The Unanchored Central Banker

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

Comments by

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A Few Key Takeaways from the Book

- Real interest rates and inflation will reach a higher-for-longer steady state in increasingly aged economies
  - Early warning signs already

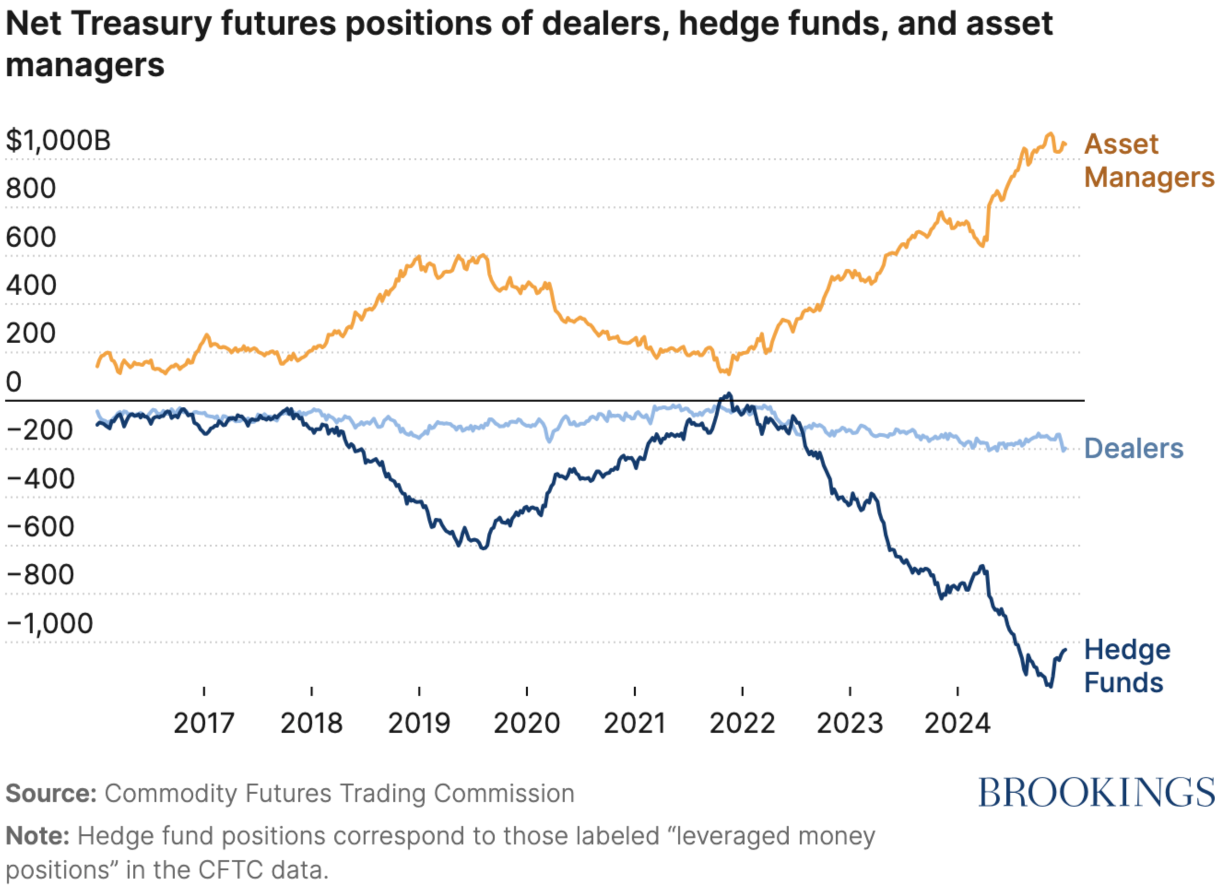
- **Structural inflection in demography -> fiscal deterioration -> fiscal dominance -> central banks forced to choose between inflation vs fiscal/financial stability**
  - Impact of AI is unclear

- Possible policy solutions other than inflation / default: tax / fiscal prudence, growth, financial repression

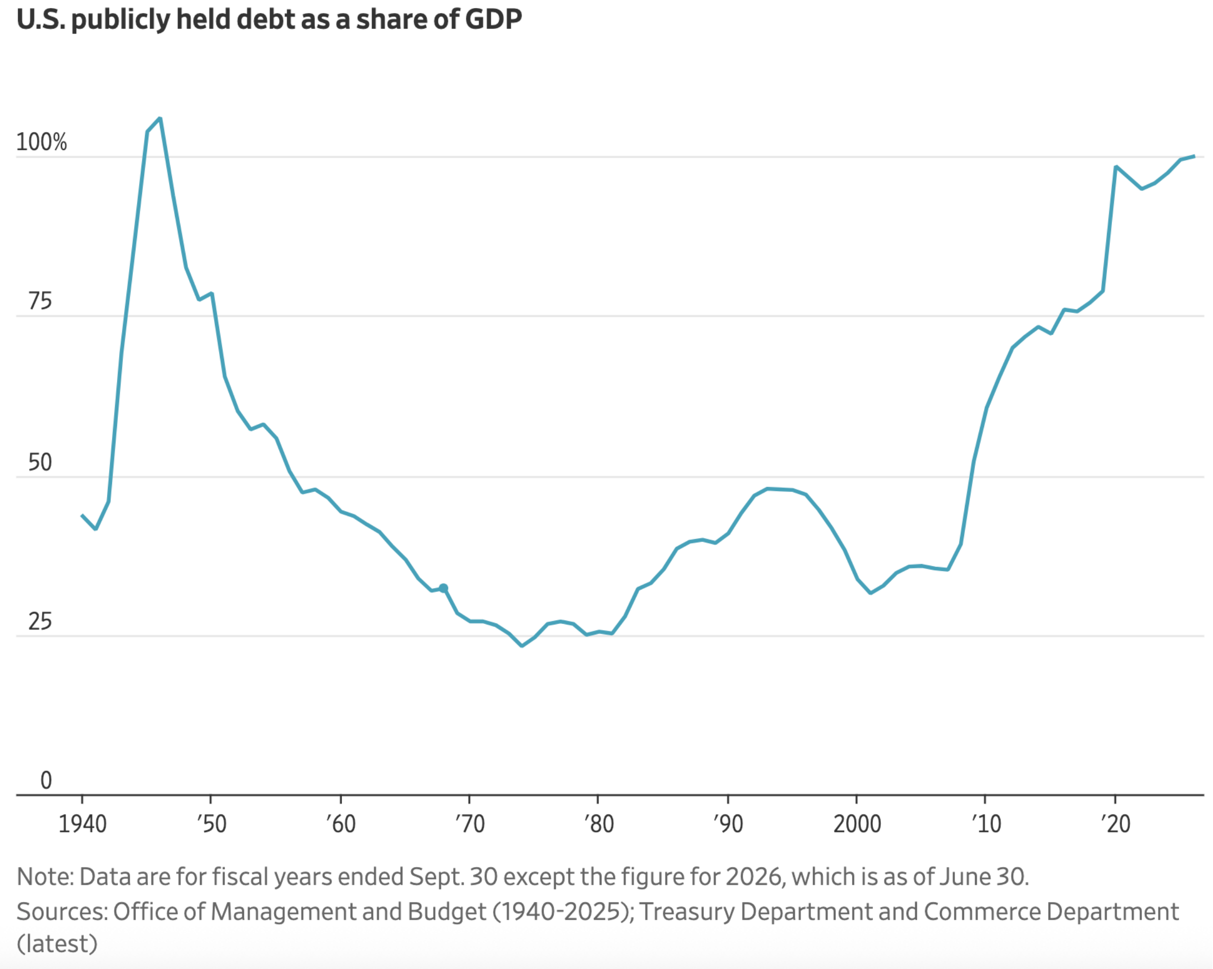
1. Are Central Banks not at all to be faulted?

- QE was perhaps inevitable given the scale and scope of the GFC and the COVID shocks
- But did its imprint have to be this long and this large?
- QE is increasingly demonstrated in the academic literature to be akin to a “put option on the (fixed income) term premium(s)”
  - It increases fiscal leverage.
  - It increases private sector leverage in repo markets (which feed on each other)
- Put simply, QE was a “shock” on the eve of the GFC / COVID… but by changing expectations, it changed bond markets and issuers forever!
- (Conjecture) AI-repricing leverage >> COVID leverage >> GFC leverage

Rise in Private and Government Leverage

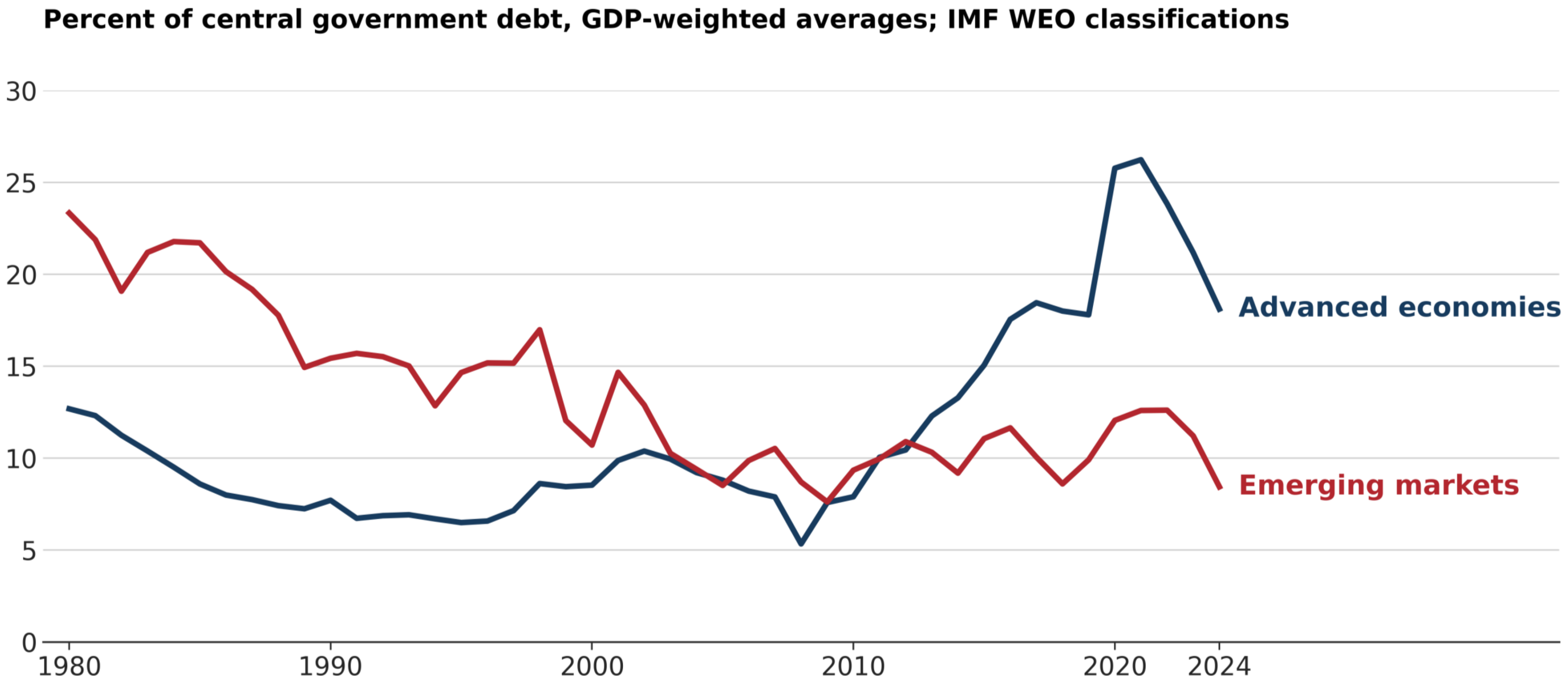


Source: Kashyap, Anil K, Jeremy C. Stein, Jonathan L. Wallen, and Joshua Younger. 2025. “Treasury Market Dysfunction and the Role of the Central Bank.” *Brookings Papers on Economic Activity*, Spring: 221–265.



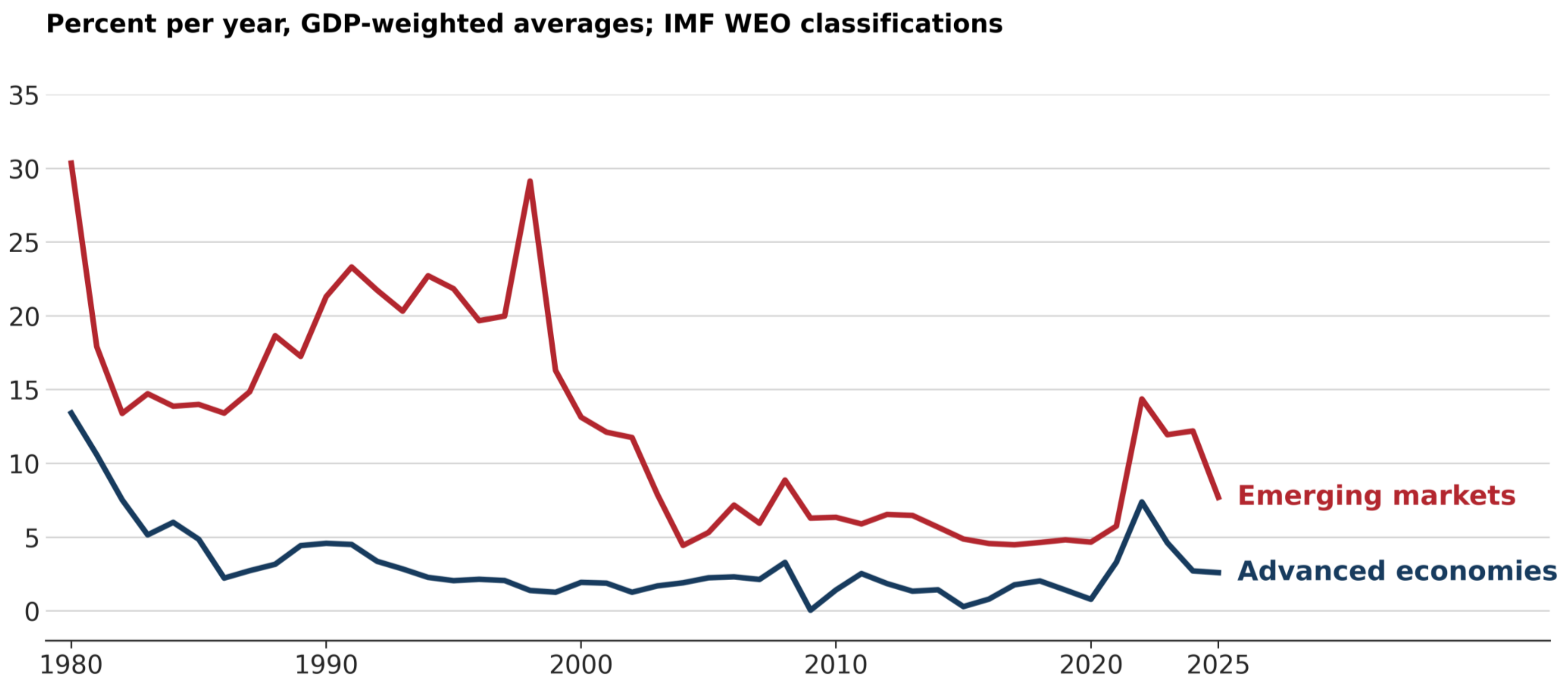
Source: Wall Street Journal, “U.S. Debt Just Topped $40 Trillion,” August 2026; US Treasury, Debt to the Penny and Monthly Treasury Statement.

CBs in AEs swapped places with EMs, post QE?



Notes: The figure reports annual GDP-weighted averages of central bank claims on the central government as a share of central government debt, 1980–2024. The balanced sample contains 15 advanced economies and 11 emerging market and developing economies with observations for at least 90 percent of the sample period. Sources: IMF International Financial Statistics, Global Debt Database, and World Economic Outlook; national central banks; authors' calculations.

Will AEs' inflation swap places with EMs, post QE?



Notes: The figure reports annual GDP-weighted averages of consumer price inflation, measured as the percentage change in average consumer prices, from 1980 to 2025. Country classifications follow the IMF World Economic Outlook. The sample begins with the balanced sample used in Figure 1 and retains countries with inflation observations for at least 90 percent of the period, leaving 15 advanced economies and 9 emerging market and developing economies. Sources: IMF World Economic Outlook, April 2026 vintage; authors' calculations.

2. How will it play out? What can CBs do?

- Short-term: Fiscal problems need to be rolled over
- Long-term: FTPL → Inflation, consolidated view of CB b/s and fisc
- A framework: Govt horizon is short-term, CB charged with inflation-targeting over the long term
- A dominated CB ignores the long-term inflation effect while supporting fiscal in the short term
  - Caveat: Some stabilization gains (could be short-lived), convenience yield pickup, risk-premium reductions, growing out of debt (unlikely)
- Repression: Makes future inflation-growth tradeoff trickier or unclear
- **Long-term CB objective creates incentives for budget deficit reduction… the preferred alternative!**
- This is what EMs have learnt from a painful past, and AEs can avoid being their painful future

“On the Importance of Independent Regulatory Institutions – The Case of the Central Bank”

In his excellent biography, *Volcker: The Triumph of Persistence* (2012), my former NYU Stern colleague, Bill Silber, describes in vivid detail how in the 1980s, the then Federal Reserve Governor Paul Volcker adopted a curmudgeonly approach to setting interest rates to target inflation.

Besides resisting any and all pressure to keep rates low, which would have effectively allowed cheap funding – in the short term – of President Reagan’s expansionary deficit-based manifesto, Volcker engaged personally with the President to convey the perils of running high fiscal deficits right after double-digit inflation had just been tamed.

“On the Importance of Independent Regulatory Institutions – The Case of the Central Bank”

In the end, Volcker won the day as wise counsel prevailed, deficits were reined in, and inflation tamed even further.

…

Governments that do not respect central bank independence will sooner or later incur the wrath of financial markets, ignite economic fire, and come to rue the day they undermined an important regulatory institution; their wiser counterparts who invest in central bank independence will enjoy lower costs of borrowing, the love of international investors, and longer life spans.

3. Perspective on China useful…

- China 2.0 is seen as causing and partly a symptom of global imbalances
- "Addiction is not without deep underlying pain"
- Housing sector woes and wealth destruction → Weak consumption
- Chinese government attempting to sustain real consumption by deflating domestically
- Deflation spillovers worldwide
- Parallel: Monetary policy for national objectives, fx/global spillovers
- Should the world be helping China address its housing woes?

Highly thought-provoking…

Highly recommend it!

Thank you ☺