverage over oil prices—the great inflation of the late 1960s and 1970s might arguably have been less severe. By the mid-1960s, as is the case today, fiscal imbalances were already elevated, and governments' inability to resolve disputes with major oil-producing countries helped set the stage for one of the most disruptive inflationary episodes on record.

The combination of high public debt across advanced economies and today's geopolitical realignment feels uncomfortably familiar, and it reminds us that macroeconomic stability is first and foremost a global public good. **F&D**

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