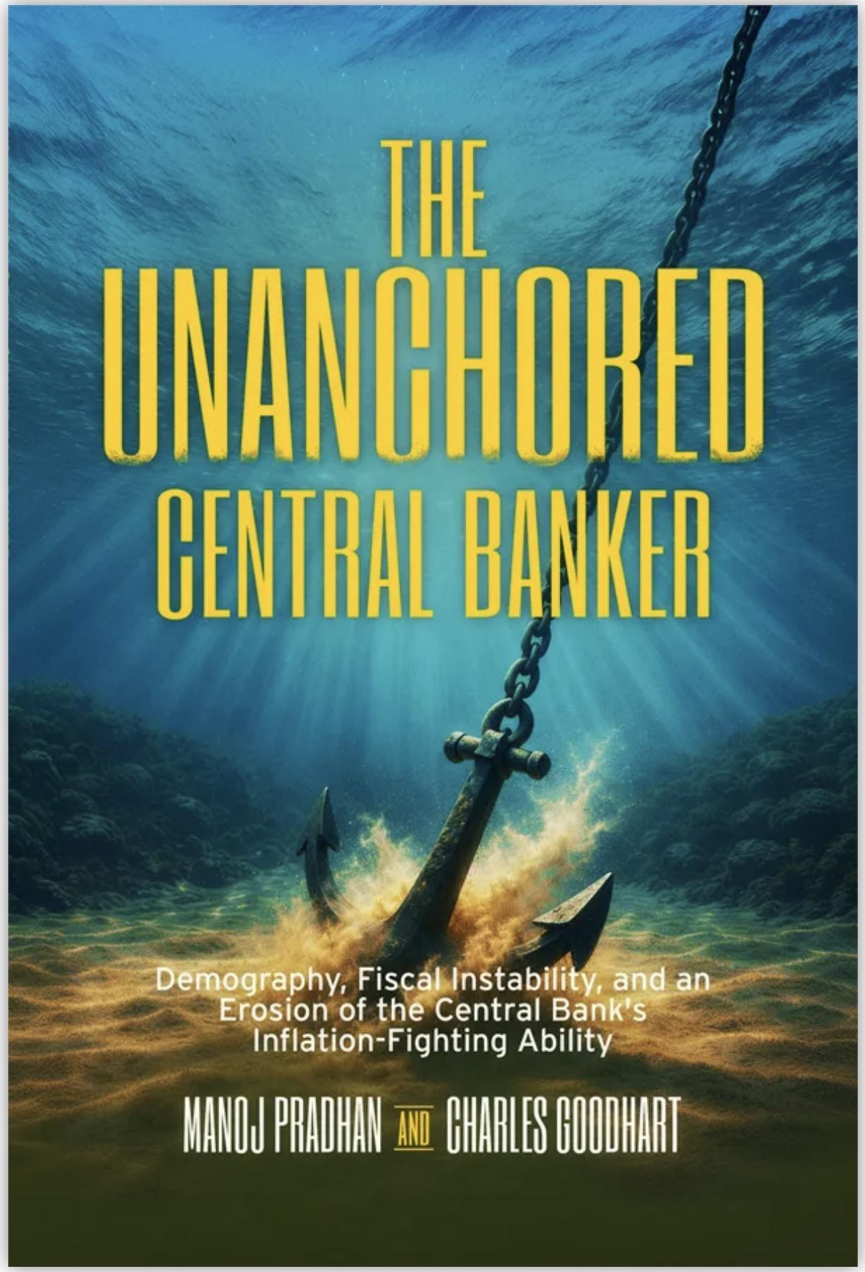
Sep 2026

The Unanchored Central Banker

Demography,
Fiscal Instability,
and an Erosion of the
Central Bank's Inflation-Fighting Ability



The Main Message From Our Second Book

Our first book, The Great Demographic Reversal, warned about problems that would arise when the **demographic sweet spot turned sour**.

Our view that **real interest rates and inflation will reach a higher-for-longer steady state** remains intact. Most critiques appear unrealistic and, hence, unreliable.

The structural inflection in demography (and the related political fallout – political fiscal cycles, less immigration) has helped accelerate **fiscal deterioration** at a pace even faster than we had expected… and future demographic trends will not help.

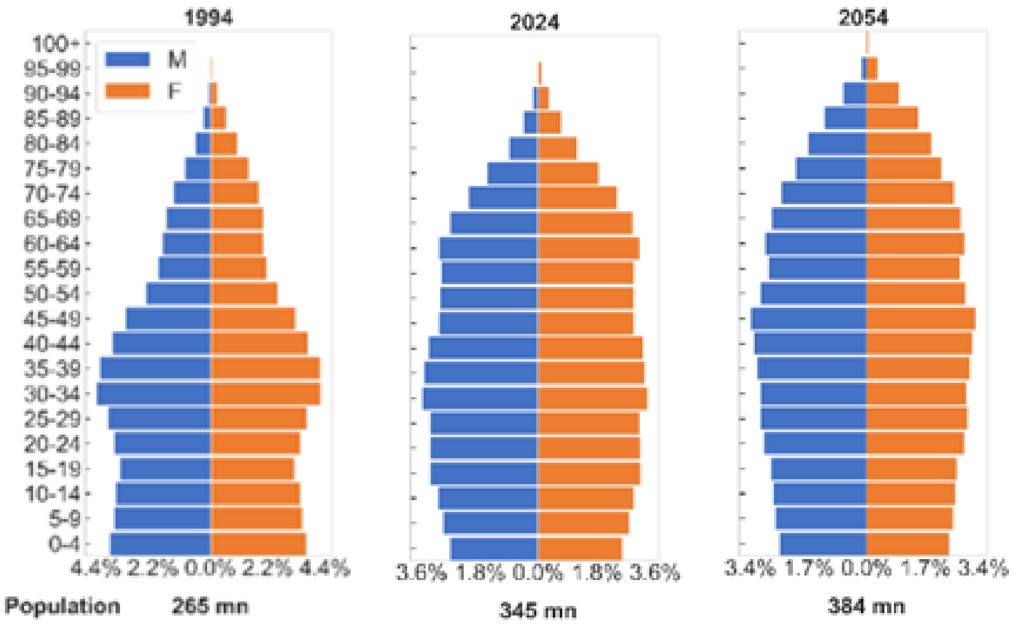
Fiscal dominance will mean that central banks (through little fault of their own) will be forced to choose a balance between fighting inflation and avoiding fiscal/financial instability, without achieving either objective completely.

Pyramids Belie Immigration in the US, C/A Def in China

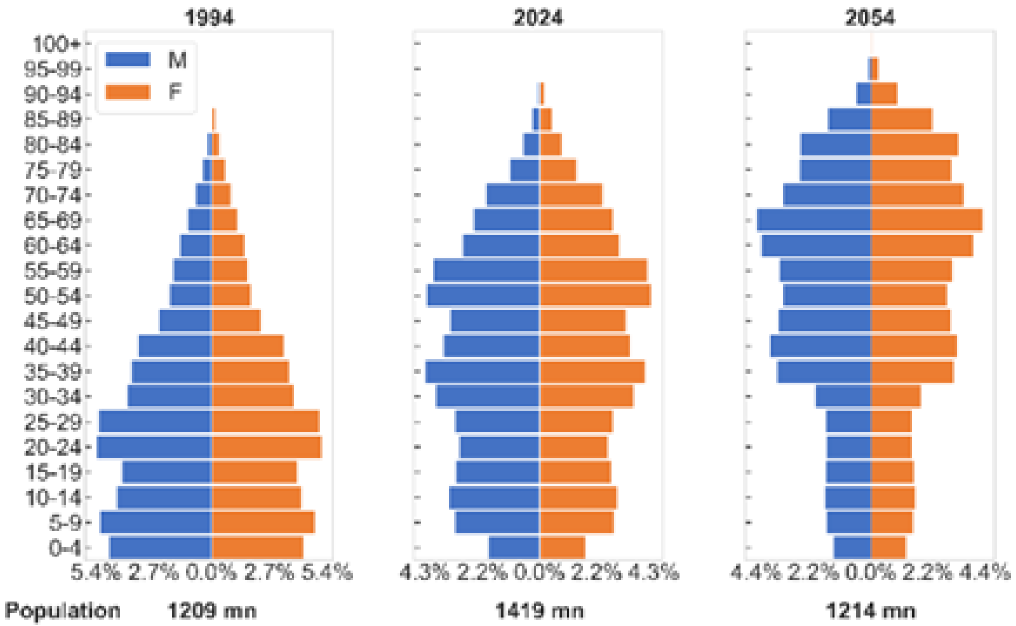
US population pyramids probably show too much optimism about future growth, thanks to still-unrealistic assumptions of future net immigration (e.g., CBO, 2026)

China's population pyramids point fairly obviously to stress on the social safety net, but also suggest future current account deficits and a growing focus on internal migration policies.

US Population Pyramid



China Population Pyramid



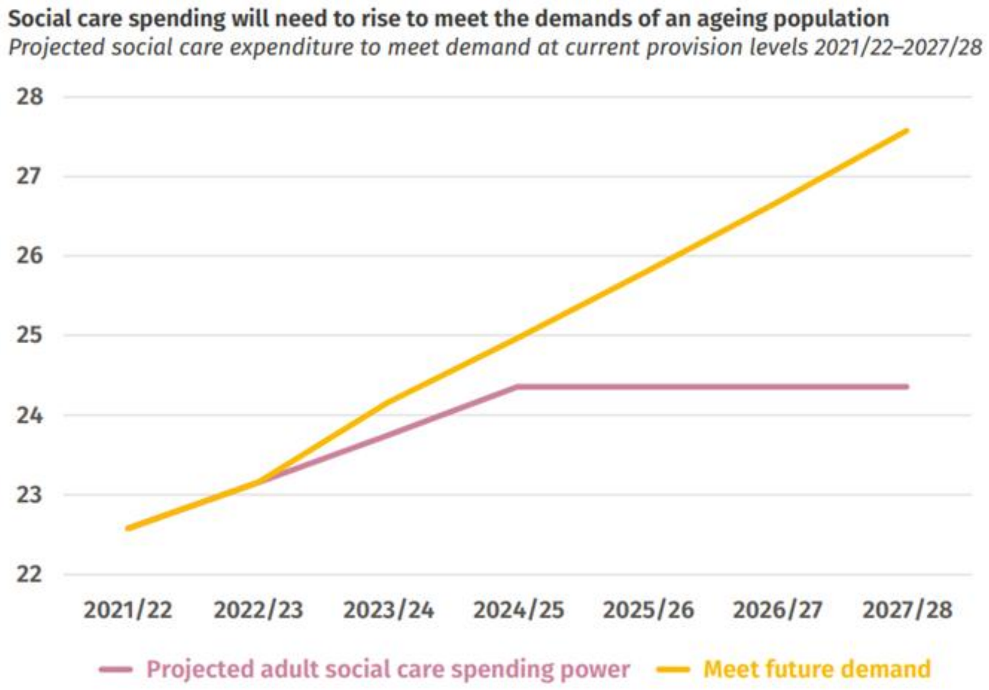
Life Expectancy vs Healthy Life Expectancy

A dispiriting proportion of life is spent in poor health, implying much greater future demand for healthcare services and caring… just as migrant carer inflows slow.

	Healthy life expectancy (HLE)	Years in poor health	Percentage life spent in poor health
Males			
2009-11	63.0	15.8	20.0
2012-14	63.4	16.1	20.2
2015-17	63.4	16.2	20.3
Females			
2009-11	64.0	18.7	22.6
2012-14	63.9	19.3	23.2
2015-17	63.8	19.4	23.3

Source: ONS (32)

Low productivity and recent fiscal deterioration mean a widening gap between the future demand and provision of social care.

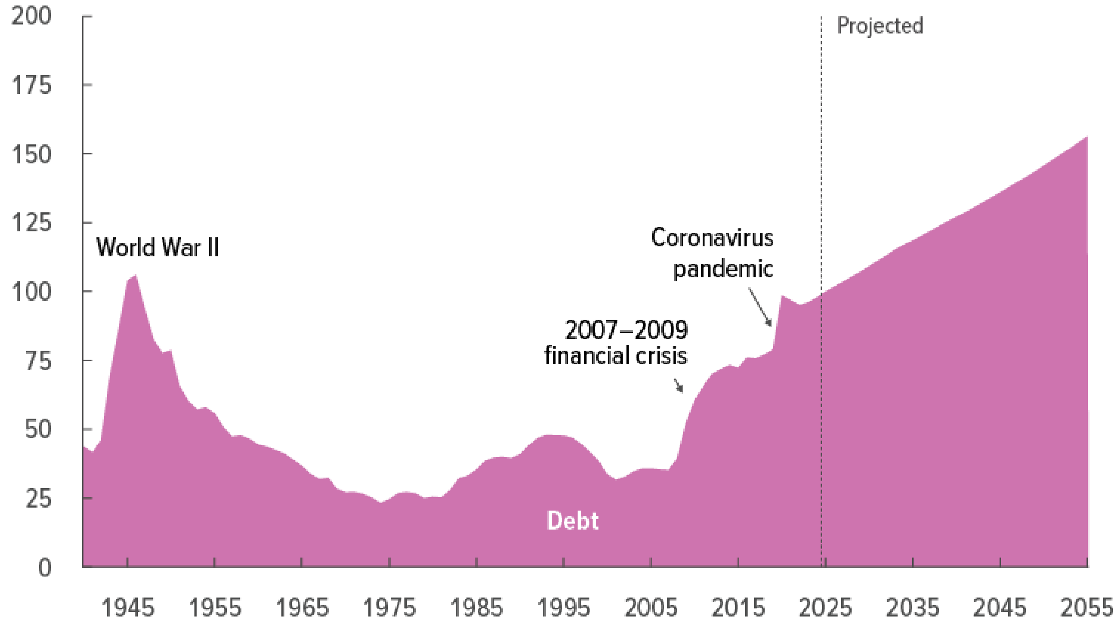


Unsustainable Fiscal Trajectories

The problem:

- Debt will rise inexorably, even with stable interest rates, due to demography-related spending (healthcare, pensions, even politics).
- Rising ($r - g$) worsens debt sustainability.
- Promised future surpluses rarely materialise.

The CBO's long-term debt/GDP forecast underestimates the fiscal problem.



Debt sustainability will worsen because of:

- Interest-insensitive spending (defence, climate change
- Decline in inward migration into the AEs.

Real Interest Rates Will Rise in Increasingly Aged Economies

Recent conventional models argue that rising life expectancy will lower real interest rates:

Why? The rise in savings from workers who face a longer life span than retirees leads to a net decrease in interest rates for the future (Carvalho et al, Obstfeld, Auclert et al).

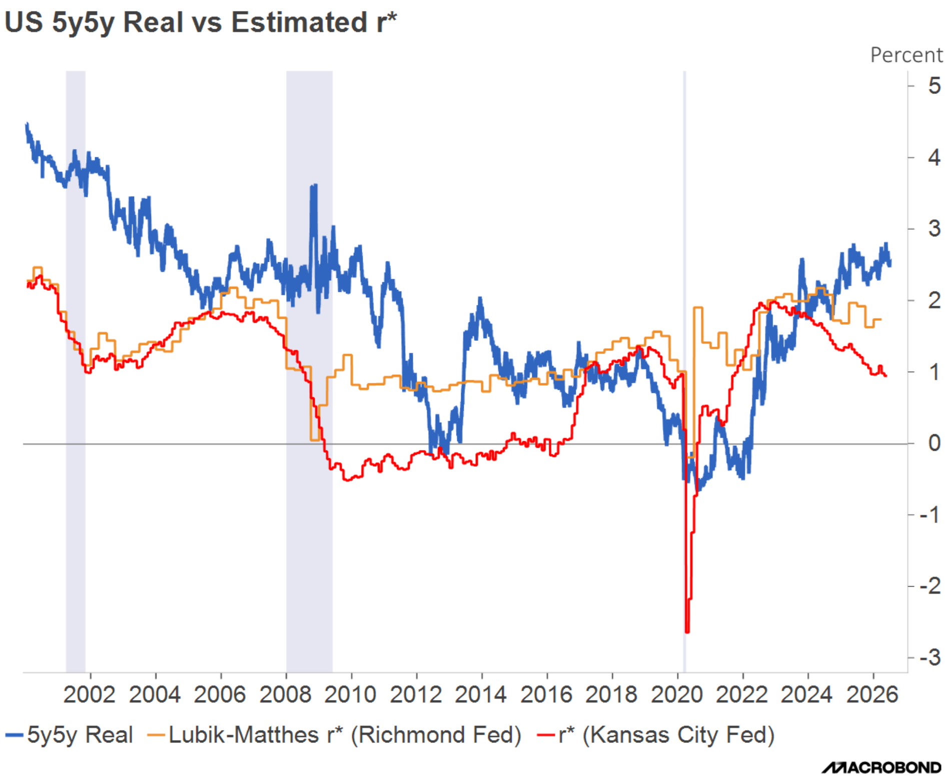
The surprising, even shocking, absence of public debt and housing

- As an example: Carvalho ('16): "We assume debt, spending, and pensions are exogenous fractions of output…". Such assumptions are too far removed from reality.
- Housing is too big to ignore, and is linked as inextricably to ageing as public debt.
- The rise in public dissaving is likely to overwhelm the increase in private saving in an increasingly aged society, pushing real interest rates higher.

Three Market Signals: r*, Front End Pricing (Z6 vs Z8)

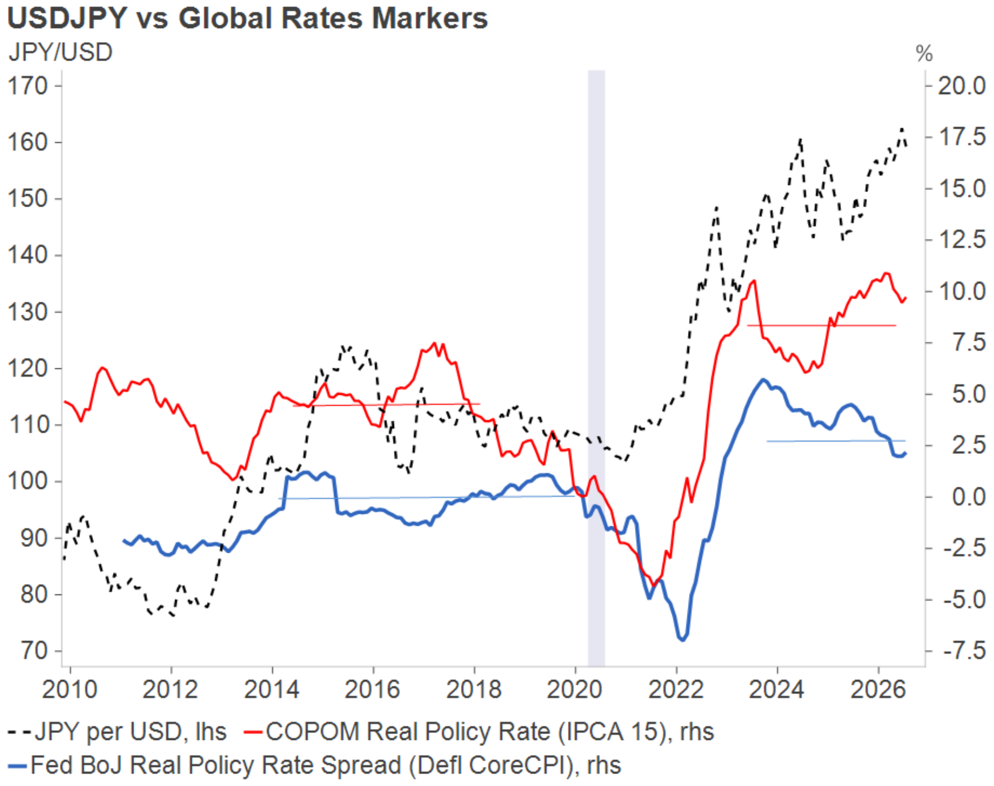
r*: Rising for markets, falling for the Fed**
5y5y includes Treasury financing (+ Hyperscaler spending). Most *r** models ignore these.

5y5y > 1y1y since '25 = Markets believe the policy stance has been expansionary, but hiking rates creates a fiscal cost, which is part of the reluctance?

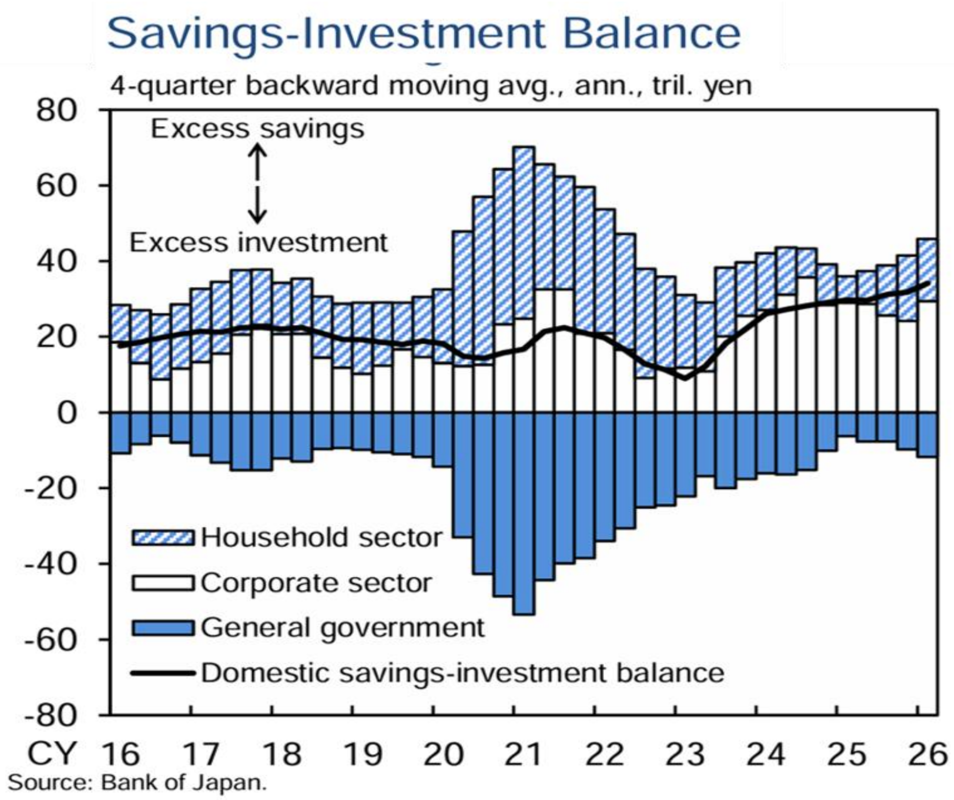


Three Market Signals: JPY, Carry, and Global Real Rates

US yields have forced all yields higher, creating a huge carry trade… pushing the Yen lower. With such spreads, BoJ hikes will do next to nothing.

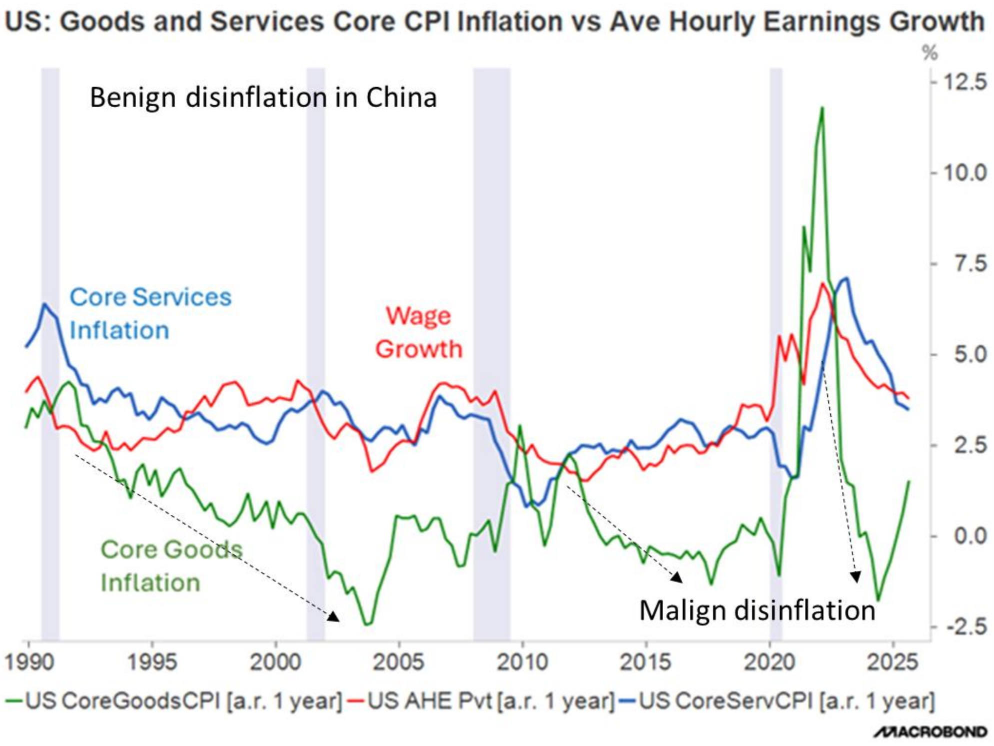


If JPY strengthens as capex pushes corporate savings lower and *r** higher: (i) global yields stay higher, (ii) EUR/JPY follows CHF/JPY

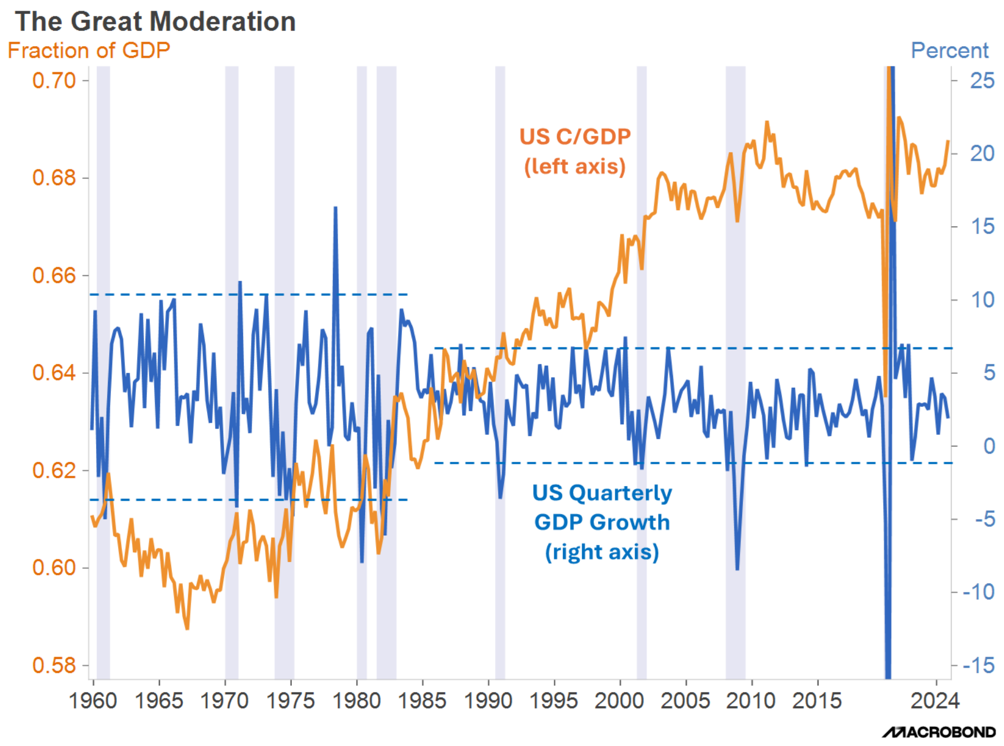


The Phillips Curve Isn't Dead, China Had Put it in a Coma

Two Phillips Curves: (i) A domestically generated *Services Phillips Curve*, tied to domestic wages, (ii) A *Goods Phillips curve* generated by China, global manufacturing.



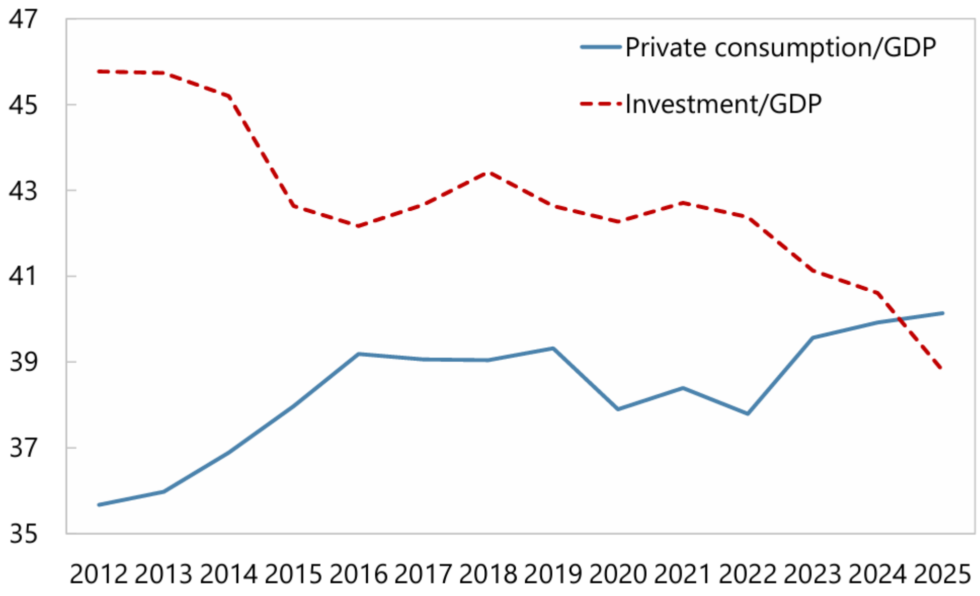
China's role in fostering the Great Moderation is underappreciated – the offshoring of investment led to a rise in C/GDP in the US, creating less volatile growth and lower inflation volatility.



Could China Deflate the World (Again)?

An ageing population and slowing growth will mean more private and public dissaving, pushing the current account into deficit… and away from the recent concern about surpluses and deflation.

Rebalancing Progress
(In percent)



Sources: National Bureau of Statistics China; and IMF staff calculations.

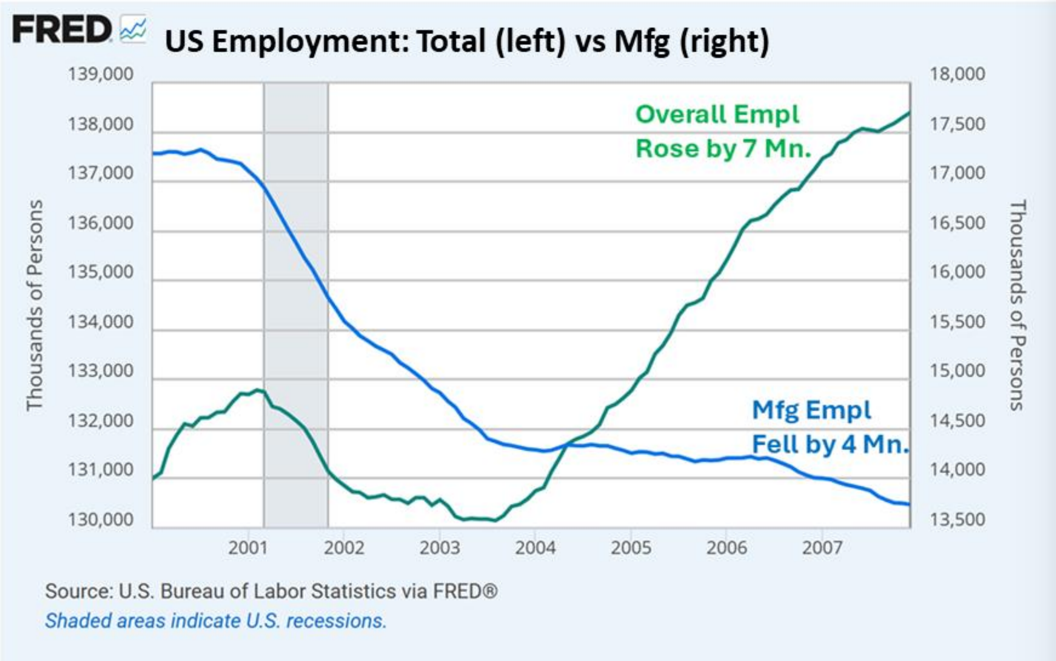
Polar views on China: In the West
A calamitous downturn, CA surplus suggests policy of deflation to generate employment.

Our view:

- Deflation is the outcome of housing and subsidies rather than a policy of supporting exports/employment (EVs, batteries, solar were all in price wars – that is changing).
- Deflation as a policy makes little sense due to (i) impact on debt sustainability, (ii) worker flows into services, not manufacturing.
- Recent policy initiatives: (i) support housing, (ii) Anti-involution, (iii) local debt.

Can AI Offset Demography *and* Disinflate the World?

China vs US Employment (Pierce, Schott '16):
• US mfg empl -4 mn, but…
• Lower inflation/rates: Gross US empl +11mn
• Within **China:** a historic internal migration



Could AI worsen fiscal spending trajectories?
• Mass unemployment = UBI (funded partly by AI profits to be socially acceptable).
• If only *some* sectors see rapid productivity growth, Baumol's cost disease can accelerate healthcare costs.

AI *reinforces* some demographic impacts
Real interest rates to rise (capex), inequality possibly falls, and energy needs = inflation?

AI vs previous shocks, mostly to Mfg (Autor)
• Mfg shocks rip through regions or sectors, creating pools of unemployment
• AI shocks diffused, easier to absorb?

Are there any ‘Solutions’ to the Fiscal Problem?

Financial Repression

- Delays crises/stress but distorts discount factor
- Forced holding of government bonds
- Limits to repression: FX becomes the release valve. E.g., Bessent’s Treasury repurchases have weakened the US dollar.

Taxes/Fiscal Prudence

- ‘No Kids’ tax: Higher tax rate, can claw back, hypothecated into a vehicle for health insurance.
- Limit expenditures on the old: Political suicide (Triple Lock UK, Social Security in the US)
- Land tax: Politically difficult (Burnham?)

Repurposing QE

- The gap between Treasury issuance and CB purchases must be absorbed by markets.
- Either a ratcheting up of real interest rates, or CB asset purchases during episodes of fiscally-induced financial instability.
- Would require a wedge between IOR and policy rates for a successful implementation.
- Effectively turn government bonds into consols, or give them a quasi-equity-like structure (e.g., coupons, buybacks).

Are the Glory Days of Central Banking Behind Us?

"We all know what to do, we just don't know how to get re-elected after we've done it"

- Jean-Claude Juncker.

• In any lasting conflict with the government, the central bank will lose.

• CBs can pursue only a balance between steady inflation and financial stability that fully achieves neither.

• Fighting inflation in highly indebted economies will lead to financial instability today, or even more inflation in the future.

Can inflation rise if expectations are anchored?