# Clouds on the Horizon

## FLAR, 6 June 2026

**Introduction**

- Thank organisers
  - Glad to be here, if only by video
- Asked to assess challenges ahead for global economy from macro-financial perspective
- My message is simple
  - Clouds are gathering on the horizon, reflecting convergence of two powerful forces
- Force 1: upward phase of the financial cycle (FC) has lost momentum / turned, just as the regulatory cycle (RC) is pushing to weaken the financial system's defences
  - ⇒ higher risk of financial instability in coming years
- Force 2: inexorable deterioration in public finances is undermining their sustainability
  - biggest M- to L-T risk to monetary, financial & macroeconomic stability of global economy
- All this happening in a political & geopolitical context that encourages these developments & complicates finding solutions
  - & is giving rise to dangerous exogenous shocks

        - War in Iran → ↓ SS & ↑ P of oil + gas + fertilisers

- Root cause: failure to take a 'long view' (Padoa-Schioppa, 2009)
    - Unrealistic to expect market participants to do so
    - But fully appropriate to expect economists & policymakers to do it
    - Jean Monnet: "What is politics if not the art of making possible what is necessary?"

**The Financial and Regulatory Cycles**

- FC: interaction between credit, risk-taking & asset prices (esp. real estate) ⇒ booms followed by busts
    - Much longer than business cycle (BC)
    - Duration: 16–20 years (vs 8–10 for BC *as traditionally measured*)
- FC marks timing of most significant financial instability episodes
    - Crises tend to occur a few years after FC's peak, when asset prices collapse & credit slows sharply or contracts
    - Examples: Nordic countries & Japan banking crises (early 1990s), GFC 2008, Great Depression 1930s
- While identification of FC remains imperfect,
    - Over years profession has developed number of indicators
- Current picture: far from reassuring

- FC losing momentum / entering downward phase in many countries, esp. advanced economies & above all US – epicentre of global finance
- Following very long period of extremely low rates, serious financial strains have already emerged:
  - Failures of US regional banks (March 2023) – averted major crisis only by timely & massive intervention
  - Failure of Credit Suisse – a globally systemic bank
- Strains so far mainly reflect interest rate risk (valuation losses); credit risk – more dangerous – only now beginning to emerge significantly
  - Failure of First Brands; problems of some US regional banks
  - Latest strains in private credit sector (eg Blue Owl)

- Positive: banking system has greater capacity to cope with losses
  - thanks to strengthened PR&S post-GFC
- Biggest risks today lie with NBFIs, which grew exponentially after GFC
  - Some risks are in plain sight
    - Time bomb: Link between insurance/reinsurance sector & private markets
      - at system level: less capital backing more illiquid & risky assets
  - but I worry even more about less visible ones

        - Opaque close links between banking sector & NBFIs

- ⇒ Even if overall picture <u>not</u> as worrying as pre-2008…
    - further episodes of financial instability to be expected
- This is where the RC comes in
    - Tighter regulation deliberately shifted risks outside banks
    - But what was unintended was failure of regulation to keep pace with developments in NBFIs
    - &, as memories of GFC fade, we now see growing pressure globally to ease R&Sory constraints on banks as well!
            - …in illusory belief this will lead to stronger growth
        - Imperative: deregulate, sometimes under pretext of 'simplifying'
    - In L-T, no tension between growth & regulation – quite the contrary!
    - History: it is precisely at times like these that R&S needs to be strengthened, not weakened

**The (Un)sustainability of Public Finances**

- Excesses driven by the financial sector: just one challenge
    - Focusing on them would be like driving looking in the rear-view mirror
- Looking forward: risks from excesses in the <u>public sector</u> loom even larger

- Unsustainability of public finances can cripple economy through inflation, financial instability, or both
- Here, picture has grown inexorably darker over time

- Mechanisms through which unsustainable public finances can cripple the economy are well known
  - As regards inflation:
    - High govt debt can severely restrict MP room for manoeuvre
    - When fiscal credibility / sovereign creditworthiness seriously questioned…
      - ….tightening MP would only exacerbate concerns & fuel inflation
        - typically via uncontrolled ER depreciation
    - ⇒ economic 'fiscal dominance', quite apart from any political
  - As regards financial instability – mechanisms both direct & indirect:
    - Direct: private sector's exposure to losses on govt debt – eg the 'diabolic loop' during euro area debt crisis 2011
    - Indirect: when financial instability erupts, soundness of public finances is ultimate guarantee of financial system solvency
    - CB can act as LoLR but cannot address insolvency – only govt can

        - If market confidence in state solvency evaporates, financial system loses its safety net

- Indeed, close link between MP & FP is all too often forgotten
    - Both operate through 'intertwined' balance sheets – those of CB & govt
    - Transmission mechanisms overlap, particularly through financial conditions
    - Fundamentally, both guarantee state's privileged access to resources: MP via money issuance; FP via power to tax
    - They support each other: MP can prevent technical default of state; power to tax ultimately supports value of money
- Now, if we look at state of global govt debt: signs are alarming
    - After steady increase since 1980s, debt-to-GDP ratios have reached historical peaks – similar to, or higher than, WWII
    - Outlook far from reassuring: in absence of consolidation, debt-to-GDP set to rise further in long term even if $r < g$
        - Increase even more pronounced when demographic ageing, green transition & higher defence spending (geopolitical tensions) factored in
    - If $r > g$ again, self-reinforcing dynamic would be much stronger
        - Cost of servicing debt currently not far from historic lows

    - Would exceed historical peak if rates return to mid-1990s levels – quite normal from long-term perspective
  - Recent less mechanical IMF projections also paint a worrying picture
    - & should remember that they have proved systematically rosy in the past!
- Some counting on current wave of technological innovation – esp. AI – to revive growth
  - Always been optimistic about technological progress, but hope is not a strategy
  - & impact of latest innovation wave does not seem likely to significantly change the picture for many years to come
- How did we get here?
  - In short: political inability to take difficult but far-sighted decisions
  - Fuelled by a 'growth illusion' (BIS):
    - idea that growth can be strengthened sustainably through expansionary F & MP, even at cost of reducing 'safety margins'
- Who is responsible?
  - Financial markets – unable to give warning signals in time
  - Rating agencies – too reluctant to downgrade, or only doing so belatedly

    - International organisations (OECD, IMF) – IMF only recently began to raise serious concerns
    - Academics who, faced with exceptionally long period of very low (even negative nominal) rates, spoke of a 'New Normal' with no end in sight, effectively eliminating budgetary constraints
    - Central banks bear some responsibility too
        - Contrary to popular belief, CBs can have long-lasting effect on real rates
        - Coexistence of low & stable inflation with low unemployment is not an unequivocal sign that rate is at equilibrium (r*)
        - Pre-GFC: low rates most likely contributed to financial imbalances in the long run
        - Post-GFC recovery: keeping rates low / reducing further – incl. through QE – did not deliver desired effect
        - Inflation remained below target; MP (like FP) lost valuable safety margins
        - ⇒ contributed to sudden post-Covid inflationary surge
- Like Agatha Christie's Murder on the Orient Express:
    - we all are guilty, to some extent
- So far, I have talked about two forces – state of F & RCs, OTOH & Gov D unsustainability, OTOH, separately

    - But these forces interact and reinforce each other
- OTOH; FC has been a major factor → deterioration of public finances
        - Could continue to do so in future
    - FC booms flatter hugely fiscal accounts
        - Especially tax-revenue rich
    - & FC busts are a key cause of major fiscal deterioration
- OTOH, in the future, fiscal deterioration could amplify costs of financial busts
    - By triggering FI
    - Or by reducing RPM to soften blow

**What Needs to Be Done?**

- We need a change of course inspired by P-S's L-T view
- This means:
    - Abandoning the growth illusion
    - Recognising importance of maintaining safety margins / 'buffers' in M & FP
    - Strengthening the financial system's defences through PP
    - & rediscovering structural policies to allow market forces to boost the economy <u>on a sustainable basis</u>
- All this, of course, is easier said than done

- The huge political economy obstacles that have prevented the shift so far will not go away
    - just think of the endemic Saint Augustinian attitude to fiscal consolidation
        - Of type: “Lord, give me chastity and continence, but not yet”
    - as Jean-Claude Juncker used to say
        - “We all know what to do; what we don’t know is how to get re-elected after we’ve done it”
- Indeed, if anything, the obstacles to a change of course are growing
        - beyond exogenous shocks such as wars
- We have been seeing a…
    - Retreat from globalisation & heightened geopolitical tensions
    - & a shift in the centre of gravity of political spectrum
        - Not least due to inability to manage impact of past trade & migration flows

        ⇒ ↑ Pressure on safety margins of all three policies: M, F & P Ps
        - Striking example: growing questioning of CB autonomy
            - an essential element of ‘institutional hygiene’
    - All this is also testing very mechanisms of international cooperation needed to respond adequately to challenges of what is still a deeply integrated world

- Perhaps the picture painted is too pessimistic – but Gramsci was right:
    - "To achieve ambitious goals, we need to combine the pessimism of the mind with the optimism of the will"
- Let's just hope that the political class is up to the task