Strengthening foundations for the future

Speech by Pablo Hernández de Cos
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Ladies and gentlemen

Welcome to the presentation of our Annual Economic Report for 2026.

The Report is our flagship publication, where we set out our perspectives on key developments and challenges facing policymakers around the world.

Chapter I reviews the past year through two lenses: "progress" and "peril". Progress is seen in rapid advances in artificial intelligence (AI) and their potential to boost economic activity; and peril arises from heightened inflationary pressures, financial vulnerabilities – including those related to AI exuberance – and high public debt, all of which weigh on the outlook.

Chapter II delves more deeply into the challenges central banks face from historically high public debt and evolving financial markets.

To preserve macroeconomic and financial stability in this environment, all policy domains have a role to play. Discipline in each domain expands the room that the others have to act.

This overarching message also applies to Chapter III of the Report, which Frank will present. In that chapter, we explain why digital innovation in monetary instruments will bear fruit only if rooted in institutional features that have stood the test of time.

Let me start with Chapter I.

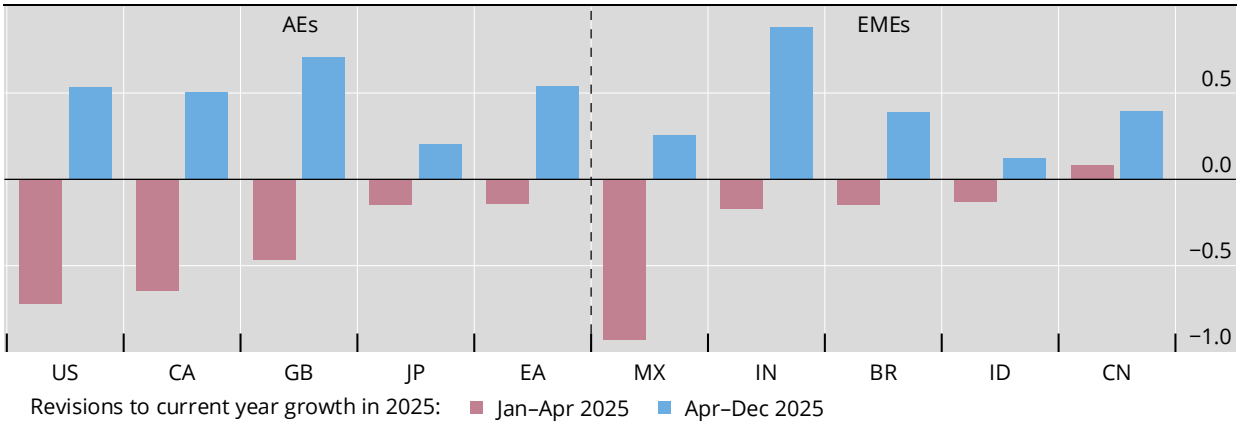
Progress and peril

The past 12 months have been eventful. A year ago, many feared that higher tariffs would slow global growth and trade significantly, especially in the United States and among its close trading partners, as shown in the red bars in Graph 1. Fortunately, as we now know, the global economy proved resilient, for three main reasons.

Growth initially downgraded on tariffs, but later revised up

In percentage points

Graph 1



Sources: Consensus Economics; BIS.

First, effective tariff rates were lower than initially feared. The peak announced US tariff rate was more than 25%. But, due to trade deals and exemptions, the effective rate ended up closer to 10% on average, as you can see by comparing the blue and red lines in Graph 2.A. These lower than expected tariffs account for about a third of the upward revisions to 2025 growth, shown by the red bars in Graph 2.B.

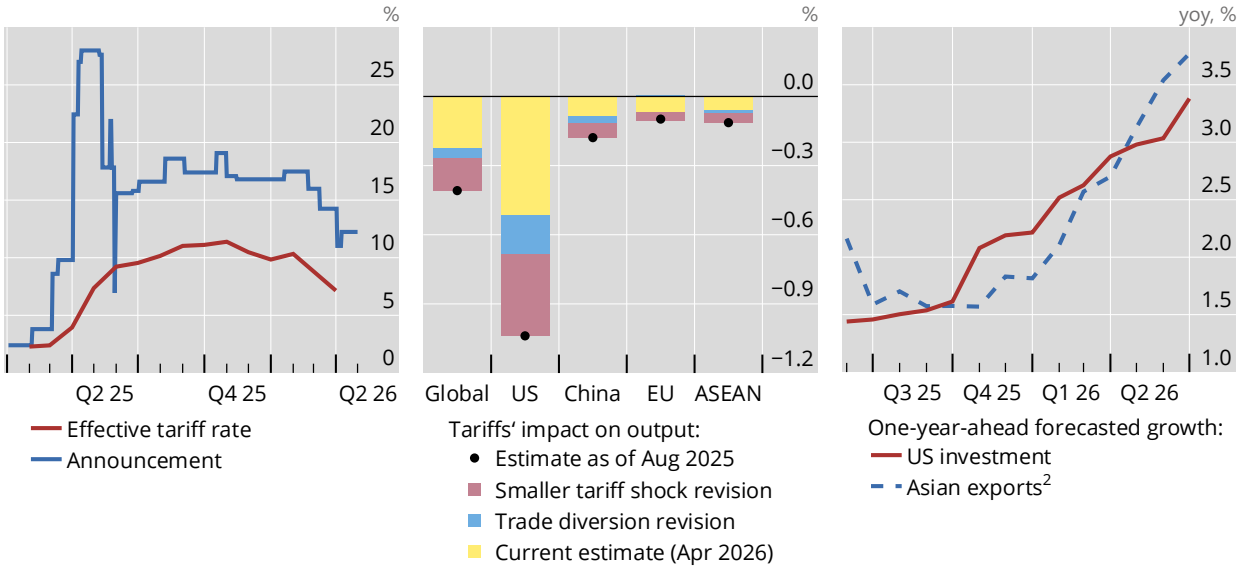
Several offsets muted the impact of tariffs

Graph 2

A. Effective tariff rates fell short of officially announced rates

B. Smaller tariffs and trade diversion moderated the output impact[1]

C. AI-related investment provided a lift



ASEAN = Association of Southeast Asian Nations.

[1] Red and blue bars capture, respectively, upward revisions due to lower realised tariff rates (based on The Budget Lab estimates as of April 2026) and greater cross-country substitution associated with trade diversion. [2] GDP-PPP weighted average of KR, MY, SG and TH.

Sources: H Zhao, "Assessing the macroeconomic impacts of the 2025 US tariffs", *BIS Working Papers*, no 1316, 2025; IMF; Penn Wharton Budget Model; The Budget Lab at Yale; Focus Economics; BIS.

Second, firms adapted quickly. They front-loaded shipments, rerouted and trans-shipped trade and absorbed part of the cost increases in their margins. This helped cushion the impact of tariffs on growth and inflation, at least temporarily.

Third, a surge in optimism about AI spurred a capital expenditure boom on AI-related infrastructure. The effects were felt most keenly in the United States but also had a global spillover along the AI supply chain. As you can see in Graph 2.C, there were significant upward revisions to US investment and Asian exports. The same optimism also buoyed risk appetite and kept global financial conditions loose, despite high policy uncertainty and geopolitical tensions. This tailwind is still very much at work today.

Together, these three factors contributed to strong upward growth revisions in the second half of last year, as shown in the blue bars in Graph 1. By the end of 2025, global growth was close to what had been expected before the tariffs were announced.

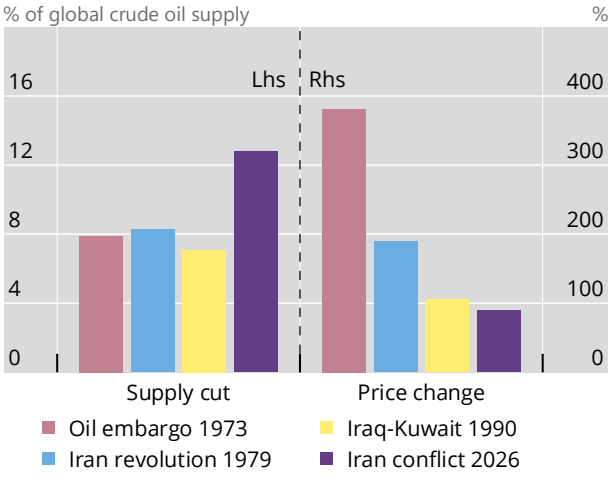
The global economy entered 2026 with solid momentum, which continued until the outbreak of conflict in the Middle East. The conflict marked a new negative supply shock, continuing a string of such events since the Covid-19 pandemic.

And it was a major shock. The reduction in the oil supply following the closure of the Strait of Hormuz was unprecedented. In volume terms, it was larger than the 1970s energy crises, as shown in Graph 3.A. The conflict led to downgrades in the growth projections across countries, as shown in Graph 3.B.

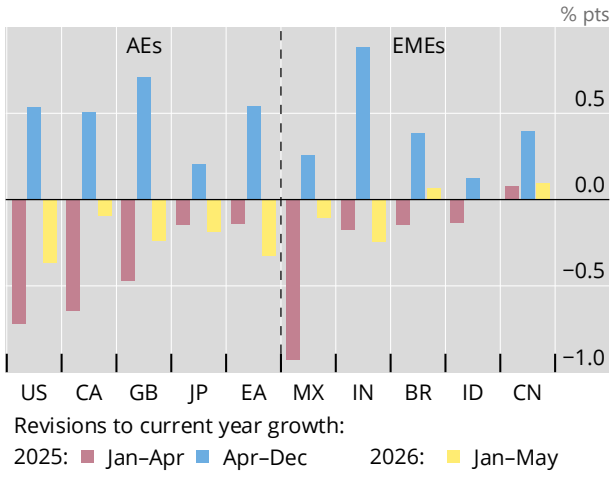
Outbreak of Middle East conflict weighed on outlook

Graph 3

A. Middle East conflict led to historic energy supply cut[1]



B. Growth projections were revised down in response



[1] Peak supply cuts divided by average of global crude oil supply in the three months prior to the event. Price changes calculated from the month prior to the event to peak using Saudi Arabian Light oil benchmark (until 1980), dated Brent prices sourced from World Bank Commodity Price Data (1990 episode) and the Brent crude prompt price for delivery in 10 days at the Sullom Voe terminal (2026 episode).

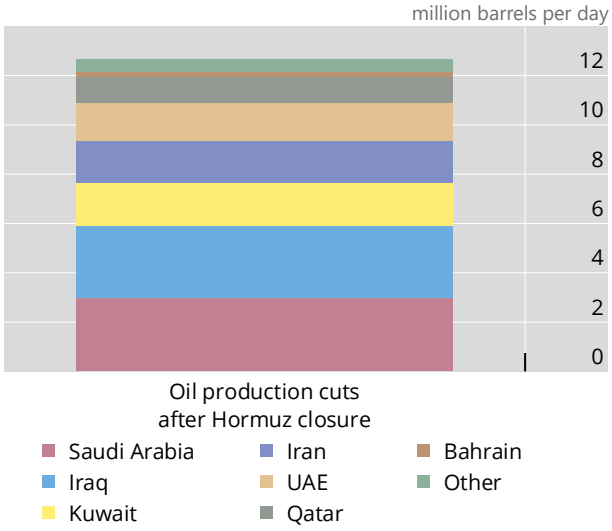
Sources: World Bank; US Energy Information Administration; Consensus Economics; Kpler; LSEG Datastream; LSEG Workspace; Macrobond; BIS.

Nonetheless, financial markets remained buoyant. Equity prices surged and oil futures prices were restrained, in large part due to expectations of a swift resolution to the conflict. Signs that the Strait of Hormuz might soon reopen on a sustainable basis have brought further relief to financial markets.

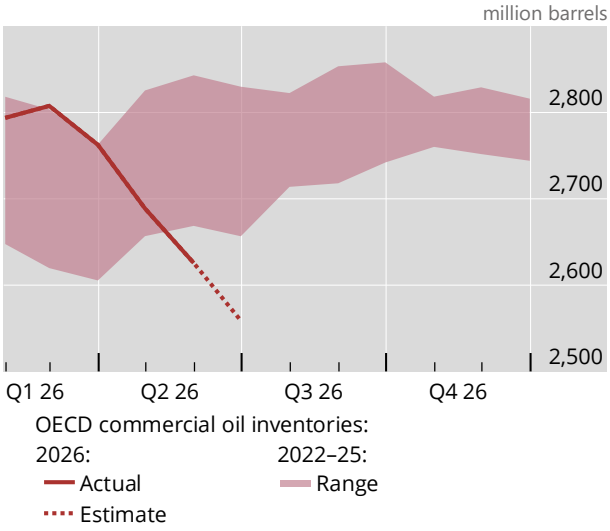
However, even if the reopening of the Strait of Hormuz is confirmed, we should not be complacent. The conflict's effects could linger. The prolonged production pause across the region, as shown in Graph 4.A, could complicate and delay the ramp-up of output. Repairing damaged facilities and normalising shipping traffic will also take time. Meanwhile, the need to rebuild depleted oil reserves, shown in Graph 4.B, could keep demand and price pressures elevated.

Persistent effects from the conflict — Graph 4

A. Prolonged Hormuz closure raises challenges of resuming production



B. Rebuilding depleted reserves could keep market conditions tight[1]



[1] OECD commercial crude oil and other liquids inventories; EIA forecasts as of June 2026 (dashed line) assuming flows through Strait of Hormuz slowly start to resume in the third quarter of 2026.

Sources: US Energy Information Administration (EIA); Kpler; LSEG Datastream; BIS.

Four pressure points

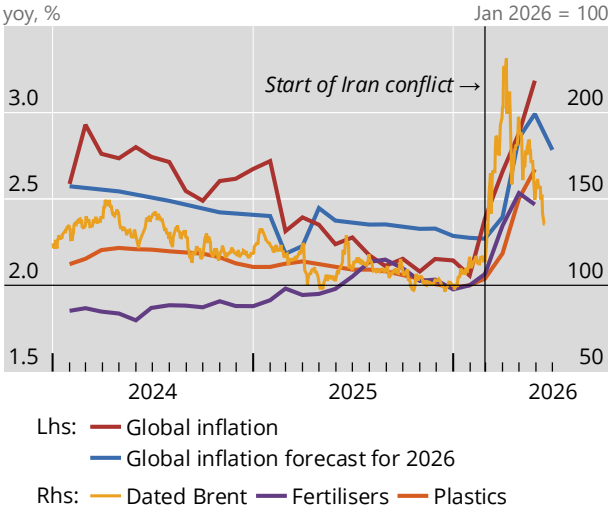
Looking ahead, the global outlook will be shaped by how the persistent ramifications of AI optimism and the conflict interact with existing vulnerabilities. In this year's Annual Economic Report, we highlight four pressure points: (i) the return of inflation; (ii) risks from AI-related exuberance; (iii) amplification from existing financial vulnerabilities; and (iv) pressures on public finance.

Let me discuss each in turn.

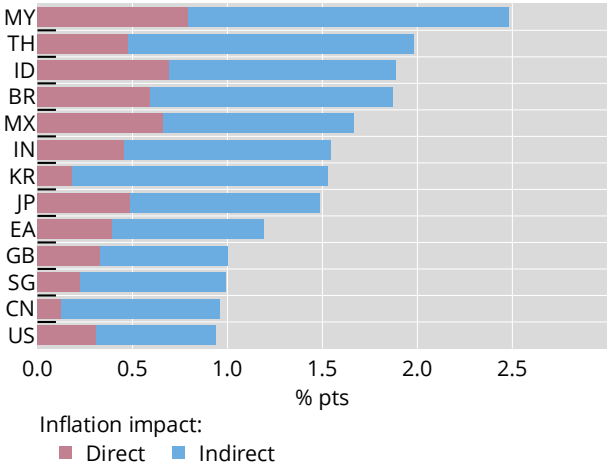
Inflationary pressures rising

Graph 5

A. Signs of rising inflation[1]



B. Supply chain linkages could amplify higher input prices[2]



[1] Global inflation and global inflation forecast are the GDP-PPP weighted cross-country averages of headline inflation and consensus forecasts of 2026 inflation, respectively. For details, see additional notes to Graph 8 in Chapter I of the BIS *Annual Economic Report 2026*. [2] The consumer price index (CPI) inflation impact of a joint 10% price increase in four input sectors – oil and gas, refined petroleum, chemicals and plastic products. Direct effects refer to shocked items in the CPI basket; indirect effects capture propagation through supply chain linkages.

Sources: IMF; World Bank; Bloomberg; Consensus Economics; LSEG Datastream; national data; BIS.

First, inflation. As shown in Graph 5.A, global inflation has risen by one percentage point since the conflict in the Middle East began. Even if the strait is sustainably reopened, the risk is that this initial increase persists.

Supply chains are a key propagation channel. Given time lags in production, rises in the prices of key inputs like plastics and fertilisers – shown in Graph 5.B – could continue to exert upward pressure on inflation even after energy flows and oil prices normalise.

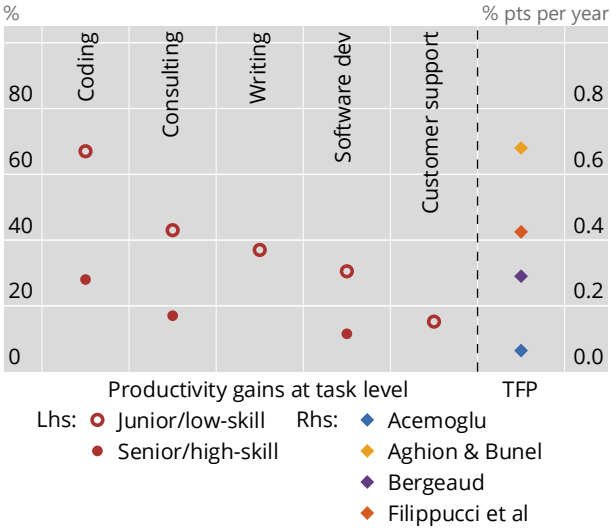
Even if these pipeline pressures themselves are temporary, higher inflation could become entrenched. With memories of the previous inflation surge still fresh in people's memory, household and firm inflation expectations could de-anchor more quickly than in the past.

But there are mitigating factors. Economies have more labour market slack than in 2021, which should help contain wage pressures. And the starting point for interest rates is much higher now than in the last inflation surge.

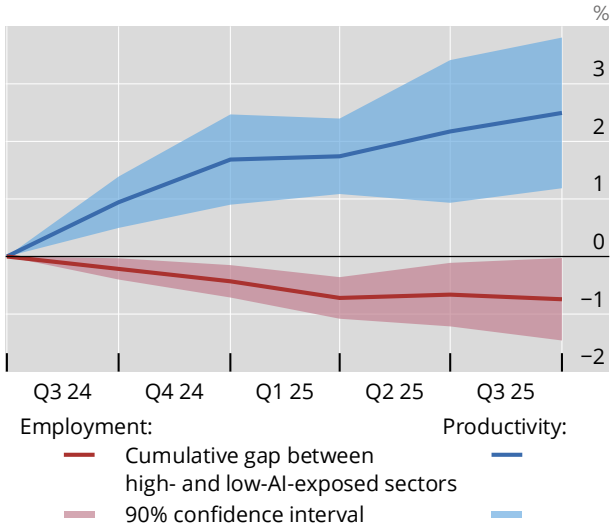
Long-term implications of AI

Graph 6

A. AI holds promise of productivity gains…[1]



B. …but raises questions about labour market adjustments[2]



AI = artificial intelligence; software dev = software developers; TFP = total factor productivity.

[1] Data sources for task level productivity gains: coding output from Gambacorta et al (2024); consultant tasks from Dell'Acqua et al (2023); clerical tasks and writing from Noy and Zhang (2023); software developers' productivity from Cui et al (2026); and customer support from Brynjolfsson et al (2025). [2] Based on a cross-sectoral period-by-period regression where cumulative productivity (employment) growth is regressed on Q3 2024 log of productivity (employment) and Q3 2024 sectoral exposure to AI in the United States.

Sources: D Acemoglu, "The simple macroeconomics of AI", *Economic Policy*, vol 40, no 121, 2025; P Aghion and S Bunel, "AI and growth: where do we stand?", mimeo, 2024; A Bergeaud, "The past, present and future of European productivity", *POID Working Paper*, no 103, 2024; E Brynjolfsson, D Li and L Raymond, "Generative AI at work", *Quarterly Journal of Economics*, vol 140, no 2, 2025; K Cui, M Demirer, S Jaffe, L Musolff, S Peng and T Salz, "The effects of generative AI on high-skilled work: evidence from three field experiments with software developers", *Management Science*, 2026; F Dell'Acqua, E McFowland III, E Mollick, H Lifshitz-Assaf, K Kellogg, S Rajendran, L Krayer, F Candelon and K Lakhani, "Navigating the jagged technological frontier: field experimental evidence of the effects of AI on knowledge worker productivity and quality", *Harvard Business School Working Paper*, no 24-013, 2023; F Filippucci, P Gal and M Schief, "Miracle or myth? Assessing the macroeconomic productivity gains from artificial intelligence", *OECD Artificial Intelligence Papers*, no 29, 2024; L Gambacorta, H Qiu, D Rees and S Shan,: "Generative AI and labour productivity: a field experiment on coding", *BIS Working Papers*, no 1208, 2024; S Noy and W Zhang, "Experimental evidence on the productivity effects of generative artificial intelligence", *Science*, vol 381, no 6654, 2023; national data; BIS.

The second pressure point relates to AI. AI represents the most consequential technological advancement of our generation. Over the long term, it promises to lift productivity and serve as a powerful engine for growth. Task-level studies consistently indicate that AI delivers large efficiency gains (Graph 6.A). At the aggregate level, the effects appear modest so far, reflecting challenges in adopting the technology at scale and integrating it with production processes. Still, the productivity gains are likely to arrive eventually, particularly if the technology improves to the point where knowledge creation can be automated.

But AI development also raises fundamental questions about the future of work and income distribution. To date, labour displacements have yet to occur at scale. But there are signs of possible adjustments to come. Already, US industries with higher exposure to AI record lower employment growth than their less-exposed counterparts (Graph 6.B).

The monetary policy implications, including for the natural rate of interest (r-star), hinge on how these tensions are resolved, an issue we explore in this year's report. Under favourable scenarios, where AI leads to permanently higher productivity growth, the economy can sustain higher consumption growth and r-star increases. But if AI-induced automation crowds out labour income and consumption, sapping incentives to innovate, a demand bottleneck may become a binding constraint to growth. In this case, the initial rise of r-star due to faster productivity growth could reverse as the weaker demand channel takes hold.

Beyond labour markets and growth, AI will also have implications for inflation. If r-star increases and monetary policy does not keep up, inflation will likely rise, with the opposite consequences if r-star falls.

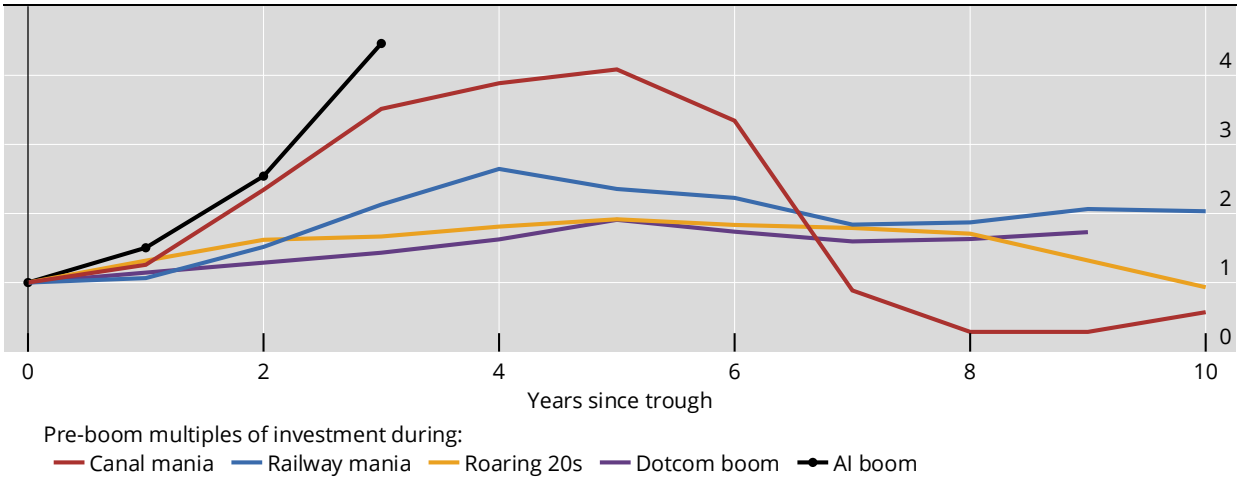
AI exuberance also has implications for the near-term outlook. To date, it has provided an impetus to growth, through both real and financial channels. The question is whether this can be sustained.

One risk is that large-scale investment in AI infrastructure becomes excessive, as each firm tries to outcompete rivals and dominate market share. This could leave the sector more vulnerable if AI underdelivers, possibly bringing the current investment boom to an abrupt end with large macroeconomic consequences. Boom-bust investment cycles often accompany technological breakthroughs, as shown in Graph 7. We should therefore balance optimism with caution.

Parallels with historical episodes of tech-led investment booms[1]

Multiples of pre-boom trough

Graph 7



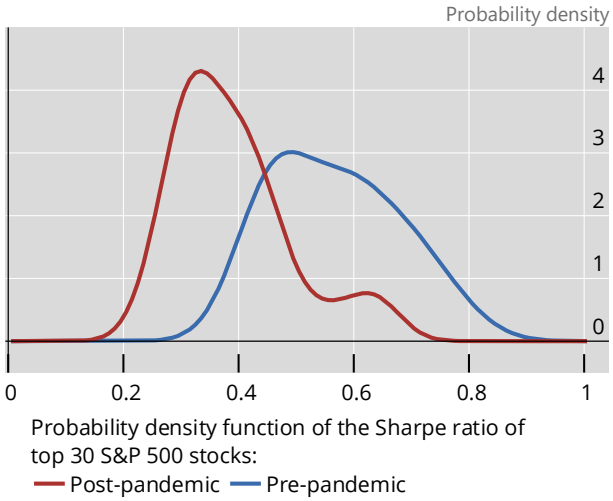
[1] Episodes refer to the following series, and pre-boom troughs refer to the following years. Canal mania = US canal construction spending, 1835; railway mania = GB real investment, 1843; roaring 20s = US private fixed asset investment, 1921; dotcom boom = US private fixed investment in information processing equipment and software, 1995; AI boom = AI hyperscalers' capital expenditure, 2023. AI hyperscalers' 2026 capital expenditure collected from earnings calls and press releases.

Sources: H Cranmer, "Canal investment, 1815–1860", in W Parker (ed), *Trends in the American economy in the nineteenth century*, Princeton University Press, 1960; Bank of England; Federal Reserve Bank of St Louis; Bank of America; S&P Global Market Intelligence; companies' communications; national data; BIS.

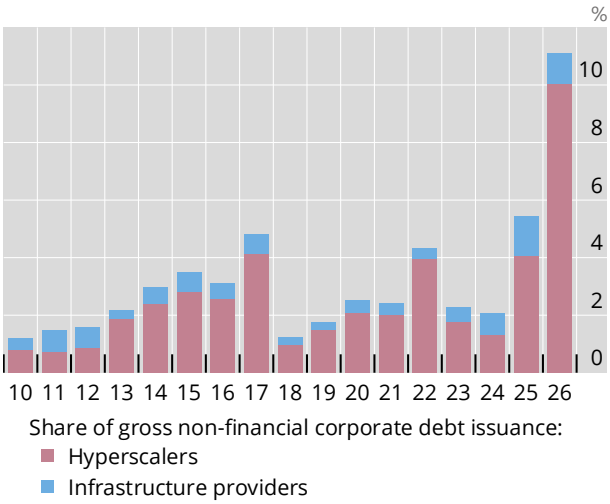
Financial vulnerabilities remain

Graph 8

A. Risk compensation has fallen markedly in US stock market[1]



B. AI firms' investments are increasingly financed by debt[2]



NFC = non-financial corporation.

[1] Kernel distributions are constructed using monthly Sharpe ratios of an equally weighted portfolio of the 30 largest stocks in the S&P 500. Pre-pandemic period corresponds to January 2014 through December 2019. Post-pandemic period corresponds to January 2021 through January 2026. Sharpe ratio = excess return divided by volatility. [2] Based on data for nine hyperscalers and 32 global infrastructure providers.

Sources: Kenneth French Data Library; LSEG Datastream, LSEG Workspace; S&P Global Market Intelligence; BIS.

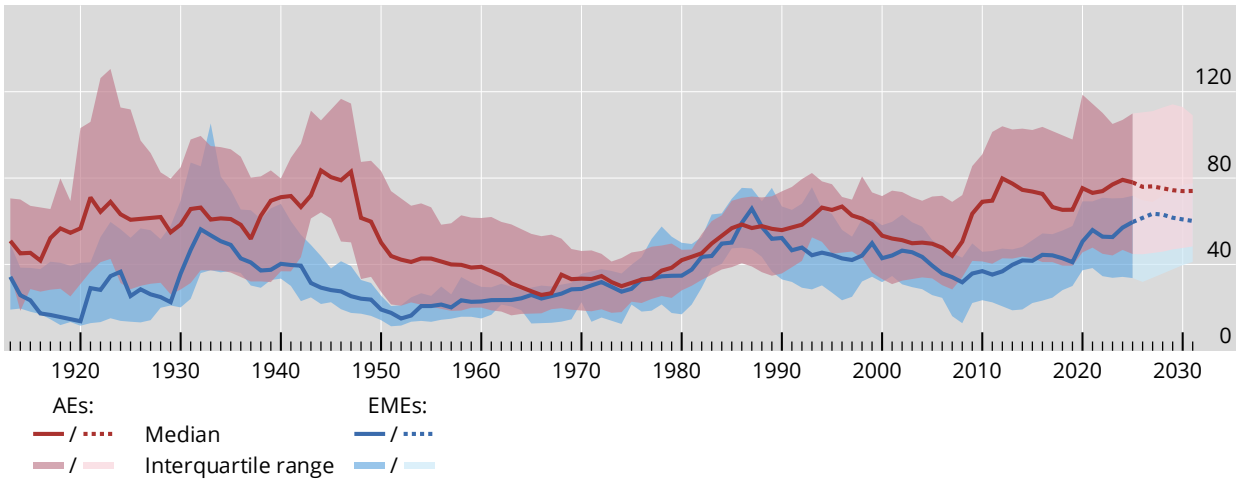
The third pressure point comes from financial vulnerabilities. Easy financial conditions are partly driven by a compression of risk premia, as shown in Graph 8.A. Stretched equity valuations could unwind abruptly and amplify adverse scenarios where interest rates rise or AI payoffs disappoint. This time around, a large correction in AI-driven valuations could carry more pronounced wealth effects and sharper drops in consumption, as households' exposure to equity markets has grown substantially in recent decades.

AI firms, and their related ecosystem, have also relied increasingly on debt to finance their activities, as shown in Graph 8.B. Should the current aggressive pace of capital expenditure deployment slow or come to a halt, borrowers across the supply chain may struggle to replace lost revenue and service their debt. In addition to leverage, the opaque and circular financing structures of some AI activities, as well as the growing footprint of private credit, further highlight the potential for financial amplification. In this environment, a sudden repricing of credit risk – either triggered by AI disappointment or higher interest rates – could tighten financial conditions significantly. The current tension between exuberant risk appetite and persistent macroeconomic risks could thus resolve in a disruptive way.

The final pressure point comes from growing strains on public finance. Public debt was on a steady upward trajectory well before the recent energy crisis unfolded. It has now reached levels near post-World War II highs in many economies, as shown in Graph 9. Ongoing geopolitical conflicts create pressures for additional fiscal measures. At the same time, interest burdens and refinancing needs are rising, as shown in Graph 10. Interest rate growth differentials have become less favourable, adding to the challenge of putting public finances on a sustainable path.

Public debt is now near post-World War II highs[1]

As a percentage of GDP — Graph 9



The dotted lines and lighter shaded areas indicate forecasts.

[1] The sample covers 27 AEs and 24 EMEs, subject to data availability. General (if not available, central) government debt at nominal (if not available, market) value.

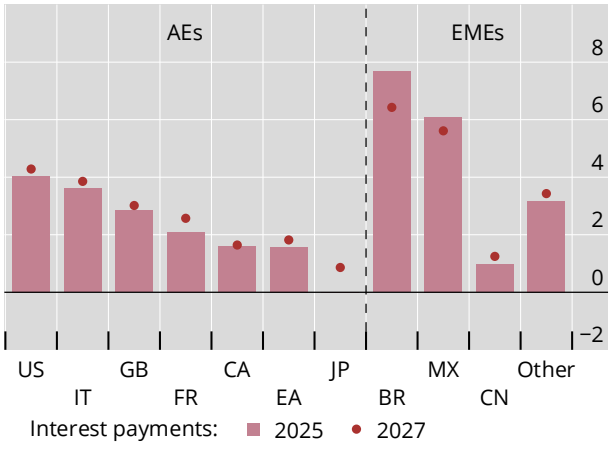
Sources: IMF; Finaeon; national data; BIS.

The last two pressure points are not new. But the risks they pose have grown further and could significantly influence the environment in which central banks operate for the foreseeable future. We analyse these issues in depth in Chapter II of the Report.

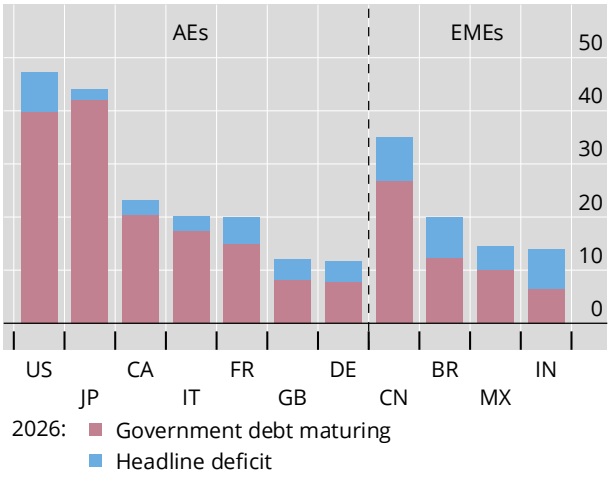
Higher public debt is cutting fiscal space

As a percentage of GDP — Graph 10

A. Interest payments are constraining fiscal space...[1]



B. ...as governments face large financing needs



[1] General government, net interest payments; OECD (2026) data if available, IMF (2026) data otherwise. For the regions, GDP-PPP weighted averages for 10 other AEs and 19 other EMEs.

Sources: IMF; OECD; Bloomberg; BIS.

High public debt and shifting financial markets

The rising public debt can be partly attributed to the fiscal response to successive major shocks such as the Great Financial Crisis (GFC), the Covid-19 pandemic and the energy crisis following Russia's invasion of Ukraine. But it also reflects a broader challenge: many countries do not consolidate sufficiently in economic upswings.

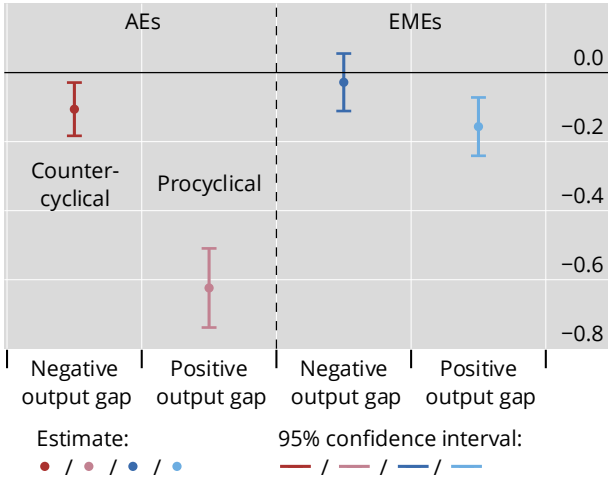
For a long time, fiscal policy in many countries has been asymmetric. Governments tend to ease aggressively in downturns but do not rebuild buffers sufficiently when times are good. Following the GFC, governments also appear to have become even less responsive to rising public debt levels.

Graph 11 illustrates both features: fiscal tightening in good times has been much less forceful than easing in bad times, notably in advanced economies (Graph 11.A); and the response of primary balances to higher debt has weakened since the 2000s (Graph 11.B).

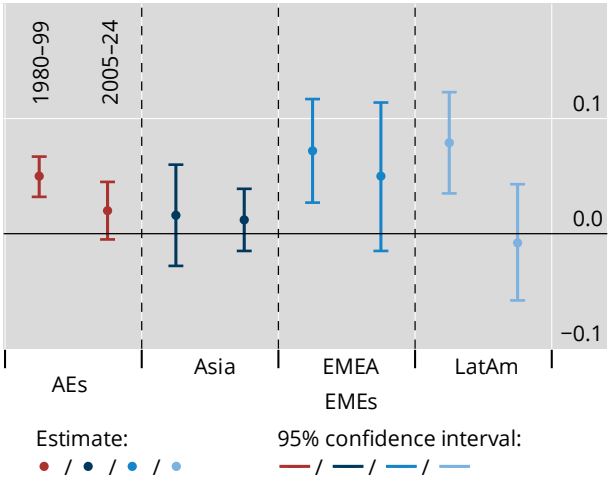
Fiscal policy is procyclical in expansions and less responsive to debt[1]

In percentage points — Graph 11

A. Discretionary fiscal policy is asymmetric over the business cycle[2]



B. Primary balance responds less to rising public debt[3]



EMEA = Europe, the Middle East and Africa; LatAm = Latin America.

[1] The sample covers 27 AEs and 24 EMEs (seven in Asia, 11 in EMEA and six in LatAm). [2] The graph shows that when the output gap is negative then the cyclically adjusted primary balance (CAPB) decreases for AEs and does not change for EMEs. This implies a countercyclical response of fiscal policy to the business cycle for AEs. When the output gap is positive, the CAPB decreases for both AEs and EMEs, implying a procyclical fiscal policy. Estimates are based on weighted mean group estimators for coefficients from country-level regressions of the CAPB on their lagged values, past positive and negative output gaps and past debt levels. Sample period: 1980–2024, subject to data availability. [3] Based on panel regressions for primary balances against their lags, the output and spending gaps and the lagged debt ratios interacted with interest rate-growth differentials over a window of 20 years, controlling for time and country fixed effects.

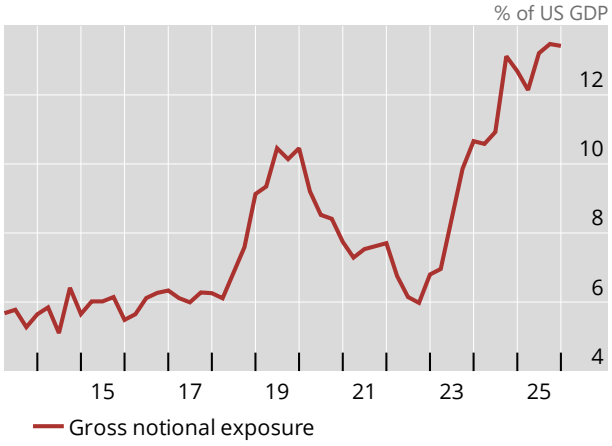
Sources: IMF; OECD; World Bank; European Commission; Finaeon; LSEG Datastream; national data; BIS.

Looking ahead, failure to rebuild buffers in good times poses risks. Without consolidation, it will be difficult to accommodate necessary or inevitable public service expenditures, such as those related to age-related social spending, critical infrastructure investments and heightened defence needs. Failing to adjust would result in even higher debt levels than now. The point at which such debt becomes unsustainable is uncertain. But it would be imprudent for governments to test those limits.

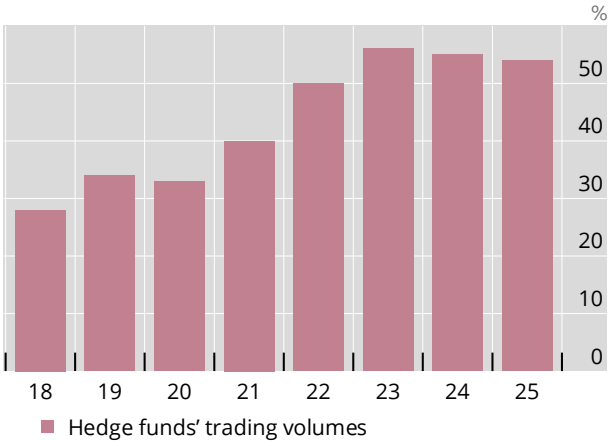
Compounding these challenges, the markets that absorb the larger volume of debt look very different from two decades ago. Intermediation has increasingly moved beyond banks to non-banks. In most countries, pension funds and insurers continue to provide steady, long-term demand for government debt. However, highly leveraged hedge funds now play a much bigger role in intermediating government bonds. As Graph 12 shows, hedge funds' sovereign exposures have risen markedly in the United States and their share of electronic trading in European government bonds has increased significantly.

Hedge funds are taking a bigger role in major sovereign bond markets — Graph 12

A. Hedge funds' US sovereign debt exposure has grown...[1]



B. ...and their footprint in European markets has also expanded[2]



[1] Data are based on responses to US Securities and Exchange Commission Form PF. [2] Percentage of electronic secondary market trading volumes in euro area government bonds on Tradeweb. The observation for 2025 covers data until August 2025.

Sources: F Ferrara, T Linzert, B Nguyen, I Rahmouni-Rousseau, M Skrzypińska and L Vaz Cruz, "Hedge funds: good or bad for market functioning?", *The ECB Blog*, 23 September 2024; IMF; Office of Financial Research; Tradeweb; BIS.

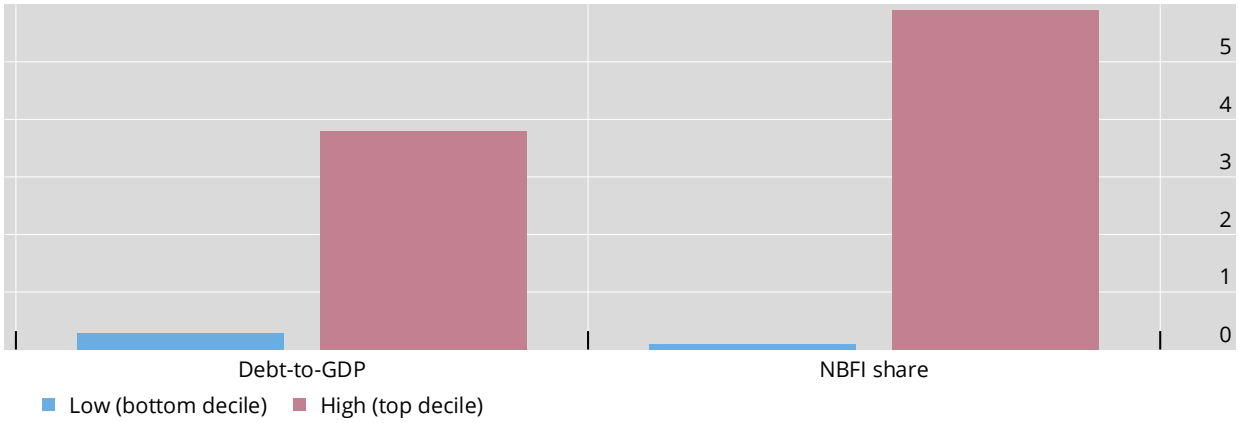
Their strategies rely on short-term repo funding, often on very low or even zero haircuts. This can make liquidity look ample in good times, yet liquidity can quickly vanish when stress arises.

This market shift has created a new sovereign-financial stability nexus. The traditional sovereign-bank feedback nexus is less prominent than a decade ago, not least because banks are better capitalised and more liquid due to the post-GFC regulatory reforms. Instead, today stress can potentially propagate more rapidly and widely – through funding markets, across borders and between non-banks and banks, which remain closely linked via repo, derivatives and prime brokerage.

High public debt and a large NBFI footprint raise the probability of experiencing severe market dysfunction[1]

In per cent

Graph 13



NBFI = non-bank financial institution.

[1] Probability that US Treasury market stress is above its average during the Great Financial Crisis. Estimated following I Aldasoro, P Hördahl, A Schrimpf and S Zhu, "Predicting financial market stress with machine learning", *BIS Working Papers*, no 1250, 2025. The sample period is from July 2011 to January 2024.

Sources: M Drehmann and S Zhu, "NBFIs, high public debt and the risk of market dysfunction", *BIS Bulletin,* forthcoming, 2026; BIS.

Against this backdrop, higher public debt and a larger role of non-bank financial institutions (NBFIs) raise the likelihood of severe market dysfunction. As Graph 13 shows, the estimated probability of experiencing a stress event like the GFC within the next three months is about 10 times higher when the ratio of public debt to GDP is in its highest decile than when it is in its lowest decile. The probability of such an event also rises considerably when the share of NBFIs in government bond holdings is in its top decile.

Moreover, fiscal surprises and market liquidity feed on each other: adverse fiscal news or problems in the financial sector can erode liquidity, amplifying yield moves and shrinking fiscal space faster than long-run fundamentals alone would suggest.[Slide: High public debt and a large NBFI footprint raise the probability of experiencing market stress similar to the GFC]

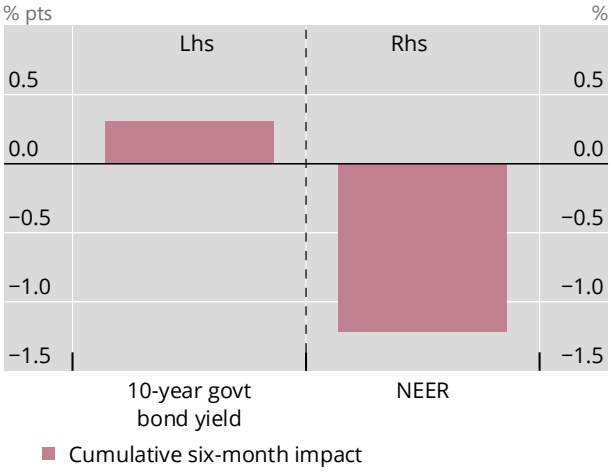
Three challenges for central banks

Higher public debt and the new sovereign-financial stability nexus are likely to complicate the task of central banks in the coming years. Let me focus on three challenges, starting with fiscal risk repricing.

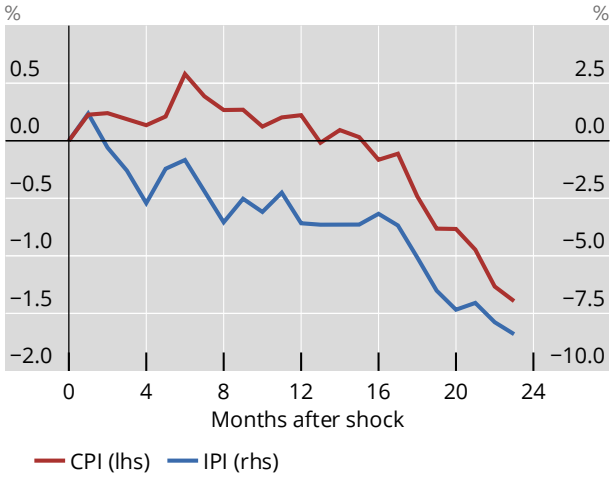
Higher fiscal risk has macroeconomic consequences[1]

Graph 14

A. Fiscal risk repricing tightens financial conditions…



B. …weighing on activity and pushing up prices initially



CPI = consumer price index; IPI = industrial production index; NEER = nominal effective exchange rate.

[1] Impact of a 1 percentage point increase in five-year government bond yields due to a fiscal risk shock. Estimated using a monthly sample from 2010 to 2025. The sample covers 25 AEs and 15 EMEs, subject to data availability.

Sources: D Gorea, D X Ng and F Zampolli, "Financial and real effects of fiscal risk", *BIS Working Papers*, forthcoming, 2026; BIS.

Fiscal risk repricing occurs when investors become more concerned about the sustainability of public finances. Therefore, they demand higher returns to hold government debt. When public debt is high or rising on an unsustainable trajectory, this repricing can happen more frequently and more abruptly. And because NBFIs now play a larger role, the initial rise in yields can be amplified by deleveraging.

The effects of this repricing on economic activity are clearly negative, but the effects on inflation are less clear-cut. Higher sovereign yields raise private sector borrowing costs. They can also force governments to undertake drastic fiscal consolidation measures. Both effects weaken demand and, over time, tend to be disinflationary.

But fiscal risk repricing could also be accompanied by an initial increase in inflation if it triggers capital outflows and currency depreciation or if fiscal concerns lead price and wage setters to revise up their inflation expectations.

This is what the evidence in the report suggests for a sample of advanced and emerging market economies. Graph 14.A shows the immediate financial market reaction: when fiscal risk is repriced, government bond yields increase and currencies depreciate, tightening financial conditions. Graph 14.B shows the macroeconomic effects: prices initially rise, as inflation expectations and import prices pick up, even though economic activity weakens. Over time, however, weaker activity dominates and inflation falls.

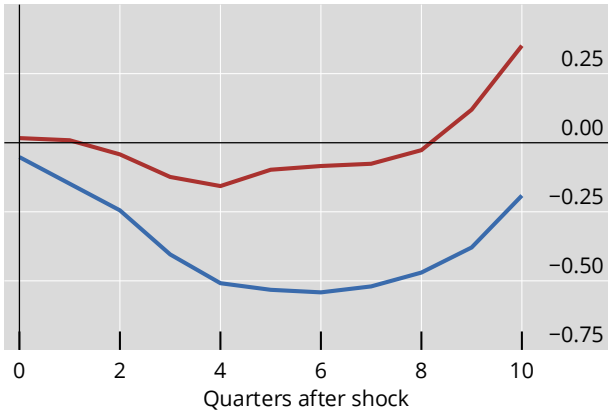
These dynamics are familiar in many emerging markets, but they could become increasingly relevant for advanced economies too.

High public debt may dampen disinflation from monetary tightening

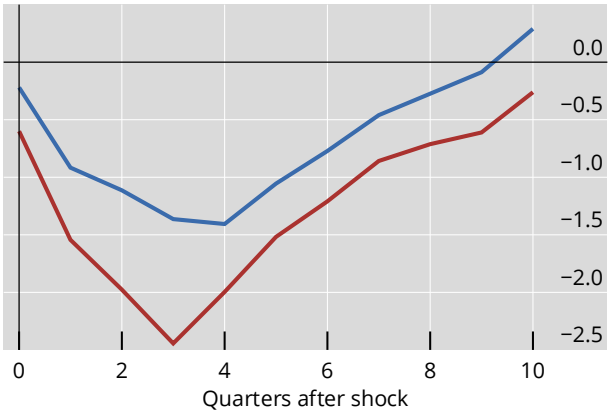
In per cent

Graph 15

A. Prices: smaller declines at high debt



B. Output: larger declines at high debt (not statistically significant)



Debt-to-GDP ratio: 120% 60%

[1] Impact of monetary policy shocks, based on local projection regressions for 11 euro area economies. The sample covers AT, BE, DE, ES, FI, FR, GR, IE, IT, NL and PT from 2001 to 2020. Public debt is divided into four buckets, reflecting ultra short debt, short debt, medium maturity debt and long debt. Monetary policy shocks are from M Jarociński and P Karadi, "Deconstructing monetary policy surprises – the role of information shocks", *American Economic Journal: Macroeconomics*, vol 12, no 2, 2020, and interacted with the public debt buckets. For estimations with high and low debt, the maturity profile is held fixed at the sample average of each maturity bucket. The size of the monetary policy shock is one standard deviation.

Sources: C Johns, A Mehrotra and F Zampolli, "Public debt and monetary policy transmission: evidence from advanced and emerging Europe", *BIS Working Papers,* forthcoming,2026; BIS.

The second challenge is calibrating monetary policy. This can become more difficult because several mechanisms pull in different directions.

On the one hand, monetary tightening can have stronger effects on activity. Higher rates raise debt service costs – the larger the debt stock is, the more this is the case. If this worsens the fiscal outlook, spreads and term premia increase, tightening financial conditions more than intended and weighing more heavily on output. Higher rates also push down bond prices, inflicting losses on bondholders. Weaker balance sheets and tighter risk limits can then restrain credit and amplify the tightening. NBFI deleveraging can magnify these effects.

On the other hand, the effects on inflation could be weaker. By raising payments to bondholders, higher rates may support spending and slow the decline in inflation that policy would otherwise deliver. A worse fiscal outlook may also make inflation expectations less responsive to monetary tightening.

Graph 15 illustrates these effects using euro area data, which makes it possible to compare the effects of monetary policy across member states with different levels of public debt. The cleanest result is on prices: following a monetary tightening, prices fell less in high-debt economies than in low-debt ones. Output also appears to fall more, especially at first. Yet the evidence for this difference is less clear beyond the short run. Overall, monetary policy can still control inflation when public debt is high, but its effectiveness may be diminished.

The third challenge is market dysfunction. As discussed, this increases with higher levels of government debt and greater NBFI activity. Such dysfunction can erupt suddenly, with sharp yield swings and vanishing liquidity, and it can be amplified by an unwinding of leveraged positions. In these moments, central banks often have little choice but to intervene.

But interventions carry costs. Repeated or large-scale operations can encourage leverage and risk-taking, foster expectations of future support, blur the policy stance in an inflationary environment and weaken fiscal discipline. They can also raise concerns about central bank independence and are hard to calibrate when price moves reflect either healthy market discipline or unhealthy market dysfunction.

Policy implications

What does this mean for policy? Central banks have demonstrated remarkable resolve in recent years, taking decisive measures to fulfil their mandates in the face of many tests. From navigating the post-pandemic inflationary surges to addressing financial market disruptions or geopolitical risks, they have acted swiftly and effectively.

Looking ahead, many challenges remain.

In the near term, policymakers must navigate the crosscurrents of AI progress and the perils of higher inflation potentially persisting. Monetary policy should stay alert to signs of second-round effects and ensure that inflation expectations remain anchored. At the same time, central banks must grapple with the multi-faceted impacts of AI, including on the near-term cyclical outlook, on financial stability and on short-term and long-term growth, requiring monetary policy strategies to be robust across a wide range of scenarios.

Challenges could arise from increasingly interwoven fiscal and monetary policies, as a less favourable supply environment interacts with high public debt. Persistent adverse supply shocks not only complicate the task for central banks but also intensify pressures on public spending. In this environment, it remains imperative that monetary policy continues to prioritise medium-term price stability, even where policy actions may have near-term adverse fiscal implications. An unwavering commitment to price stability would help anchor long-term rates and durably expand fiscal space.

Central bank independence is vital to navigate these challenges. Independence allows central banks to take decisions based on economic considerations in the long-term public interest, free from short-term political interference. But lasting success in maintaining price and financial stability ultimately depends on sound fiscal and regulatory foundations and the appropriate design of backstop facilities.

On the fiscal side, putting public finances on a sustainable path is paramount. This requires restoring symmetry to fiscal policy, with consolidation during good times anchored by credible medium-term fiscal frameworks. The pace and composition of consolidation also matters. Indiscriminate cuts to public investment risk undermining growth and fiscal sustainability. Instead,

spending should prioritise areas that boost growth, expand the tax base and attract private capital. Structural reforms should lift productivity and ensure AI's gains are durable and widely shared.

For regulation, we must pursue "congruent regulation", applying similar stringency to similar risks, regardless of legal form or business model. While challenging due to the diversity of NBFIs and fragmented frameworks, advancing this goal is essential. It is especially important to tighten safeguards against excessive leverage, liquidity mismatches and fragile funding structures that amplify stress in core markets. The regulatory framework must also keep pace with rapid AI advancements, including cyber risks. Closing these gaps would make the financial system more resilient and less prone to amplify stress in bad times.

Central bank liquidity backstops remain a powerful tool to address market dysfunction but must be carefully calibrated. They should be temporary, targeted and easily reversible, as demonstrated by the Bank of England's response to the 2022 liquidity-driven investment crisis. Expanding counterparty access to NBFIs could enhance the ability to address dysfunction through lending rather than asset purchases but requires robust regulation to mitigate risks.

These measures – fiscal consolidation, robust regulation and carefully designed backstops – are mutually reinforcing. Together, they create an environment where central banks can focus on their core mandates, ensuring price stability and financial resilience.

We must act now to strengthen these foundations. Delay will only make the necessary adjustments more costly and worsen future trade-offs. By addressing these challenges today, we can help to safeguard the stability of the global economy in the years to come.