At a crossroads: policy challenges in a shifting world

The soft landing for the global economy that was coming into view suddenly seems more elusive. Long-established trade relationships began to fray as a wave of larger than expected tariff announcements in early April hit the global economy. Growth forecasts were cut, and financial markets were jolted as policy uncertainty surged. Even as some of the initial shock has dissipated, a sense of apprehension hangs in the air.

Long-standing economic relationships that have sustained global prosperity for decades are now under strain. Yet we should not look back with rose-tinted glasses. The global economy was already wrestling with structurally low productivity growth, persistently weak fiscal positions and the build-up of large and often opaque non-bank financial positions. Rapid and disruptive technological changes pose significant challenges of their own.

Central banks need to deal with the immediate fallout while keeping top of mind the deeper, structural weaknesses that threaten the resilience of the global economy. Success will depend on maintaining public trust – trust in central banks' capacity to act and do so in the public interest. Trust in their commitment to low inflation was decisive in quelling pandemic-era inflation. Now, trust in public institutions – including the trust in money – needs to serve as a fixed point for others to rally around.

This year's Annual Economic Report assesses the state of the global economy and discusses the key policy challenges. In addition, it offers an in-depth analysis of two important issues. The first is changes in the financial system, and their implications for the global transmission of financial conditions. The second is the design of a future monetary and financial system – one that embraces innovation to unlock new possibilities while preserving the trust in money that is fundamental to economic stability.

The year under review

Until early 2025, the global economy appeared firmly on track for a soft landing. In most countries, inflation was already at or converging to targets, and global growth in 2024, at just over 3%, matched the pace of the previous year. Labour markets had largely normalised, with unemployment rates still below pre-pandemic levels. Financial markets echoed this optimism, with equities rallying on solid growth prospects and expectations of deregulation, while credit spreads remained tight.

But the outlook for the global economy quickly darkened in the second quarter of 2025 following the announcements of larger than expected broad-based US tariffs. Adding to the uncertainty were growing doubts about the return of fiscal policy to a prudent path, and questions about the commitment to central bank independence.

Financial markets revolted, with volatility climbing to levels unseen since the pandemic as stock markets around the globe plunged and corporate credit spreads widened. Unusually, the US dollar depreciated even as US government bond yields rose. Stock markets staged a comeback as some of the announcements were reversed, but bond and currency markets reflect a sense of continuing apprehension about what comes next. Once they settle, tariffs are expected to be at levels unseen in decades, exerting a significant impact on both output and inflation in the following months.

Textbook effects of tariffs for countries imposing the tariffs resemble a supply shock, raising prices and costs and dampening growth. For economies on the receiving end, the effects are more akin to a negative demand shock, with adverse effects on both growth and inflation. Retaliation would impart supply shocks to receiving countries.

But the dynamics may well turn out to be far more complex than these simple textbook effects. The global economy is not a collection of islands; it consists of a dense web of interconnections among suppliers, customers, consumers and the financial intermediaries that knit them together. Activity straddles the border, so that traded goods undergo many rounds of value added before finding their eventual customers. As the pandemic-era inflation experience made clear, disrupting supply chains could once more lead to upside surprises in inflation. Such a jolt to inflation could rekindle inflation expectations that remain sensitive after the Covid-19-related inflation experience.

Even before the full effects of tariffs take hold, economies are expected to feel the impact of high uncertainty, as firms delay investment and hiring plans and households increase precautionary saving. The slowdown has yet to show up in the hard data, but elevated measures of uncertainty and weakening consumer and business confidence indicators clearly signal a deterioration of economic activity ahead. Growth projections for 2025 are down, and significantly so for several countries.

Inflation forecasts show a more diffuse picture. While they have been revised up in the United States, inflation expectations remain little changed in most other economies. Reflecting this divergence, some central banks have paused interest rate cuts as they wait for clearer signals on how recent developments will affect inflation, while others have continued easing, citing growth risks from trade and uncertainty.

Pursuing stability and growth in a shifting world

Beyond the volatility arising from trade policy, the outlook for the global economy is clouded by significant real and macro-financial vulnerabilities. These vulnerabilities are not new, but the recent turbulence has heightened their relevance. They have the potential to amplify the effects of current shocks and, in some cases, could also generate shocks themselves. As discussed in Chapter I, vulnerabilities fall into three broad categories: real vulnerabilities such as low potential output growth and less flexible economies; rising fiscal vulnerabilities; and related macro-financial vulnerabilities associated with deeper structural shifts in the global financial system.

Rising trade fragmentation adds to real vulnerabilities

The global economy is facing a combination of long-standing and emerging structural challenges. Productivity growth has been trending down in many advanced economies for decades and more recently also in several emerging market economies, acting as a drag on growth overall.

The imposition of broad-based tariffs represents a further step towards greater trade fragmentation. These tariffs could accentuate the decline in productivity growth as supply chains come under further pressure. Ageing populations and less migration will reduce supply capacity. The Phillips curve could become steeper, meaning that inflation could rear its head even with moderate increases in activity.

For inflation expectations, it is a story of “once bitten, twice shy”. Having been surprised by the surge and persistence of inflation, households and firms respond more sensitively to inflation outcomes. A recent BIS survey of households across multiple countries reveals that their inflation perceptions have been deeply scarred by the experience of pandemic-era inflation.

Adding to these challenges is the concern that supply shocks could be more frequent and persistent in the future, driven by geopolitical tensions and extreme weather events. These developments pose further challenges to monetary policy.

Structural reforms are more critical than ever. When faced with supply shocks, reallocating resources efficiently is of first-order importance. Strengthening the supply side enhances resilience, and boosting potential growth is vital for debt sustainability.

Historically high public debt

Public debt levels have risen above peacetime highs in many countries. While elevated debt can be sustainable with robust growth and low interest rates, current and expected conditions look less favourable. Debt service can be too high even if debt is sustainable; in many economies, debt service is as high as spending on education, defence or public pensions.

High public debt increases the economy's vulnerability to adverse scenarios that could push up inflation or lead to stress in the financial system. Lack of fiscal consolidation and concerns about fiscal sustainability could lead to refinancing difficulties and sharp rises in interest rates. Central banks might come under pressure to maintain overly accommodative monetary policies, including by keeping balance sheets large. Strong institutions that protect central bank independence will be important.

High public debt also increases the vulnerability of the financial system to lower asset values when interest rates increase, especially when leverage within the system is elevated. Repricing of government debt can lead to losses for banks and non-bank financial institutions (NBFIs) with large sovereign debt holdings. Moreover, in sovereign bond markets increasingly dominated by highly leveraged hedge funds, a repricing could also trigger sharp deleveraging and a liquidity squeeze, leading to a tightening of financial conditions for the broader economy.

Maintaining fiscal sustainability is key to mitigating such risks. For many countries, this means reducing large deficits and rebuilding fiscal buffers in a growth-friendly way. This increases governments' ability to conduct countercyclical fiscal policy and creates space to accommodate future increases in essential spending, including on infrastructure and defence. But the benefits are broader than that. Lower risk premia also reduce average financing costs for the wider economy.

Shifting financial intermediation

While the Great Financial Crisis (GFC) was primarily a banking crisis, with mortgage markets at its core, the post-GFC landscape has government bond markets at its centre and asset managers of various stripes as the key intermediaries. As a result, a key risk today is liquidity stresses in government bond markets. Hedge funds, in particular, have become key providers of procyclical liquidity in government bond markets, often employing highly leveraged relative value trading strategies. By using government securities as collateral in the repo market to borrow cash for additional securities, these strategies boost returns but are also vulnerable to adverse shocks in funding, cash or derivatives markets. This vulnerability has increased further as financing terms have become increasingly lax. Haircuts have gone to zero or even negative in large sections of the repo market, meaning that creditors have stopped imposing any meaningful restraint on hedge fund leverage. This higher leverage leaves the broader market more vulnerable to disruptions, as even slight increases in haircuts can trigger forced selling and amplify financial instability. Such adverse dynamics were on display, for example, during the market turmoil of March 2020, and contributed to the volatility spike in Treasury markets in early April 2025.

NBFIs have also significantly expanded their role in cross-border transactions, primarily through bond portfolio investment. Many of these entities, including pension funds and insurance companies, manage globally diversified portfolios across multiple currencies while maintaining obligations to their beneficiaries in domestic currency. To hedge the associated currency risk, they rely heavily on derivatives markets (foreign exchange swaps, forwards and currency swaps), which had grown to $111 trillion globally by end-2024, mostly denominated in US dollars. While these instruments support cross-border positions, they also expose NBFIs to significant short-term rollover risks and funding pressures. In addition, they have amplified the role of global portfolio investors in transmitting financial shocks across borders, even among major AEs. As discussed in Chapter II, financial conditions have become more sensitive to global risk factors. This calls for a deeper understanding of the cross-border challenges inherent in a more market-based financial system and underlines the value of cooperation among central banks. Regular information-sharing and exchanges of views improve the assessment of global macroeconomic and financial developments, helping central banks to better anticipate international spillovers and calibrate their policies to minimise unintended consequences.

While strains in government bond markets have been at the core of recent financial tensions, private sector debt also remains a concern. High debt levels amplify economic downturns through wider credit spreads, rising defaults and reduced credit availability. One area to watch is private credit. Private credit markets provide a growing share of finance to smaller, highly indebted firms. Meanwhile, banks remain indirectly exposed to credit risks by lending to private credit firms.

These structural changes in the financial system call for a holistic approach by supervisors and regulators. For banking, timely and consistent adoption of Basel III across regions is a must. For NBFIs, this means aligning regulation so that activities posing similar financial stability risks are regulated with similar stringency.

Monetary policy priorities

One lesson from the pandemic era is that inflation can emerge suddenly and from supply restrictions, not only from strong aggregate demand. Structural shifts and increasing rigidity on the supply side heighten the risk of inflation potentially returning. Pandemic-era inflation has made inflation expectations more sensitive. Trade tensions exemplify the current challenges central banks face. Central banks must carefully balance supporting growth with preventing temporary price increases from turning into persistent inflation. If evidence of de-anchoring emerges, central banks must respond quickly and forcefully to inflationary shocks.

Periodic reviews, already undertaken by some major central banks, help to ensure that the monetary policy frameworks remain fit for purpose. Three key lessons from the experience of recent years stand out. First, inflation targeting must address both inflation surges and inflation undershooting targets. Second, central banks must remain agile, prioritising flexible tools and clear exit strategies to handle abrupt economic changes. Last, humility is vital. Central banks need to avoid over-reliance on baseline outlooks. Relatedly, the use of alternative scenarios can help communicate the extent of uncertainty and clarify the central bank's reaction function.

Building a monetary and financial system for the future

Monetary policy is about preserving trust in the value of money, which is essential for the monetary system itself. Digital innovation does not change the fundamental premise of trust in money underpinned by central banks. But it does open vast new potential for the functioning of the monetary and financial system. Technological innovations hold the promise of improving existing financial services and enabling entirely new contracting possibilities. But they need to be built on a strong footing. Central banks must step up to the challenge and build the foundations for the next-generation monetary and financial system.

The next-generation monetary system is grounded on tokenisation. Tokenisation means representing financial claims in a programmable platform. This integrates the claims themselves with the rules and logic governing transfers, to enable the contingent execution of actions (ie "if", "then" and "else"). Having central bank money, private forms of money and other claims in the same venue opens up new economic arrangements. We laid out this vision in our 2023 Annual Economic Report in terms of a "unified ledger". Since then, innovation has taken further strides. In securities markets, tokenisation on a unified ledger both improves the old and enables the new. The application to correspondent banking is particularly promising. Project Agorá envisages a unified ledger for correspondent banking where the sequences of account updates and associated messaging and compliance checks can all be done in one go. The traditional separation of messaging, clearing and settlement gives way to the seamless operations of a unified ledger, while preserving sound money and the integrity of the monetary system.

These examples give just a glimpse of what can be achieved. The possibilities are limited only by the imagination and ingenuity of the developers.

Alternatives built on privately issued currencies that circulate on public blockchains, such as stablecoins, fall short when set against the three key tests that money must fulfil to serve society. The first test is the *singleness* of money, which refers to the property that money is accepted at par with no questions asked, whatever form it takes. The second test is *elasticity*, which refers to the ability to provide money flexibly so that obligations are discharged in a timely way without waiting for incoming funds and thus avoiding gridlock. Last but not least, the third test is the *integrity* of the monetary system against illicit activity. Stablecoins fare poorly on all three criteria, and so they cannot serve as the mainstay of the monetary system. Whether they can play some subsidiary role going forward beyond being the gateway to the crypto ecosystem remains to be seen.

Tokenisation can deliver the best of digital innovation if it is grounded in the indispensable trust in money provided by central banks. Tokenised platforms with central bank money at the core can unlock new possibilities while maintaining stability and trust. To start, they should integrate central bank reserves, commercial bank money and government bonds – key forms of money and financial assets that form the cornerstone of the financial system. With these foundations in place, there is scope for the public and private sectors to unlock new efficiencies and capabilities.

Central banks must play a catalytic role. As guardians of the monetary system, they have the mandate and the capacity to drive change. In this, they can work with the private sector and coalesce efforts around a shared vision of the monetary and financial system of the future. By playing this role, they can help to serve society and maintain the crucial trust in money for the next generation.