



Summer revision courses: fiscal dominance, financial repression and the fiscal r^* (4/4)

> We end this series with a fourth summer revision course on fiscal dominance and financial repression.

> Recent debates over central bank independence, treasury-central bank coordination in public debt management and the persistent rise in long-term yields have all fuelled the fiscal dominance discussion, again. The concept is far from new. It describes a regime in which the central bank loses its ability to set monetary policy independently, because it is forced to accommodate the financing needs of the sovereign – the opposite of monetary dominance, where fiscal policy adjusts to the constraints set by the central bank. This tends to sustain an inflationary bias.

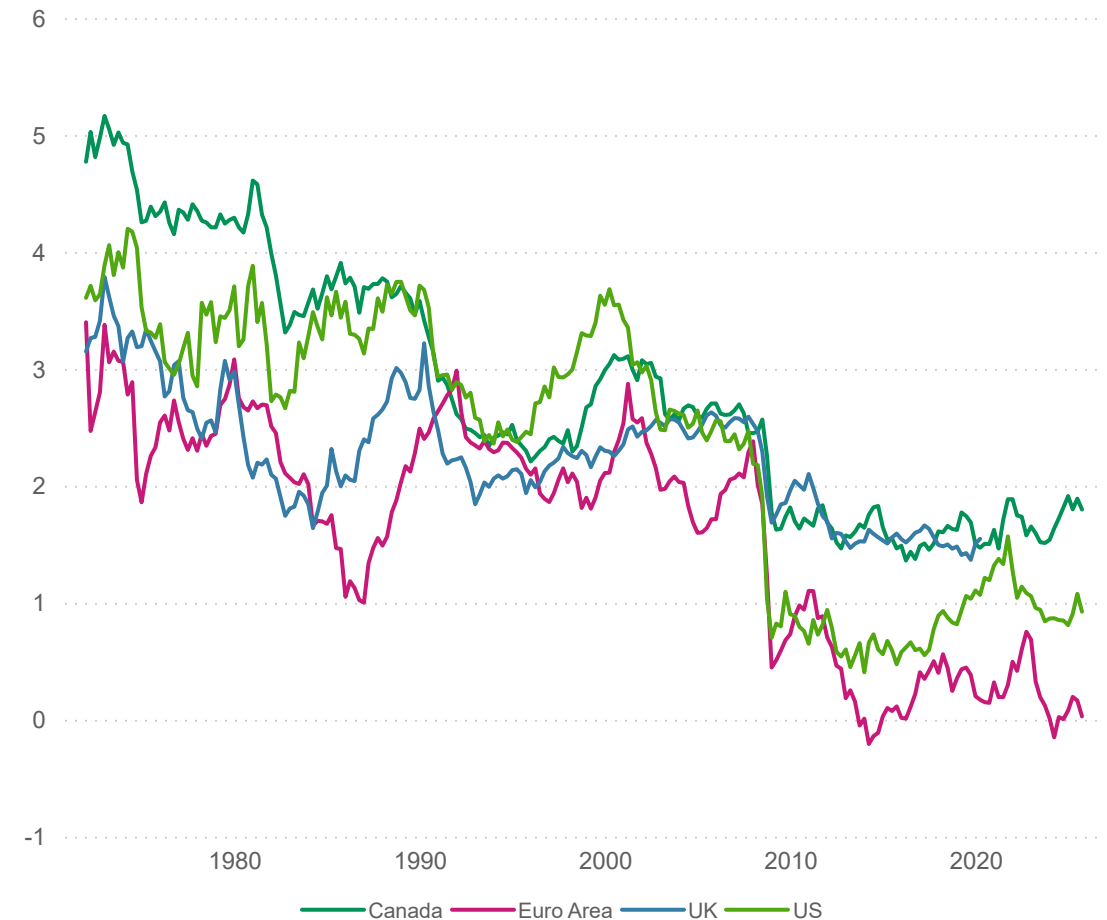
> Academic research has recently begun producing quantitative indicators on this. [Bolhuis et al. \(2025\)](#) introduce fiscal r^* and the fiscal-monetary gap – the real rate the current fiscal trajectory can sustain and its distance from the (usual) monetary r^* – providing the first rigorous cross-country measure of fiscal-monetary tension.

> The fiscal-monetary gap had been deeply negative for decades; it is now closing fast through a scissor effect: monetary r^* is stable or rising after decade of compression, while fiscal r^* is collapsing under deteriorating primary balances and higher debt loads. That compression is precisely what has tipped historically economies into financial repression.

> On that point, we discuss financial repression in depth. It shares a common destination with fiscal dominance: liquidating debt by keeping sovereign borrowing costs below trend growth, but uses a different mechanism.

> The three regimes (monetary dominance with fiscal restraint; fiscal dominance; and financial repression not necessarily coupled with fiscal dominance) produce radically different market signatures. Fiscal consolidation is the only one where bond-equity correlation stays negative and the classic 60/40 portfolio works. Fiscal dominance breaks that hedge – duration becomes a risk factor as the term premium reprices. Financial repression suppresses discount rates and structurally favours equities, but the exit can arrive abruptly – the BoJ is the current case study.

(Monetary) (real) r^* estimates in the Holston-Laubach-Williams (HLW) framework (in %)



I. Introduction: inflation as a policy-mix outcome (1/2)

Inflation is not merely a monetary phenomenon – it is, at its core, a social and political choice.

This claim, which may appear provocative at first glance, directly follows the logic of aggregate demand and supply. In a closed economy with no shocks, if the value of aggregate demand – the total flow of liabilities created by the public and private sectors – grows persistently faster than the value of aggregate supply, prices must rise to bridge the gap.

Inflation is therefore the equilibrating variable between the creation of monetary liabilities and the production of goods and services. When this imbalance is structural rather than cyclical, it generates trend inflation, which is not the product of any single shock but of the joint conduct of fiscal and monetary policy – what economists call the policy-mix.

This framing has a crucial implication: the conditions under which monetary liabilities are produced matter a lot. A government that runs persistent deficits financed by money creation is, in effect, expanding the stock of liabilities against a basket of goods and services that grows more slowly. The result is a depreciation of the unit of account – inflation – which operates as an implicit tax on savers and fixed-income holders, redistributing wealth toward leveraged agents, including the sovereign itself.

Persistently above-target inflation is therefore not a technical failure of monetary policy alone; it reflects a deeper structural imbalance in the policy-mix, one in which the fiscal authority exerts undue influence over the monetary stance.

This paper examines two mechanisms through which fiscal pressures distort the policy-mix and generate macroeconomic instability: fiscal dominance and financial repression. These two concepts are frequently conflated in policy discussions, yet they are analytically distinct:

- **Fiscal dominance refers to a regime in which monetary policy is subordinated to fiscal needs** – the central bank loses its independence and sets interest rates to accommodate government financing requirements, generating inflation as a by-product.
- **Financial repression, by contrast, refers to a broader set of policies that channel private savings toward sovereign debt at below-market rates, compressing real yields without necessarily requiring the central bank to abandon its mandate.**

Both mechanisms serve the same ultimate purpose – reducing the real burden of public debt – but they operate through different institutional channels and carry different macroeconomic (and market) costs.

I. Introduction: inflation as a policy-mix outcome (2/2)

These questions are not new and markets have learned to live with them.

The tension between fiscal and monetary authorities – and the temptation to resolve sovereign debt burdens through inflation, financial engineering or regulatory sleight of hand – has been a recurring theme in both academic research and fixed income strategy since at least the post-war period. Seminal contributions by Sargent and Wallace (1981), Leeper (1991), and Reinhart and Sbrancia (2011) have periodically brought these mechanisms back to the centre of the debate, typically when bond markets began asking uncomfortable questions about debt sustainability.

For much of the past two decades, those questions were answered – or at least deferred – by the combination of structurally declining real rates (see chart on front page), central bank credibility and the implicit assumption that fiscal consolidation would eventually materialise. That assumption is now under serious strain.

The sharp deterioration of public finances across DMs since 2008 – and more acutely since 2020 – has pushed fiscal-monetary tensions to levels that rates strategists and sovereign credit analysts can no longer treat as tail risks. Spreads, term premia and real yield dynamics are increasingly being shaped not just by the monetary policy cycle but by the structural interaction between debt trajectories and central bank mandates.

Two recent contributions provide the analytical backbone of this paper:

- Bolhuis, Koosakul and Shenai (2025) introduce the concept of fiscal r -star and the fiscal-monetary gap – a quantitative framework that, for the first time, allows the degree of tension between fiscal and monetary policy to be measured rigorously and compared across countries and historical periods.
- Bolhuis, Koosakul, Shenai and Yang (2026) then turn to the other side of the ledger, constructing new composite indicators of financial repression that decompose the phenomenon into its fiscal and monetary channels across a century of data and document its resurgence to decade-high levels in the post-crisis period.

Together, these two papers form a coherent research programme: the first provides the diagnostic – how large is the gap and what are its consequences – while the second identifies one of the key mechanisms through which that gap is being quietly managed. It is this combination of renewed market relevance and improved conceptual architecture that motivates the present paper.

The paper proceeds as follows. Section II develops the theoretical foundations of fiscal dominance, from the time-inconsistency literature to the fiscal theory of the price level. Section III introduces the fiscal r -star framework and the fiscal-monetary gap as a quantitative measure of tensions. Section IV defines financial repression, traces its intellectual genealogy and presents the new measurement framework. Section V articulates the differentiated impact of those regimes on asset prices.

II. Fiscal dominance: theoretical foundations (1/2)

The intellectual foundations of fiscal dominance are rooted in a deceptively simple observation: a government that controls both fiscal and monetary instruments faces a systematic temptation to inflate. The formal treatment of this temptation begins with Kydland and Prescott (1977), whose analysis of time inconsistency in optimal policy established that rational private agents will anticipate the government's incentive to generate surprise inflation – and will price it in. The equilibrium outcome is then an inflation bias: higher average inflation without any lasting gain in real activity (eg, most southern European countries before the EUR). For bond investors, this result has a direct translation – in the absence of credible institutional constraints, the inflation risk premium embedded in nominal yields should be structurally positive, reflecting not just uncertainty about future price levels but uncertainty about the policy regime itself.

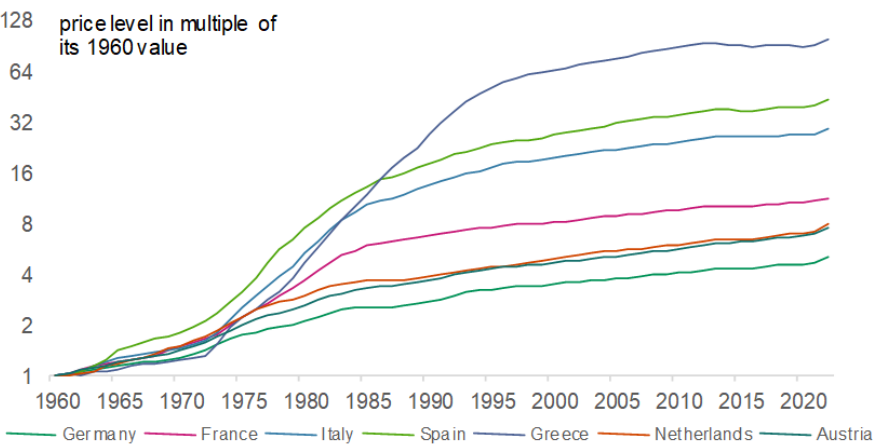
The canonical institutional response to this problem is central bank independence: by delegating monetary policy to an authority insulated from electoral pressures and committed to a price stability mandate, the government credibly ties its own hands. The central bank can then anchor inflation expectations and the fiscal authority has an incentive to calibrate its deficit to be consistent with the inflation target.

This is the regime of monetary dominance, formalised by Leeper (1991) in what remains the most precise analytical characterisation of the two possible policy configurations. In Leeper's framework, monetary dominance corresponds to a combination of active monetary policy – the central bank responds aggressively to inflation, raising real rates more than one-for-one with any deviation from target (see our second summer revision course for an application to the supply shock case) – and passive fiscal policy – the government adjusts its primary balance to "satisfy the intertemporal budget constraint", which means in practice stabilising the debt-to-GDP ratio. In this regime, the price level is determined by monetary policy, and fiscal policy accommodates whatever real interest rate the central bank sets.

The opposite configuration – fiscal dominance – arises when fiscal policy is active and monetary policy is passive. The government sets its deficit path without regard to debt sustainability, and the central bank is constrained to accommodate the resulting financing needs. The adjustment mechanism is no longer taxation but inflation: the real value of the outstanding debt stock is eroded through a combination of money creation and price-level increases. In the extreme case, the government extracts significant seigniorage revenue by constraining the central bank to monetise its deficits. Historical episodes of full fiscal dominance – Weimar Germany in the 1920s, Zimbabwe in the 2000s, Venezuela more recently – represent the limiting case of this dynamic, where the feedback loop between deficit financing and money creation becomes self-reinforcing and ultimately explosive. For market practitioners, these episodes are instructive not as direct analogies but as limiting cases that clarify the direction of travel when institutional constraints erode.

A less visible but analytically important self-reinforcing mechanism in fiscal dominance episodes is the Olivera-Tanzi effect. First identified by Olivera (1967) and formalised by Tanzi (1977, 1978), the effect describes a perverse feedback loop: because tax collection involves administrative lags, inflation erodes the real value of tax revenues between the moment a liability is assessed and the moment it is collected. The government's real fiscal position therefore deteriorates precisely as it attempts to inflate its way out of debt – widening the deficit it sought to close, and generating additional pressure to monetise. The Olivera-Tanzi effect is most acute in economies with long collection lags, low tax elasticity and poorly indexed fiscal systems – conditions that characterised much of Southern Europe before the institutional reforms of the 1990s.

Price levels of Eurozone countries, relative to 1960



CAGR inflation in Eurozone countries

	CAGR inflation						
	1960-2022	1960s	1970s	1980s	1990s	2000s	2010s
Germany	2.6%	2.6%	5.1%	2.6%	2.4%	1.6%	1.2%
France	4.0%	4.0%	9.6%	6.3%	1.7%	1.7%	1.0%
Italy	5.6%	3.9%	13.8%	9.6%	3.8%	2.2%	1.0%
Spain	6.3%	6.0%	15.3%	9.3%	3.9%	2.8%	1.0%
Greece	7.7%	2.1%	14.3%	19.0%	9.3%	3.3%	0.1%
Netherlands	3.4%	4.1%	7.3%	2.4%	2.4%	2.0%	1.6%
Austria	3.3%	3.6%	6.3%	3.5%	2.3%	1.9%	1.8%

II. Fiscal dominance: theoretical foundations (2/2)

A more sophisticated and, for contemporary DMs, more relevant theoretical framework is the **Fiscal Theory of the Price Level (FTPL)**, developed by Sims (1994), Woodford (1995), and Cochrane (2001). The FTPL posits that the price level is determined not only by monetary policy but by the intertemporal government budget constraint: the real value of outstanding nominal government debt must equal the present discounted value of future primary surpluses. When the government does not commit to generating sufficient future surpluses, the price level adjusts upward to restore the equilibrium – even if the central bank is formally independent.

The implication is striking: central bank independence is a necessary but not sufficient condition for price stability. A sufficiently irresponsible fiscal trajectory can generate inflation without any formal subordination of the monetary authority, simply by shifting private sector expectations about the future path of surpluses.

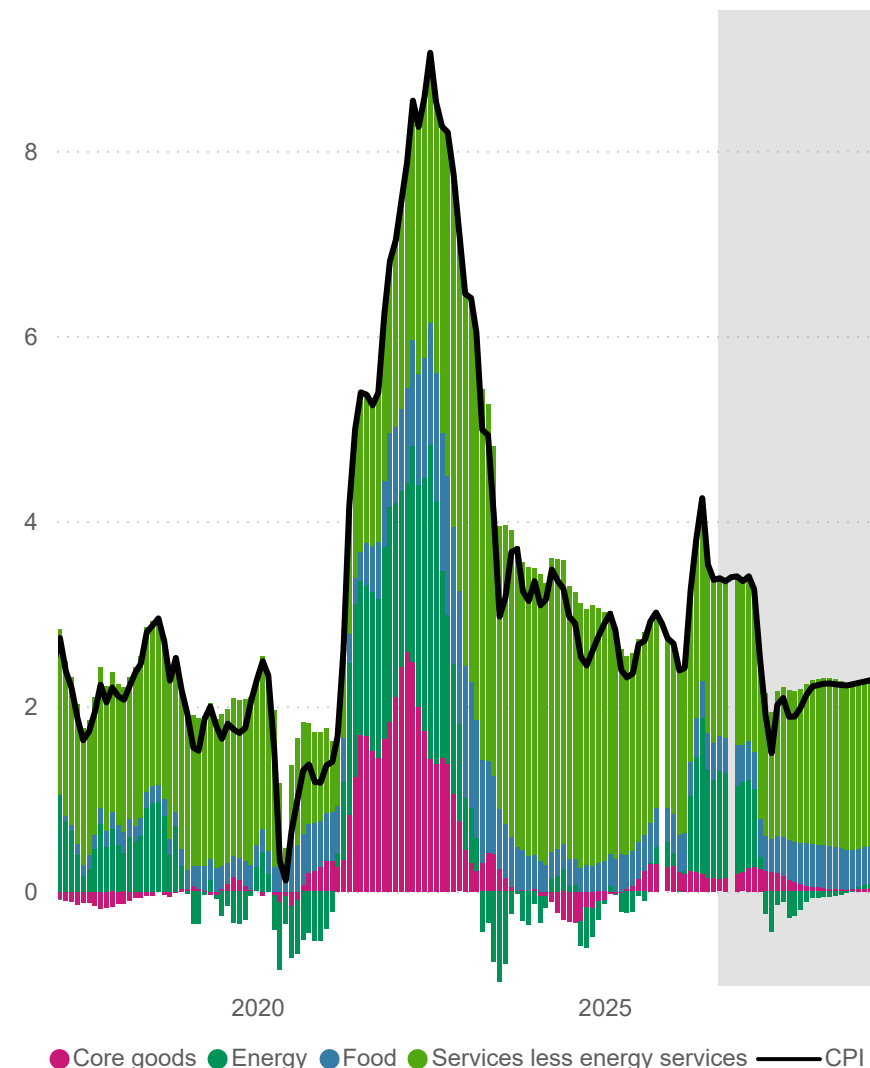
For markets, the FTPL has a concrete and underappreciated implication. If the price level is partly determined by the present value of future surpluses, then fiscal news – a deteriorating primary balance, a credible consolidation plan or a political shock that alters the expected path of taxation – is simultaneously inflation news. Sovereign bond yields, in this framework, are not merely a function of the monetary policy path; they embed a fiscal risk component that standard monetary models systematically understate. It materialises through a large term premium. The post-2020 inflation episode in most DMs can be read, at least in part, through this lens: large deficit expansions that were not accompanied by credible commitments to future surpluses generated an upward shift in the price level that monetary policy, operating alone, could not fully prevent.

In practice, the boundary between monetary and fiscal dominance is rarely sharp. A more realistic intermediate regime – which we term monetary-driven coordination – involves a central bank that maintains its inflation mandate as the primary anchor but tolerates temporary overshoots to facilitate fiscal stabilisation during deep recessions.

The Federal Reserve's adoption of Average Inflation Targeting in August 2020 exemplifies this configuration: by committing to allow inflation to run above 2% for a period, the Fed effectively permitted the government to finance large pandemic-era deficits at very low real rates, without formally abandoning its independence. This arrangement proved highly effective in catalysing the recovery – and, as subsequent events demonstrated, was significantly inflationary. The lesson is not that the Fed lost its independence, but that the boundary between monetary-driven coordination and mild fiscal dominance is porous, and that the direction of drift matters as much as the current position.

The Fed's own institutional response to this episode is instructive. At Jackson Hole in August 2025, former Chair Jerome Powell unveiled a revised Statement on Longer-Run Goals and Monetary Policy Strategy – the product of the FOMC's second five-year framework review – that amounts to a systematic unwinding of the 2020 architecture. The Fed formally abandoned Flexible Average Inflation Targeting and its embedded makeup strategy. Powell's post-mortem was unsparing: the idea of an intentional, moderate overshoot had proved irrelevant, because there was nothing intentional or moderate about the inflation that materialised in 2021-22. The revised framework returns to conventional flexible inflation targeting – a symmetric 2% target, without the asymmetric tolerance for overshooting that had created structural space for fiscal accommodation. These changes represent a deliberate reassertion of monetary dominance – and a tacit acknowledgment that framework design, not just formal independence, determines where on the fiscal-monetary spectrum a central bank actually operates.

US Headline CPI inflation with contributions (YoY in % and ppt)



III. Fiscal r^* : a new metric for fiscal dominance (1/2)

The theoretical distinction between monetary and fiscal dominance, while analytically precise, has historically lacked a direct empirical counterpart. How does one measure the degree of fiscal-monetary tension in a given economy at a given point in time?

Recently, Bolhuis, Koosakul, and Shenai (2025) address this gap by introducing two related concepts – fiscal r^* and the fiscal-monetary gap – that are new in name but deliberately anchored in the existing toolkit of macroeconomics.

What the literature already had. Two building blocks are well-established:

- The first is monetary r^* – the natural rate of interest, traceable to Wickseil and formalised in the modern literature by Laubach and Williams (2003) – defined as the real interest rate consistent with output at potential and inflation at target. It is the benchmark against which central banks calibrate their policy stance. We have discussed this concept in detail in several pieces over the past few years.
- The second is the debt-stabilising primary balance, a standard fiscal sustainability metric: the level of the primary surplus-to-GDP ratio that, given current debt, trend growth and the prevailing real interest rate on government debt, keeps the debt ratio constant. We have discussed this concept in our fiscal outlook piece earlier this year.

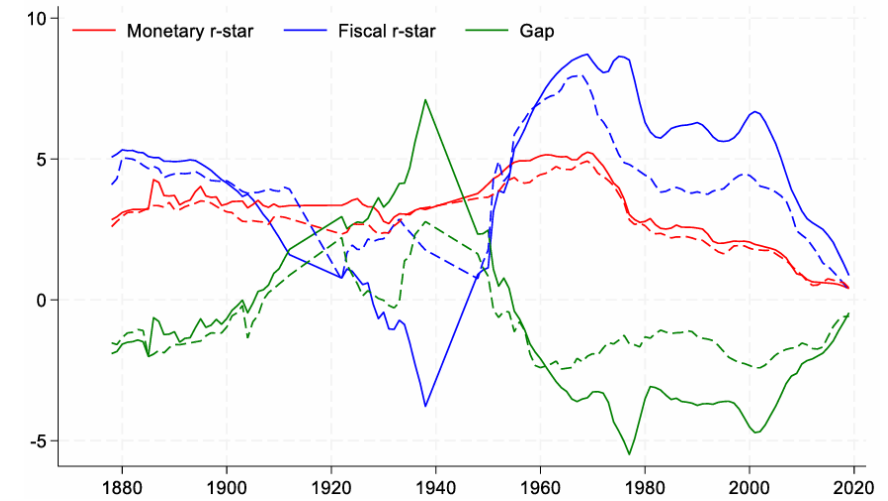
Both concepts are textbook. What the literature lacked was a way to put them in the same units and compare them directly.

Bolhuis et al. perform a conceptual inversion of the debt-stabilising primary balance. Rather than asking "what primary surplus stabilises debt given the current interest rate?", they ask: "what real interest rate would stabilise debt given the current primary balance?"

The answer is fiscal r^* . Formally, fiscal r^* is the effective real interest rate on government debt that allows the debt-to-GDP ratio to remain flat (1) with no change in the primary balance and if (2) output grows at potential, and (3) inflation is at target. The key insight is that fiscal r^* is expressed in real interest rate space – the same space as monetary r^* – making a direct comparison possible for the first time. A higher fiscal r^* signals greater fiscal sustainability: the government can afford higher real borrowing costs without its debt path becoming explosive. When fiscal r^* falls – because the primary deficit widens, potential growth slows or the debt stock rises – the ceiling on sustainable real interest rates drops and fiscal space shrinks. The concept is closely related to the debt-stabilising primary balance, but the authors argue it is more appropriate under active fiscal policy: if the primary balance is not going to adjust endogenously to stabilise debt, it makes more sense to ask what interest rate the current fiscal trajectory can sustain, rather than what fiscal adjustment would be needed at the current interest rate.

Then they add the fiscal-monetary gap, which is simply the difference between monetary r^* minus fiscal r^* . When the two coincide, there is no fundamental tension – the interest rate that stabilises inflation also stabilises debt. When monetary r^* exceeds fiscal r^* , a positive gap opens. This is the quantitative signature of fiscal-monetary tension: the rate the central bank needs to control inflation is higher than the rate the fiscal trajectory can sustain. A positive gap cannot persist indefinitely. Something must give: the central bank holds rates below what inflation control requires, accepting above-target inflation; the government consolidates, raising the primary surplus until fiscal r^* rises to meet monetary r^* ; the government compresses its effective borrowing costs through financial repression or debt management; or, absent any adjustment, debt grows without bound.

Historical estimates of fiscal r^* and the fiscal monetary gap (%)



III. Fiscal r^* : a new metric for fiscal dominance (2/2)

We present on the right hand side the evolution of monetary r^* , fiscal r^* and the gap across 16 DMs over 140 years. The picture that emerges is one of long historical cycles punctuated by two sharp discontinuities – and a contemporary trajectory that is, by historical standards, deeply concerning.

Through the late 19th and early 20th centuries, fiscal r^* ran comfortably above monetary r^* , keeping the gap negative. Prevailing fiscal stances were broadly compatible with – or even permissive of – higher real interest rates: governments were running manageable debt loads, potential growth was solid and the debt-stabilising interest rate ceiling sat well above what monetary conditions required. The first discontinuity arrives in the late 1930s and through WWII. Fiscal r^* collapses as wartime borrowing explodes debt stocks and widens deficits, while monetary r^* remains elevated – the gap turns sharply positive, reaching its historical peak. This is the canonical episode of fiscal dominance and the chart makes its severity clear.

The post-war decades bring an equally dramatic reversal. Demobilisation reduces deficits, strong potential growth lifts fiscal r^* and the gap swings deeply negative through the 1950s and 1960s – a period during which fiscal positions were, if anything, overly conservative relative to what monetary conditions would have permitted. From the 1980s onward, the two series converge and the gap stabilises near zero through the Great Moderation, reflecting the simultaneous achievement of fiscal consolidation and low, stable inflation across most advanced economies.

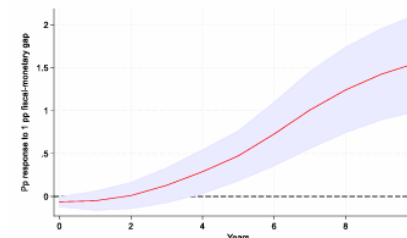
The second discontinuity – more gradual but no less consequential – begins around 2000 and accelerates after the Global Financial Crisis. Fiscal r^* enters a prolonged and steep decline: rising debt stocks, widening structural deficits, and slowing potential growth progressively lower the ceiling on sustainable real interest rates. Monetary r^* , by contrast, remains comparatively stable and, after the post-pandemic tightening cycle, rises. The gap widens steadily and by the early 2020s has returned to territory last seen in the early 1950s. Unlike the wartime episode, this deterioration is not the product of a single shock but of a slow structural drift – which makes it, in some respects, harder to reverse.

Historically, a widening fiscal-monetary gap is followed – with a lag of several years – by a persistent rise in inflation, an increase in the debt-to-GDP ratio, a depreciation of the exchange rate, and a meaningfully elevated probability of both financial and sovereign debt crises. The multi-year lag is itself an important finding. It means that the gap functions less like an alarm bell than like a pressure gauge: tensions accumulate quietly, often below the threshold of market attention, until the fiscal-monetary configuration becomes untenable and an adjustment is forced.

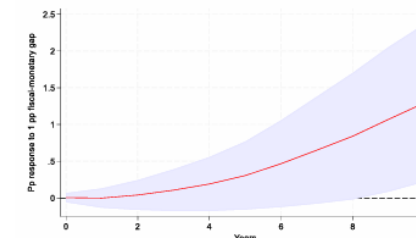
The most policy-relevant result concerns which resolution mechanism tends to prevail in practice. Larger gaps are systematically associated with the subsequent emergence of financial repression, below-market deposit rates, directed lending, capital controls. When fiscal consolidation is politically unavailable and overt monetary accommodation is institutionally constrained by central bank independence, governments have historically reached for subtler tools to compress their effective borrowing costs. The gap thus predicts not only macroeconomic deterioration but the specific institutional response that tends to follow. It is to that response that we now turn.

Shocks to the Fiscal-Monetary Gap and Macroeconomic Indicators in Bolhuis et al. (2025)

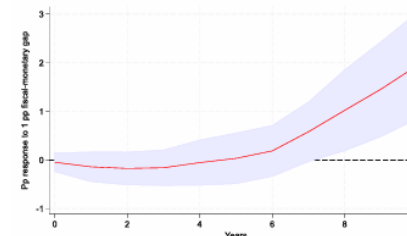
(A) Expected change in the debt ratio



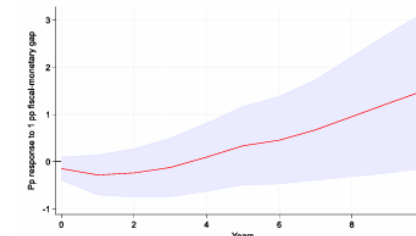
(B) Expected change in the price level



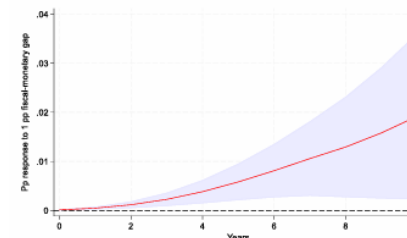
(C) Cumulative nominal depreciation relative to USD¹



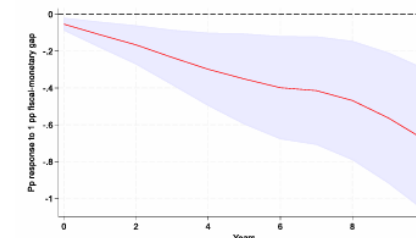
(D) Cumulative depreciation relative to commodity basket²



(E) Cumulative fiscal consolidation³



(F) Cumulative debt liquidation



¹ USA not included in sample. Units expressed in foreign currency units per 1 unit USD.

² Units expressed in foreign currency unit per 1 unit of basket, equal weighted 27 commodities, including beef, hides, lamb, pork, coal, petroleum, barley, corn, rice, rye, wheat, copper, lead, nickel, steel, tin, zinc, gold, silver, cocoa, coffee, cotton, palm oil, sugar, tea, tobacco, wool.

³ Measured as the cumulative sum of the primary balance.

IV. Financial repression (1/2)

When fiscal consolidation is politically unavailable and overt monetary accommodation is institutionally constrained by central bank independence, governments have historically reached for a third option – one that compresses effective borrowing costs quietly, distributes its costs diffusely across savers and creditors, and operates through the architecture of the financial system rather than through explicit policy decisions. That option is financial repression. It does not announce itself. Its costs are sufficiently opaque to be politically sustainable in ways that neither a tax increase nor an explicit inflation target overshoot could be. Understanding it requires both a conceptual foundation and a precise account of the mechanisms through which it operates.

The term was introduced by McKinnon and Shaw in 1973 to describe the systematic distortion of financial markets in DMs – interest rate ceilings, directed credit and state ownership of banks – that suppressed financial intermediation and stunted growth. In their original framing, financial repression was primarily a development failure: by keeping deposit rates below market-clearing levels, governments discouraged saving, misallocated capital and stunted the financial sector. The fiscal dimension was secondary.

It was Reinhart and Sbrancia, in their 2011 and 2015 papers, who reoriented the concept toward its sovereign debt management function. In their framework, financial repression is the ensemble of policies that keep the government's effective real borrowing cost below what free markets would set – and, crucially, below the rate of economic growth – thereby liquidating the real value of the debt stock without requiring a primary surplus. The mechanism is what they call debt liquidation: when the real interest rate on government debt is held persistently negative, the debt-to-GDP ratio falls automatically, year after year, through a transfer of wealth from bondholders to the sovereign that is technically legal, politically invisible, and arithmetically powerful.

The toolkit of the postwar era was blunt: it included explicit interest rate ceilings – most famously the US' Regulation Q, which prohibited interest on demand deposits and capped savings rates; capital controls and exchange restrictions under the Bretton Woods framework that engineered a forced home bias, trapping domestic savings in low-yielding government bonds; high and often unremunerated reserve requirements that functioned as a tax on the banking system; directed lending requirements compelling pension funds and insurance companies to hold government debt in their portfolios.

Recently, Bolhuis et al. moved beyond the binary distinction between "repression" and "no repression" that characterises much of the earlier literature, and constructed a continuous, multi-dimensional index of financial repression that can be tracked across 16 DMs over a century.

The paper disaggregates repression into two analytically distinct channels, each with its own institutional logic and contemporary manifestation:

- **The fiscal/prudential channel creates structural, captive demand for government bonds through regulatory requirements.** For instance, Basel III's Liquidity Coverage Ratio designates sovereign debt as the canonical High Quality Liquid Asset; Solvency II imposes analogous constraints on insurers. The result is large, price-inelastic, compliance-driven demand for sovereign debt – functionally identical to the directed lending mandates of the Bretton Woods era, but justified on financial stability grounds.
- **The monetary channel operates through asset purchases by central banks (eg, QE):** by removing duration from private portfolios and replacing it with central bank reserves, asset purchase programmes compress term premia and hold long-term yields below market-clearing levels. Critically, this fiscal benefit need not imply any subordination of the central bank to fiscal objectives – QE deployed by a fully independent central bank in pursuit of its price stability mandate can produce financial repression as a pure by-product. The intent is monetary; the effect on sovereign borrowing costs is nonetheless real. This is what makes the monetary channel analytically distinct from fiscal dominance: the institution remains independent, its mandate intact, yet the government's effective financing cost is compressed all the same.

IV. Financial repression (2/2)

The empirical picture that emerges from recent research is striking in both its historical sweep and its contemporary implications. Three stylised facts stand out:

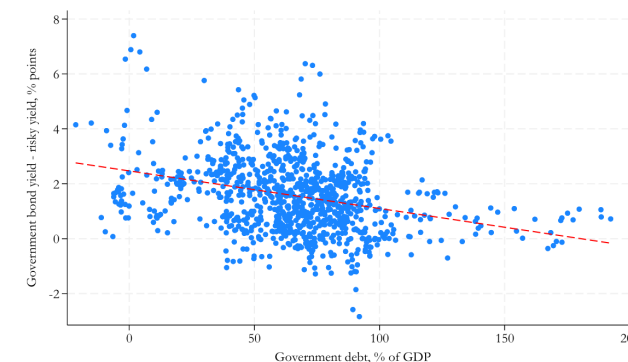
- **First, higher sovereign debt burdens are associated with lower, not higher, relative returns on government bonds. This is the paper's foundational empirical result – and it runs directly counter to the standard risk-compensation logic: sovereigns with the largest debt stocks are precisely those whose bonds yield the least in real terms. The liquidation effect is not incidental; it is systematic.**
- **Second, commercial banks hold a disproportionately large share of government debt precisely when returns on sovereign bonds are lowest and debt burdens are highest. This is not a market equilibrium outcome. It reflects the fiscal/prudential channel at work: HQLA requirements and analogous regulatory constraints create a captive, price-inelastic buyer that absorbs sovereign debt regardless of its risk-adjusted return.**
- **Third, government securities account for a larger share of commercial bank assets when debt burdens are higher and sovereign bond returns are lower relative to private assets. This extends the second fact: not only do banks hold more government debt in absolute terms under repression, they do so at the expense of private sector exposure – crowding out the very lending that drives productive investment.**

Taken together, the three facts describe a self-reinforcing mechanism: high debt generates repression, repression compresses sovereign yields and compressed yields are absorbed by a captive banking sector that substitutes public for private assets.

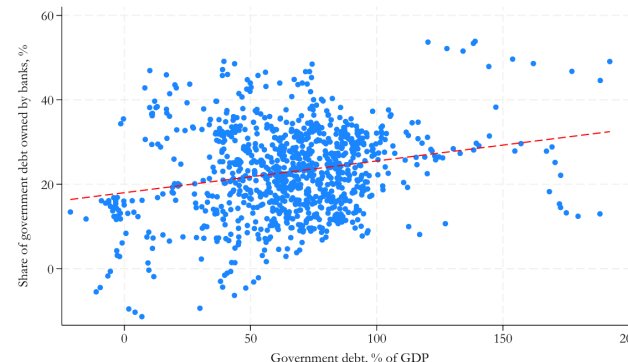
The contemporary institutional landscape differs from the postwar period in ways that constrain the effectiveness of financial repression as a debt reduction strategy. Capital accounts are largely open across advanced economies, making it far harder to trap domestic savings in low-yielding government bonds – roughly one-third of DMs government debt is now held by non-residents who can readily reduce their holdings when real returns turn negative. Inflation-indexed instruments give investors partial protection against the inflation channel. And the very central bank independence that constrains overt monetary accommodation (ie, full fiscal dominance) also limits the most aggressive forms of yield curve control.

The most granular empirical instantiation of these mechanisms comes from Chien, Cole and Lustig (2026) and Chien, Du and Lustig (2025), whose work on Japan – at 226% of GDP, the natural limiting case – provides the country-level anatomy that no cross-country index can supply. Their central finding is counterintuitive: Japan's public sector has not merely survived its debt burden – it has profited from it. Consolidating the central government, GPIF, public financial institutions and the BoJ into a single balance sheet reveals a sovereign running a carry trade: borrow short at near-zero BoJ-controlled rates, invest long in domestic equities and foreign securities and pocket the spread. Over 2013-23, this generated annualised excess returns of 4.66% above funding costs – 6.25% of GDP over the period. Duration mismatch is not a bug; it is the engine. Three mechanisms sustain it: QE suppressed the JGB term premium; hedging requirements trap domestic savings in JPY assets; and the cost falls disproportionately on non-participant households. They estimate that for them a 1pt rate decline destroys 6-9% of total wealth. The arrangement is self-reinforcing – but fragile with the BoJ now normalising.

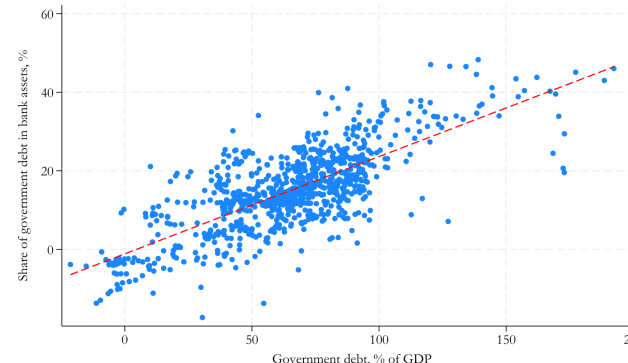
Stylised fact 1: Government bond yields relative to private assets and public debt burdens



Stylised fact 2: Commercial bank holdings of government debt and public debt burdens



Stylised fact 3: Government securities as a share of commercial bank assets and public debt burdens



V. Which asset price implications?

The three regimes produce sharply differentiated asset price signatures across inflation, short bonds, long bonds and equities.

Fiscal consolidation is the clean scenario – and the rarest. Inflation comes down, the central bank has room to cut and the whole curve rallies. Short bonds reprice first, long bonds follow as the term premium compresses. Equities take a short-term hit from weaker growth, but the lower discount rate more than compensates at a 12-18 month horizon. Bond-equity correlation goes negative: your duration hedge actually works. It is the only regime where a vanilla 60/40 just runs itself.

Fiscal dominance is where the 60/40 breaks. The central bank is effectively subordinated to the Treasury – rates stay too low for too long, inflation gets sticky and the bond market eventually forces the adjustment the policy rate would not (ie, bear steepening). Short bonds look fine on paper but bleed in real terms. Long bonds are the real pain trade: the term premium re-prices violently because investors demand compensation for inflation risk they can no longer trust the central bank to contain – duration becomes a risk factor, not a hedge. Equities are mixed: companies with pricing power and hard assets hold up, but growth multiples compress as discount rates rise and macro uncertainty spikes. The bond-equity correlation turns positive – both sell off on bad fiscal news – which is exactly when you need diversification most and have none. In this scenario, there is no place to really hide.

Financial repression without fiscal dominance is the most insidious regime because it looks benign for a long time. Inflation stays moderate, short rates are anchored by the central bank and nominal volatility is low. But long bonds are quietly being sacrificed: captive demand from banks and the central bank compresses the term premium well below any fair-value level, locking in negative real yields for duration holders. Equities are the structural winner – suppressed discount rates mechanically inflate multiples and the carry accrues to asset holders while depositors and bond investors absorb the implicit tax. Japan 2013-23 is the textbook: 4.66% annualised excess return on the consolidated sovereign balance sheet, funded by households with no equity exposure. The trap is the exit: when repression unwinds – as the BoJ is now demonstrating – long bonds take immediate capital losses and the repricing is abrupt precisely because the distortion had been building silently for years.

In practice, in our view:

- **The US is currently heading toward a grey zone.** The preconditions for fiscal dominance are building: structural deficit north of 6% of GDP, net interest above USD1trn, debt above 100% and rising fast. The Fed has not been subordinated yet, but the pressure is mounting.
- **In Europe, repression is unwinding, while protection against fiscal dominance remain strong.** A decade of ECB ownership and captive bank demand suppressed the term premium artificially, but the ECB has now normalised with its monetary framework and QT. Defence spending is forcing long supply and some fiscal stories (eg, France, Germany) are eroding the captive bid. The risk is not a sudden outburst – it is a slow leak that accelerates if spreads widen on fiscal news.

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Valentin Giust

Global Markets Research contact details

Jean-François Paren			Head of Global Markets Research +33 1 41 89 33 95		
	Asia (Hong Kong, Singapore & Tokyo)		Europe (London & Paris)		Americas (New York)
Macro Strategy	Takuji Aida Chief Economist Japan +81 3 4580 5360	Ken Matsumoto Macro Strategist Japan +81 3 4580 5337	Louis Harreau Head of Developed Markets Macro & Strategy +33 1 41 89 98 95	Valentin Giust Global Macro Strategist +33 1 41 89 30 01	Nicholas Van Ness ** Chief US Economist +1 212 261 7601
Interest Rates			Jean-François Perrin Head of Rates and Inflation Research & Strategy +33 1 41 89 73 49 Matthias Loise Inflation Strategist +33 1 41 89 20 06	Guillaume Martin Interest Rates Strategist +33 1 41 89 37 66 Riccardo Lamia Interest Rates Strategist +33 1 41 89 63 83 Monna Dimitrova Interest Rates Strategist +33 1 41 89 05 61	Alex Li ** Head of US Rates Strategy +1 212 261 3950
Emerging Markets	Xiaojia Zhi Chief China Economist Head of Research, Asia ex-Japan +852 2826 5725 Eddie Cheung CFA Senior Emerging Market Strategist +852 2826 1553	Jeffrey Zhang Emerging Market Strategist +852 2826 5749 Yeon Jin Kim Emerging Market Analyst +852 2826 5756	Sébastien Barbé Head of Emerging Market Research & Strategy +33 1 41 89 15 97		Olga Yangol ** Head of Emerging Market Research & Strategy, Americas +1 212 261 3953
Foreign Exchange	David Forrester Senior FX Strategist +65 6439 9826		Valentin Marinov Head of G10 FX Research & Strategy +44 20 7214 5289	Alexandre Dolci FX Strategist +44 20 7214 5064	
Quant Research			Alexandre Borel Data Scientist +33 1 57 87 34 27		

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