



# Strengthening foundations for the future

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# Strengthening foundations for the future

## Chapter I

Progress and peril

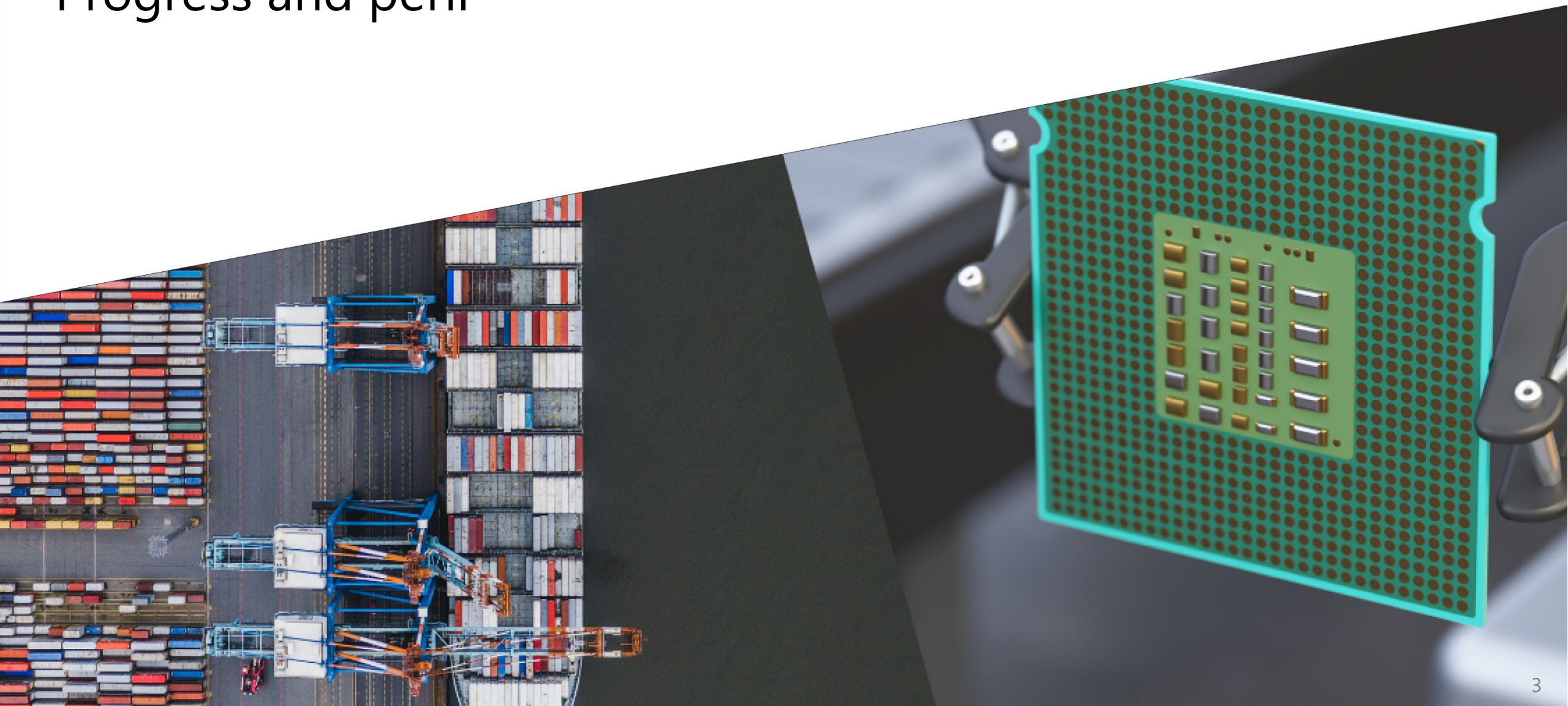
## Chapter II

High public debt and shifting financial markets

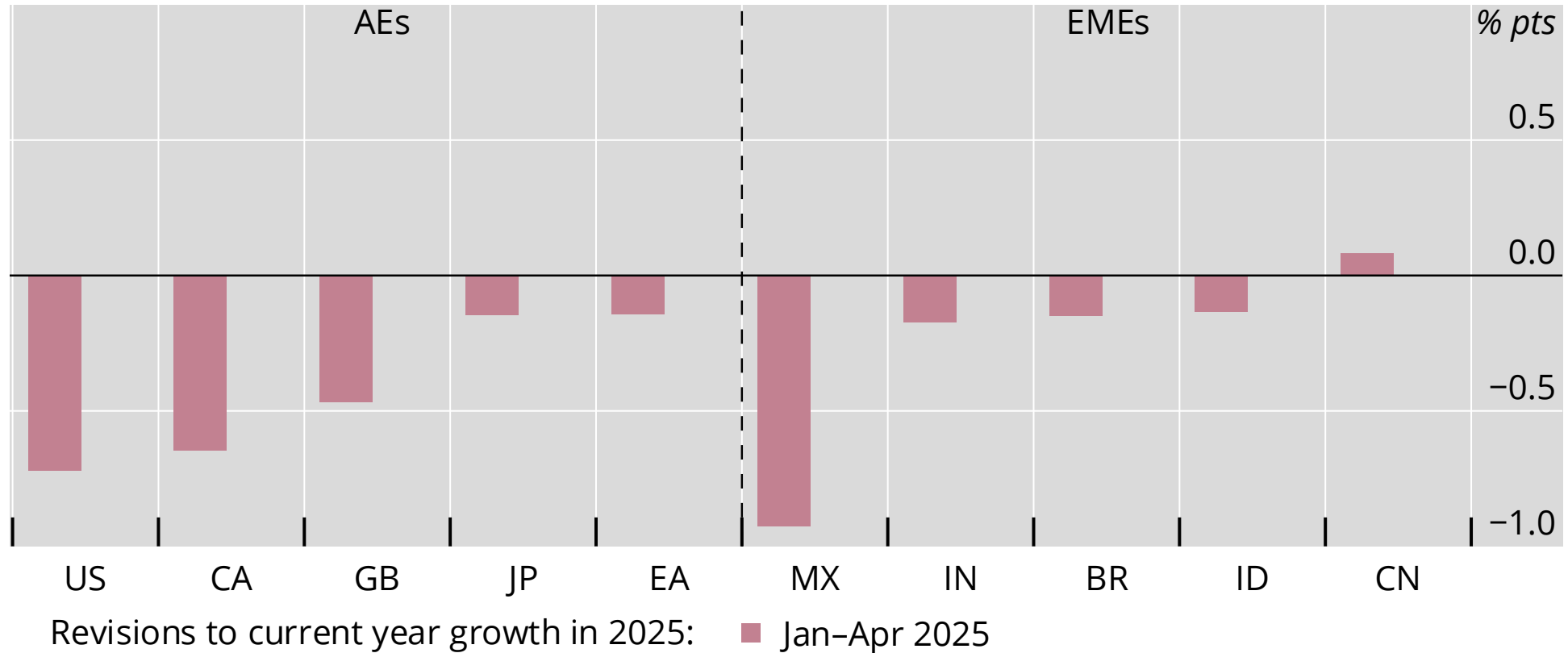


# Chapter I

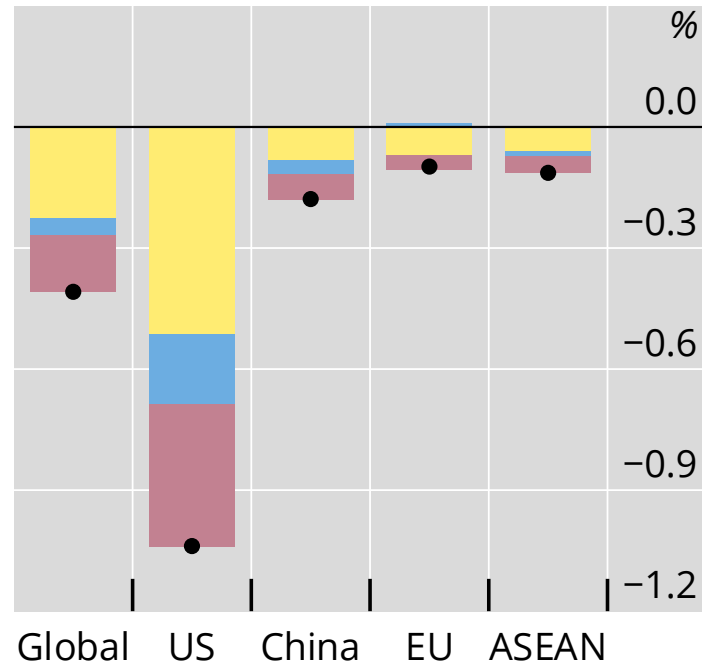
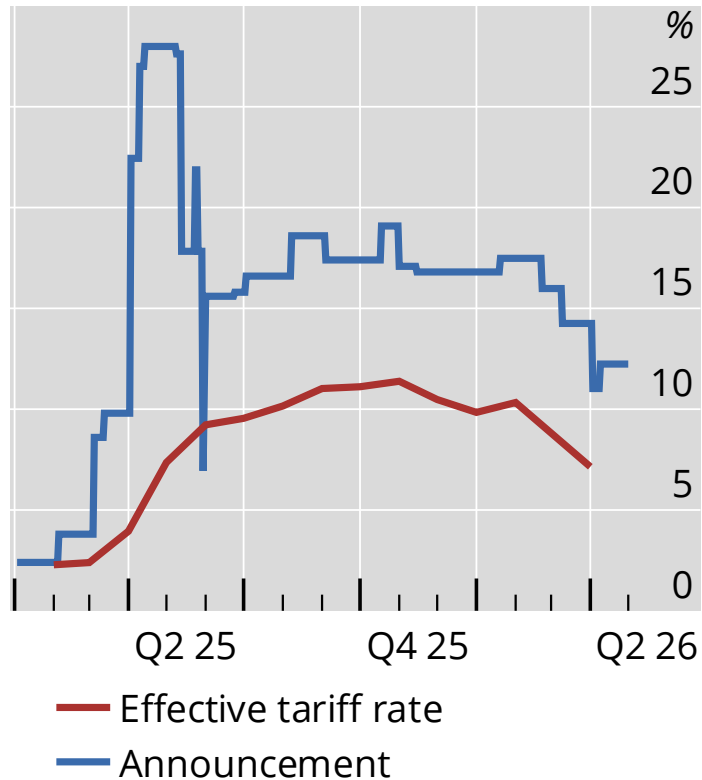
## Progress and peril



## Tariffs initially prompted growth downgrades

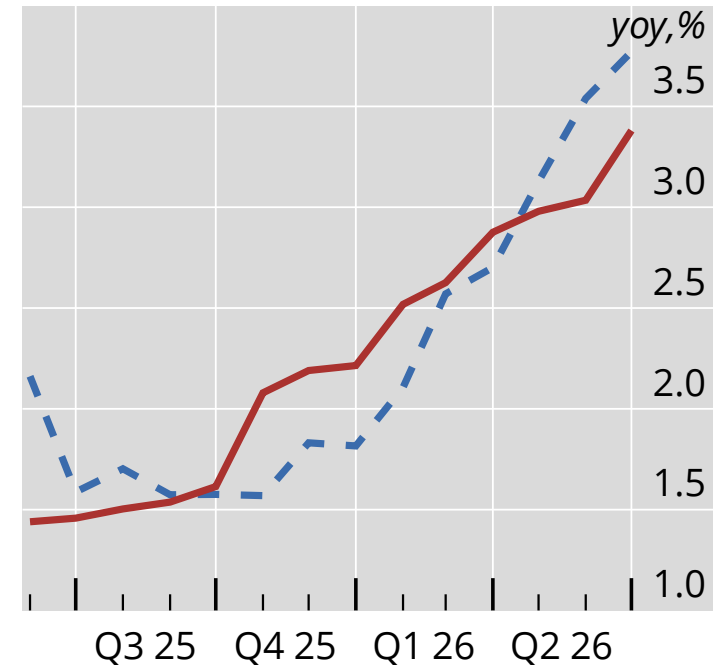


## Lower tariffs, trade diversion and AI-related investment provided lifts



Tariffs' impact on output:

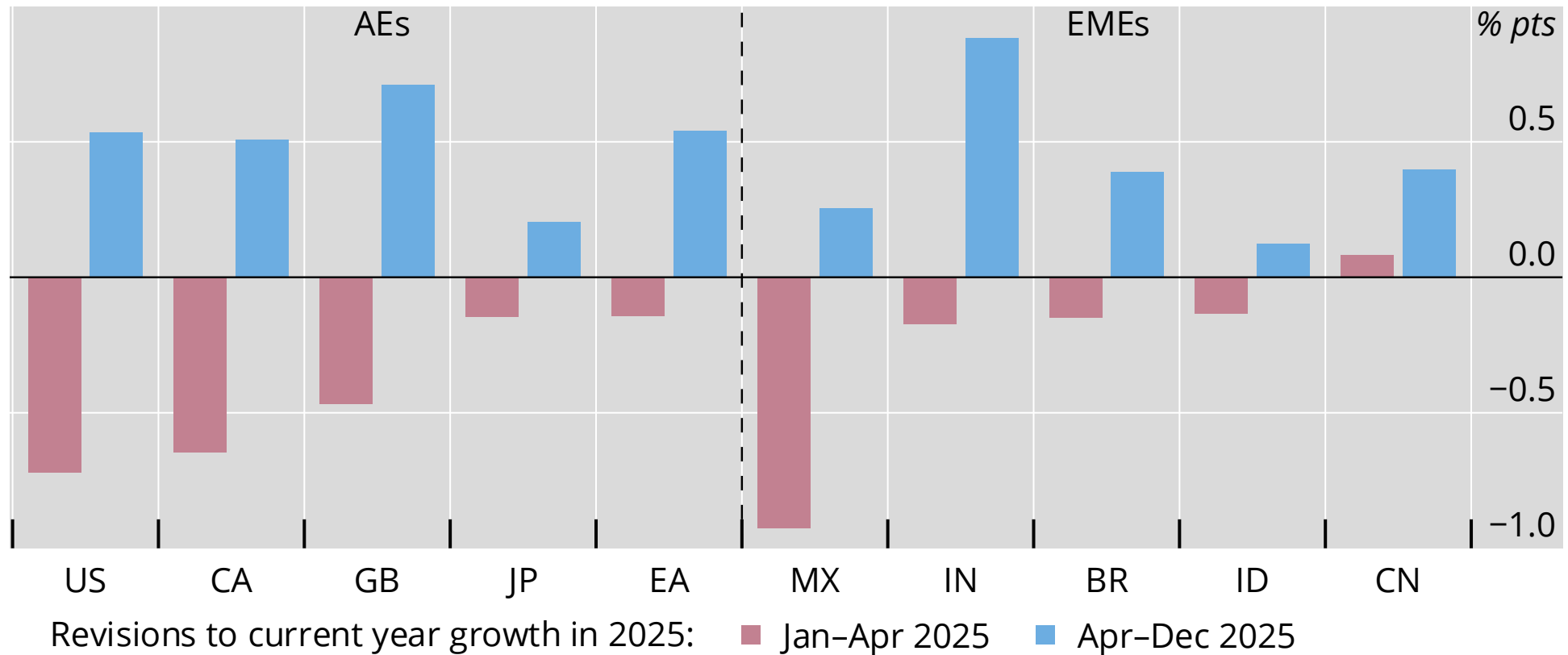
- Estimate as of Aug 2025
- Smaller tariff shock revision
- Trade diversion revision
- Current estimate (Apr 2026)



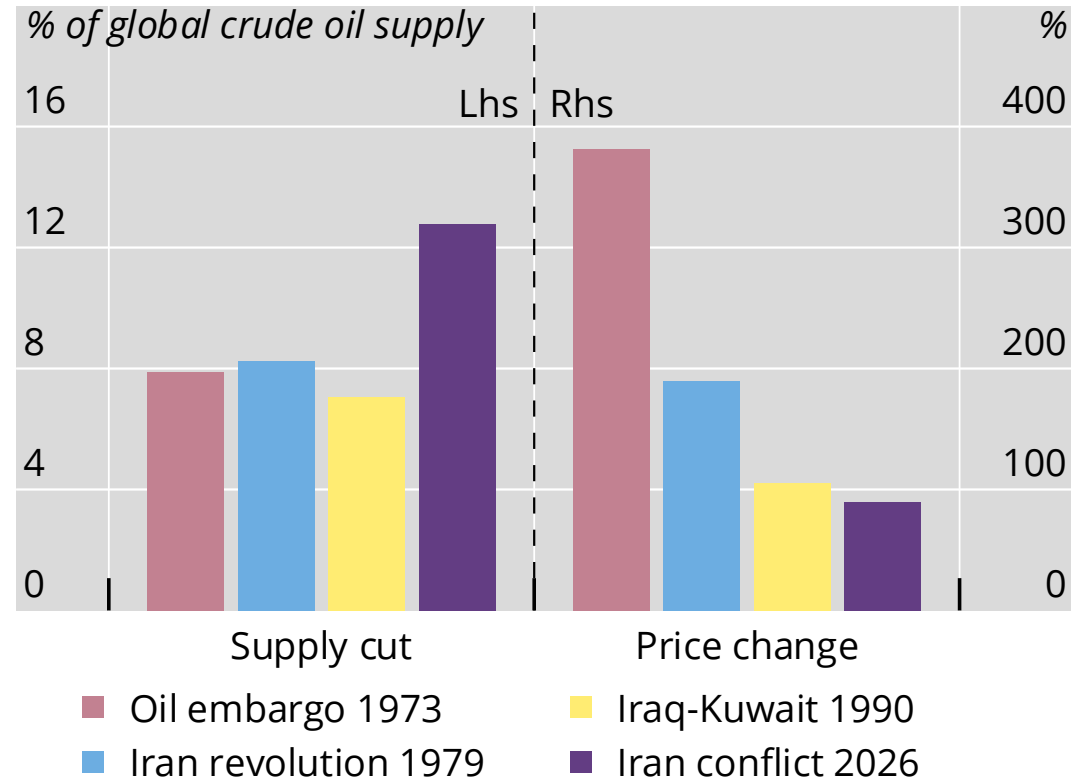
One-year-ahead forecasted growth:

- US investment
- - Asian exports

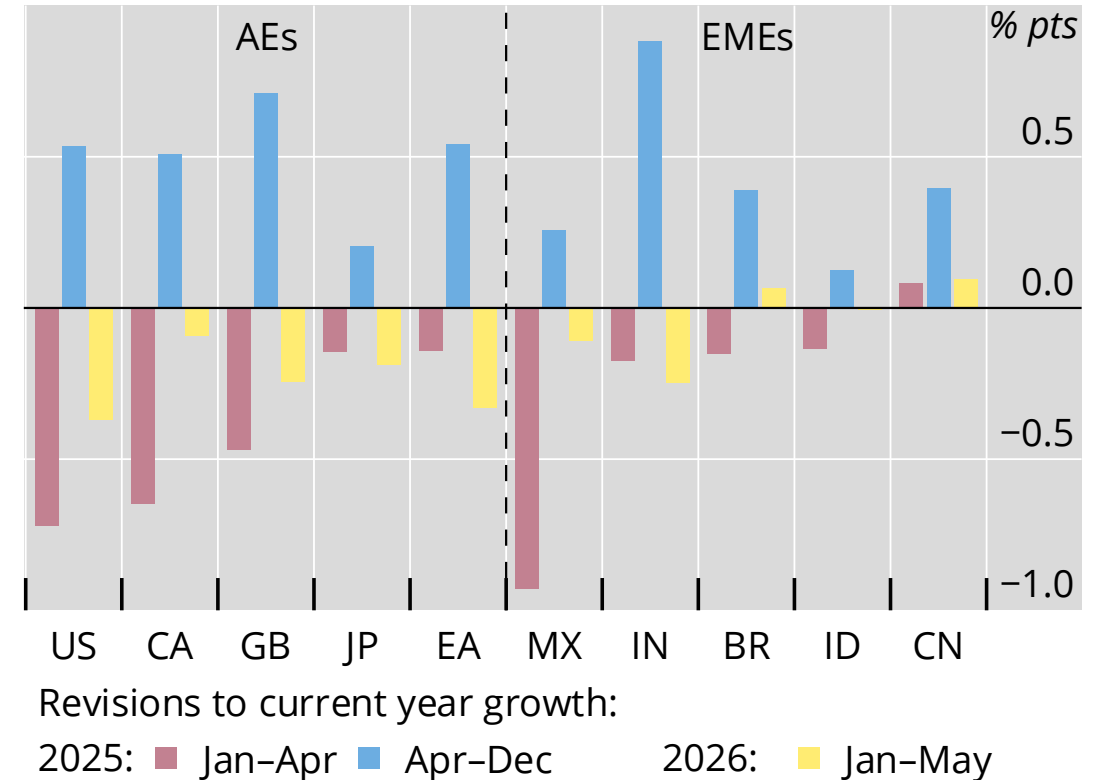
## Leading to subsequent growth upgrades



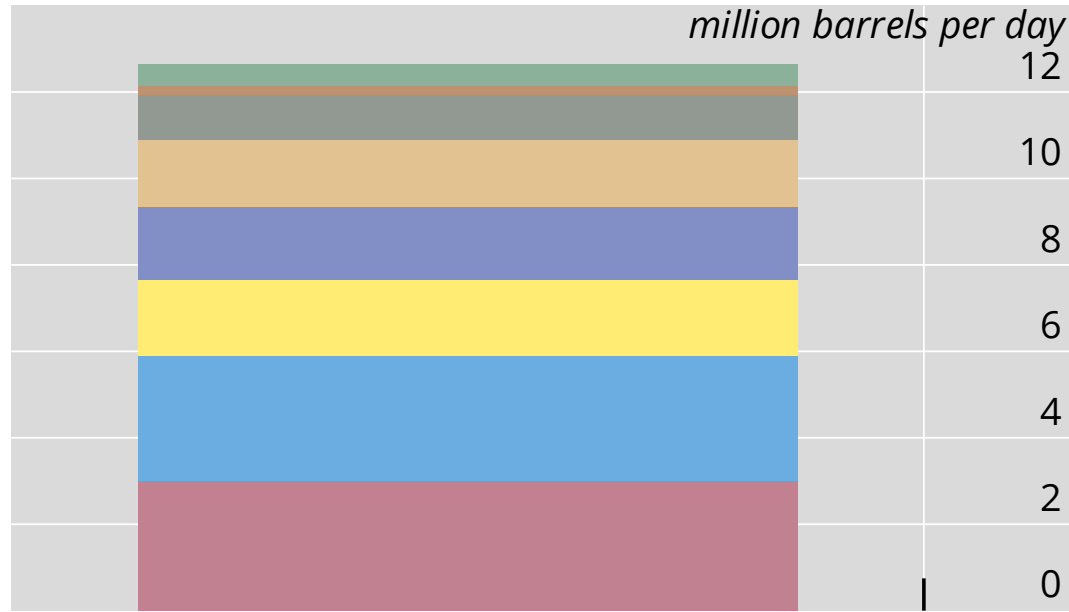
## Middle East conflict led to historic energy supply cut...



## ...prompting downgrades of growth projections



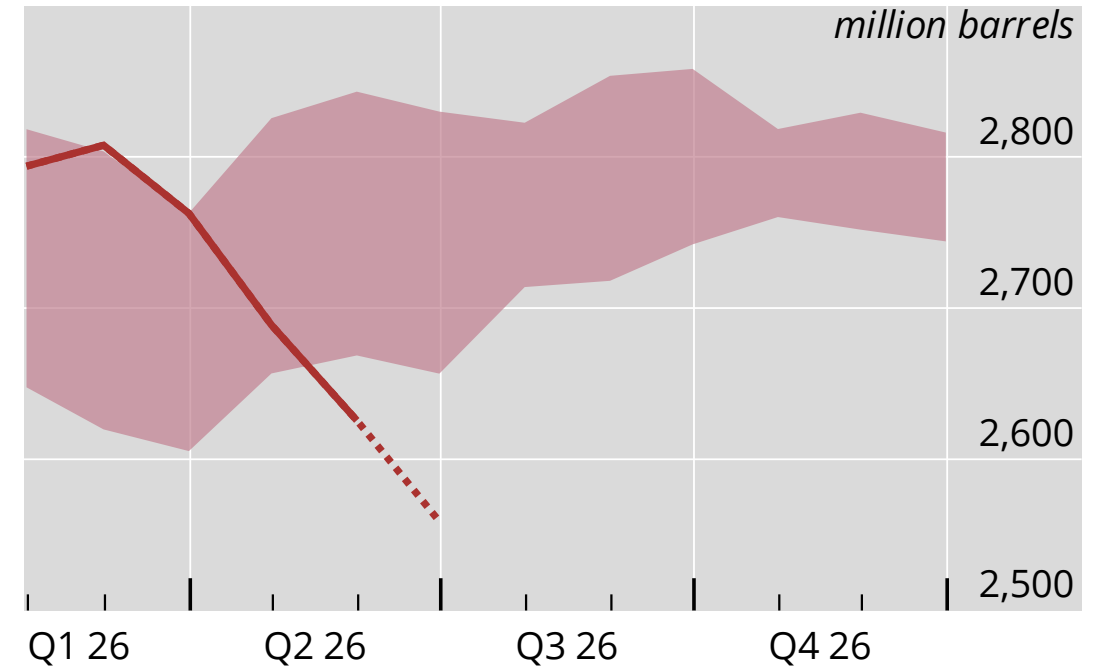
## Prolonged Hormuz closure raises challenges of resuming production



Oil production cuts after Hormuz closure



## Rebuilding depleted reserves could keep market conditions tight



OECD commercial oil inventories:

2026:

2022-25:

— Actual

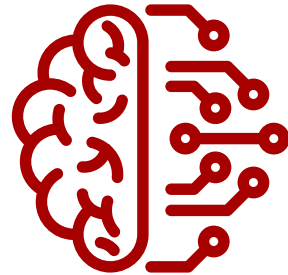
■ Range

⋯ Estimate

## Four pressure points



Inflation



AI

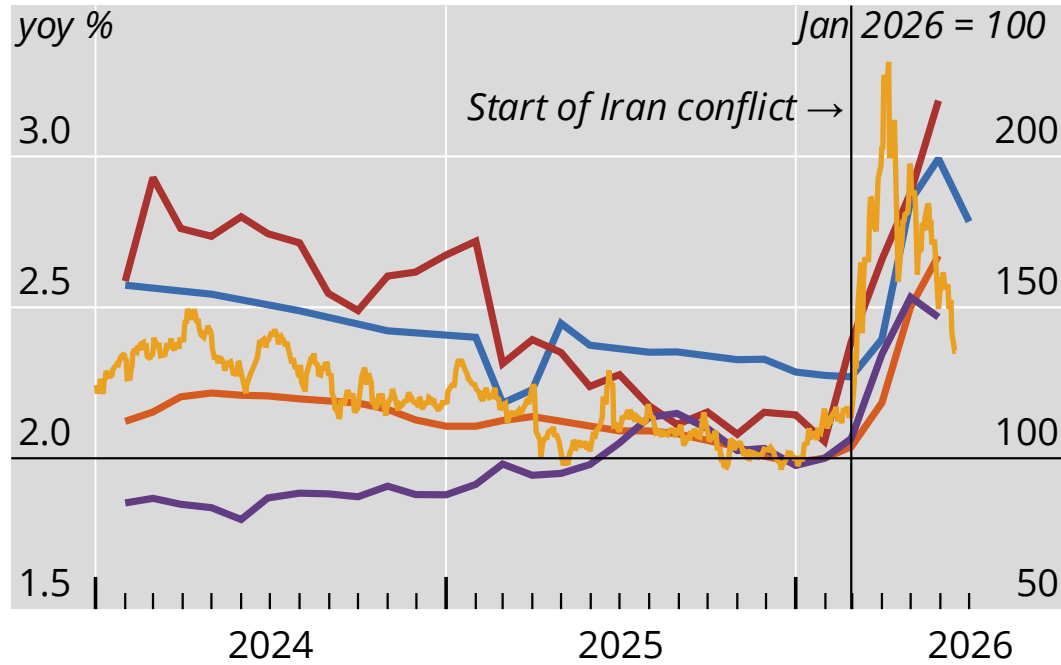


Financial  
vulnerabilities



Public  
finance

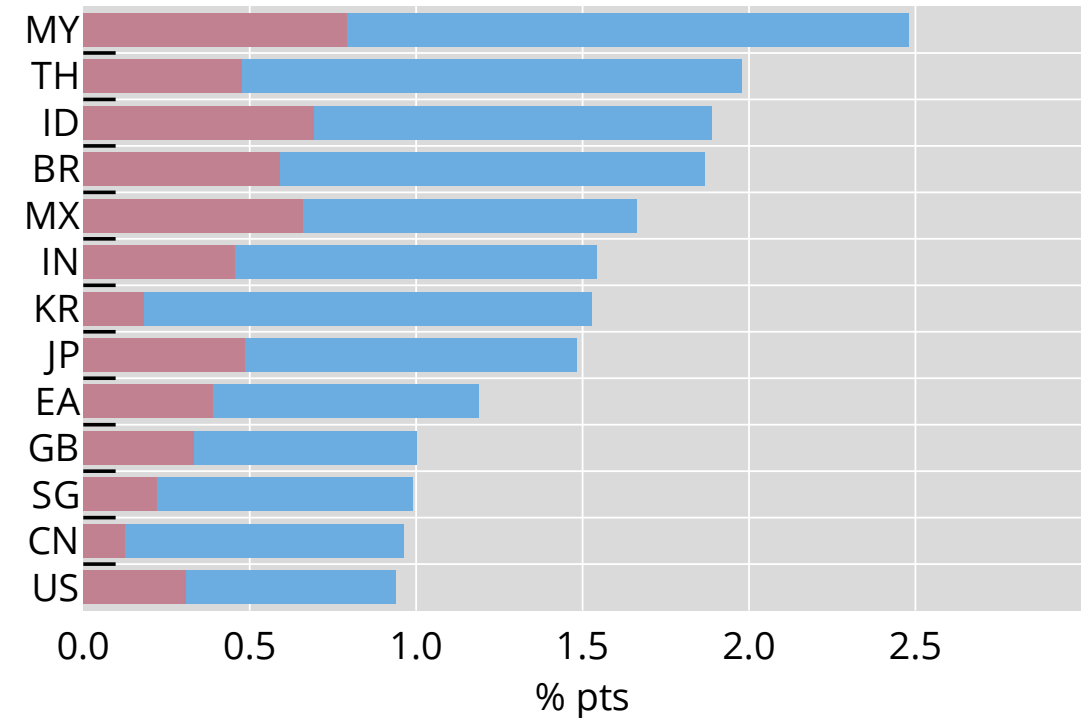
## Signs of rising inflation



Lhs: — Global inflation  
 — Global inflation forecast for 2026

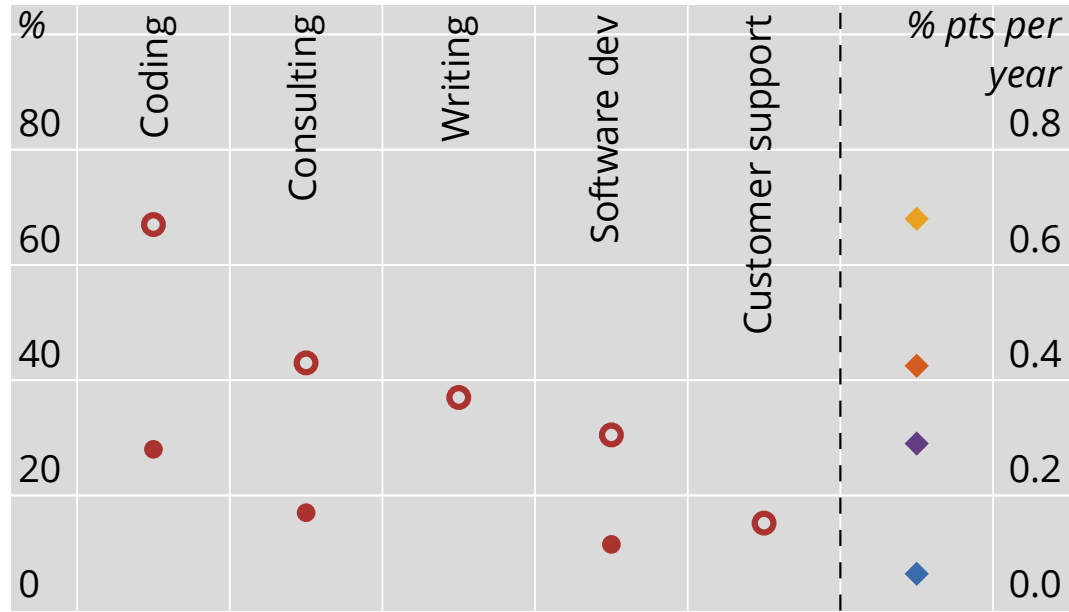
Rhs: — Dated Brent — Fertilisers — Plastics

## Supply chain linkages could amplify higher input prices



Inflation impact:  
 ■ Direct ■ Indirect

## AI holds promise of productivity gains...

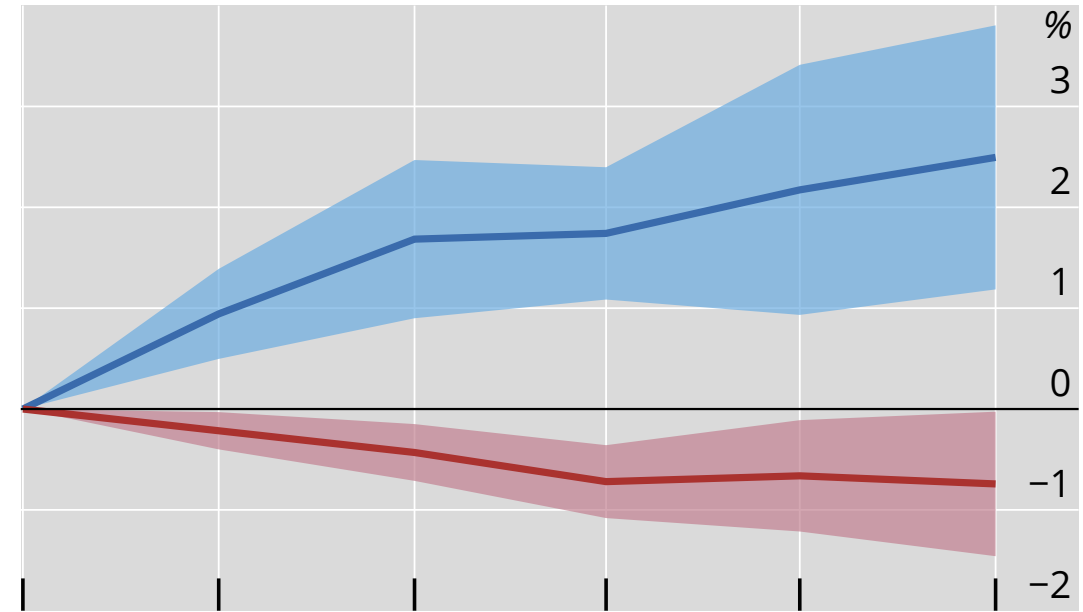


Productivity gains at task level

Lhs: ○ Junior/low-skill    ● Senior/high-skill

Rhs: ◆ Acemoglu  
◆ Aghion & Bunel  
◆ Bergeaud  
◆ Filippucci et al

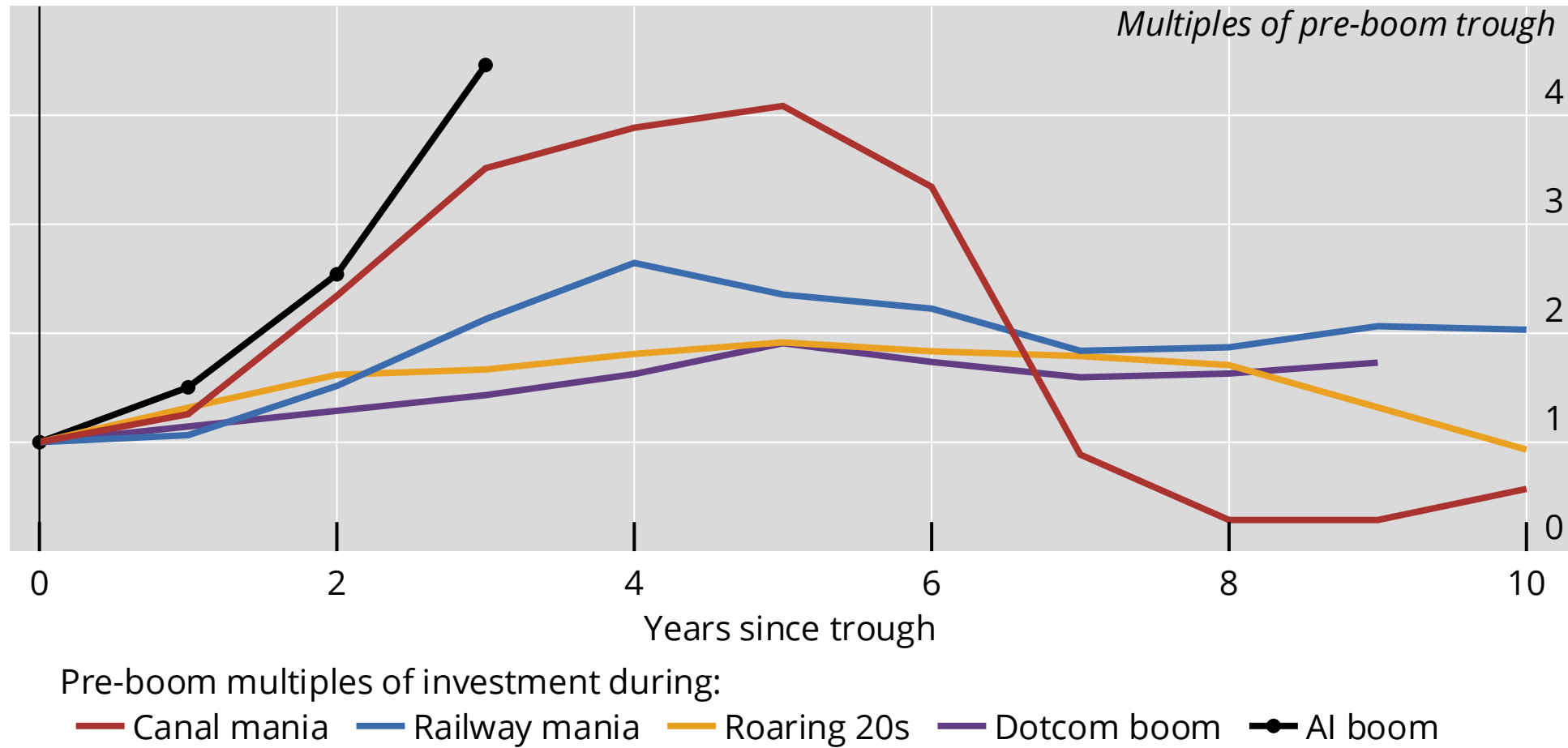
## ...but raises questions about labour market adjustments



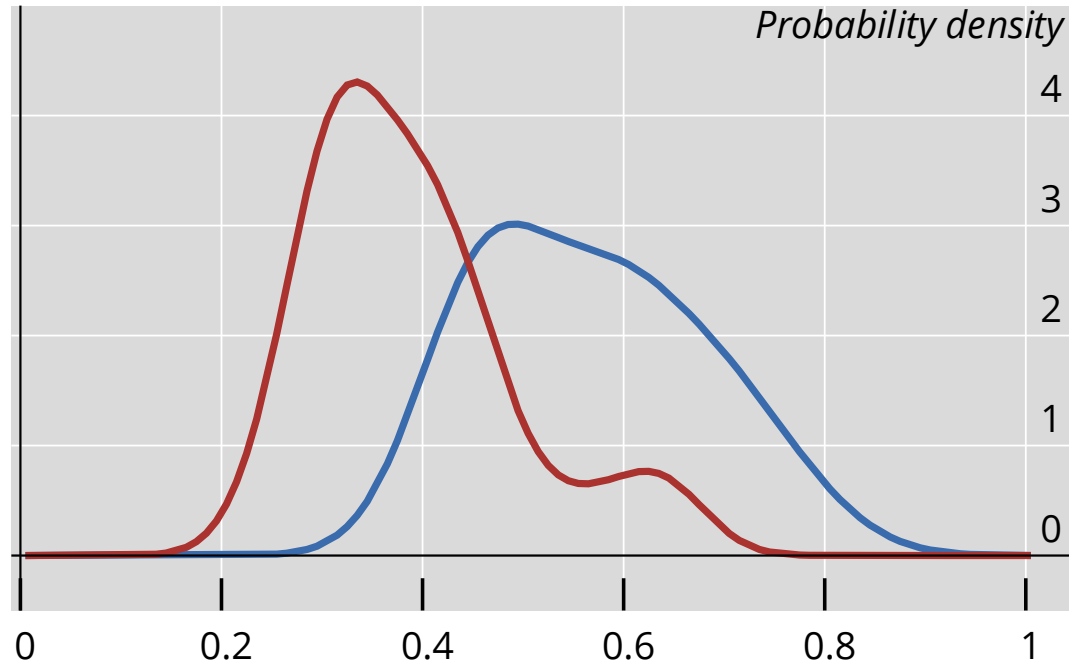
Employment: — Cumulative gap between high- and low-AI-exposed sectors

Productivity: — 90% confidence interval

## Parallels with historical episodes of tech-led investment booms



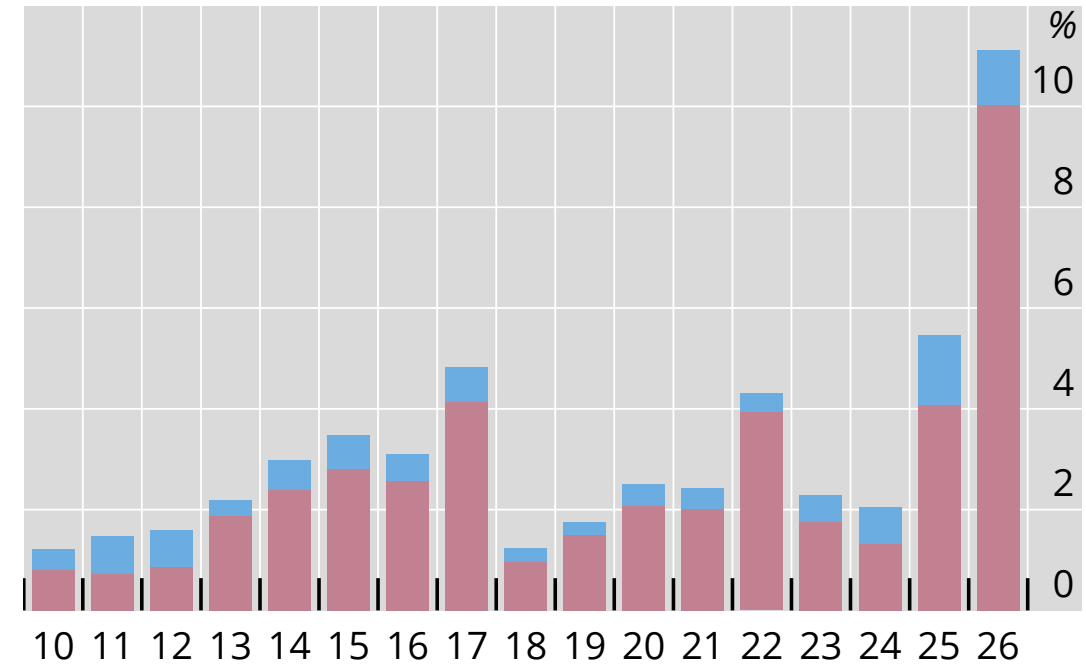
## Risk compensation has fallen markedly in US stock market



Probability density function of the Sharpe ratio of top 30 S&P 500 stocks:

— Post-pandemic — Pre-pandemic

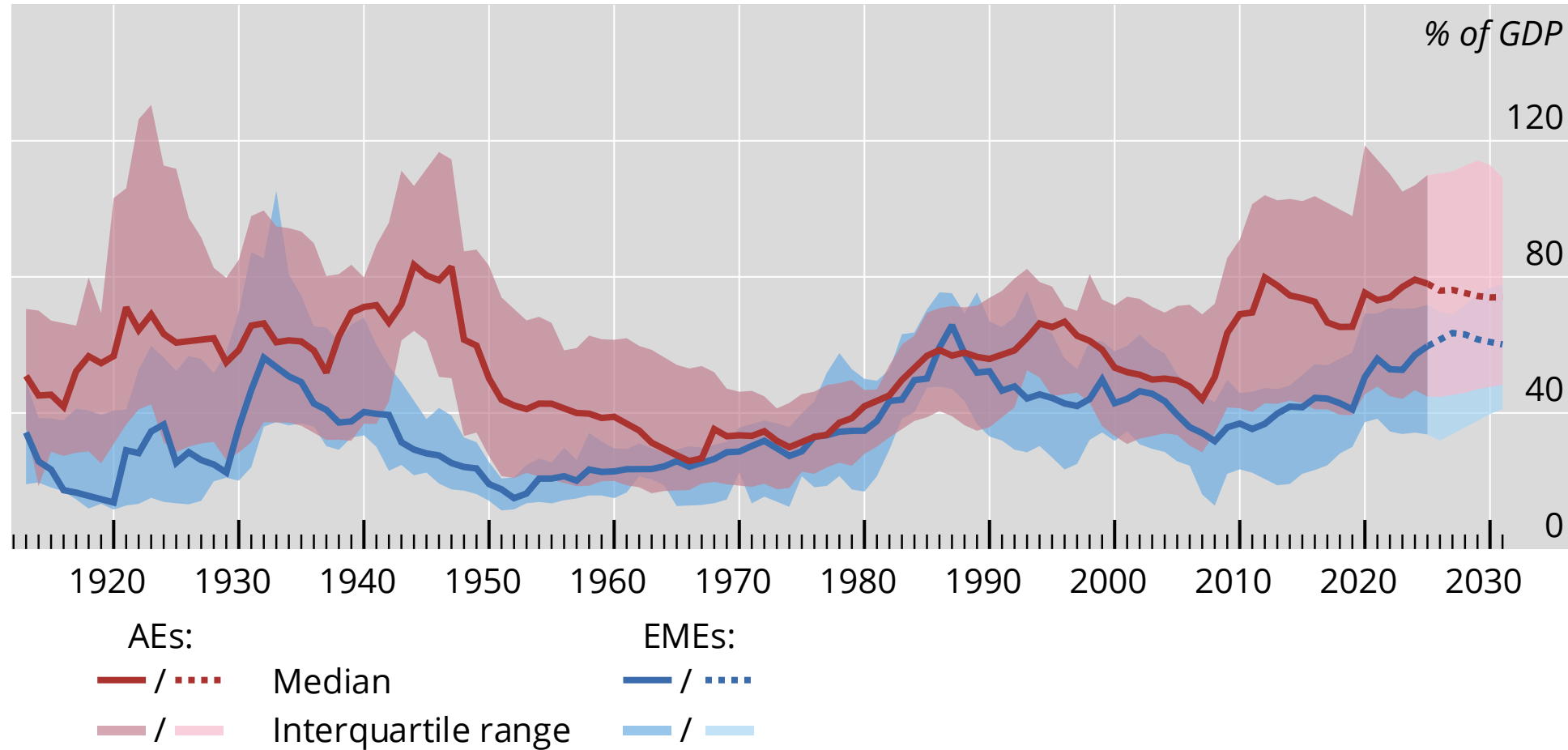
## AI firms' investments are increasingly financed by debt



Share of gross non-financial corporate debt issuance:

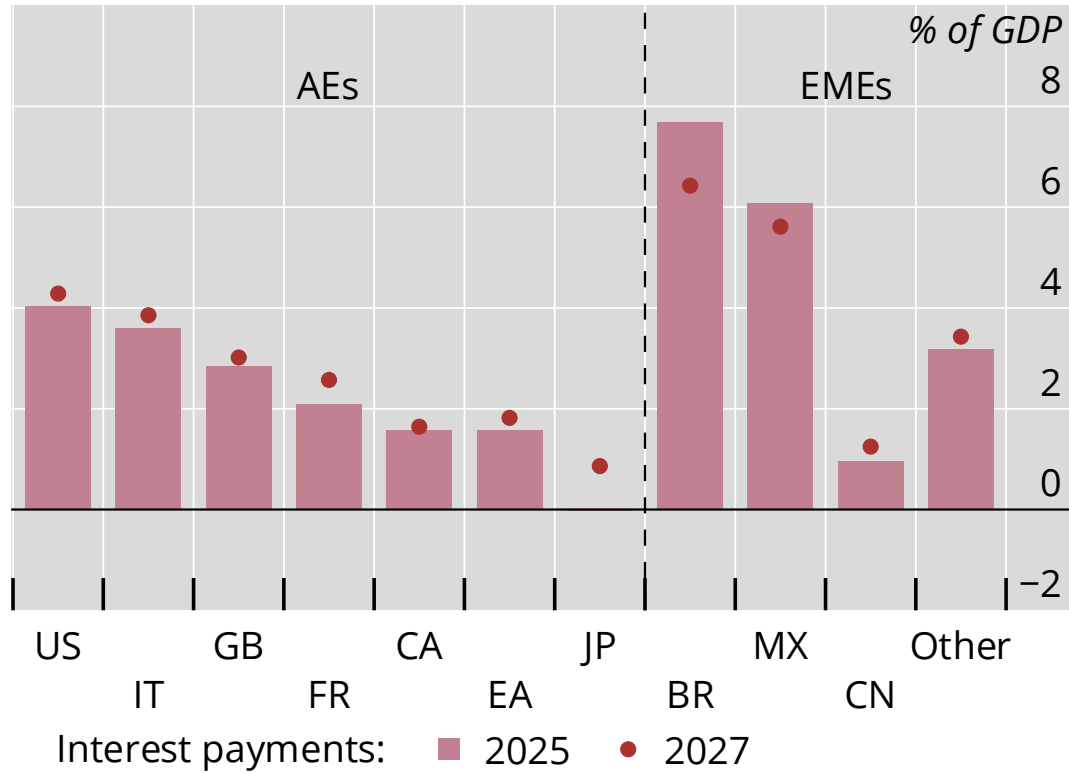
■ Hyperscalers  
■ Infrastructure providers

## Public debt is now near post-World War II highs

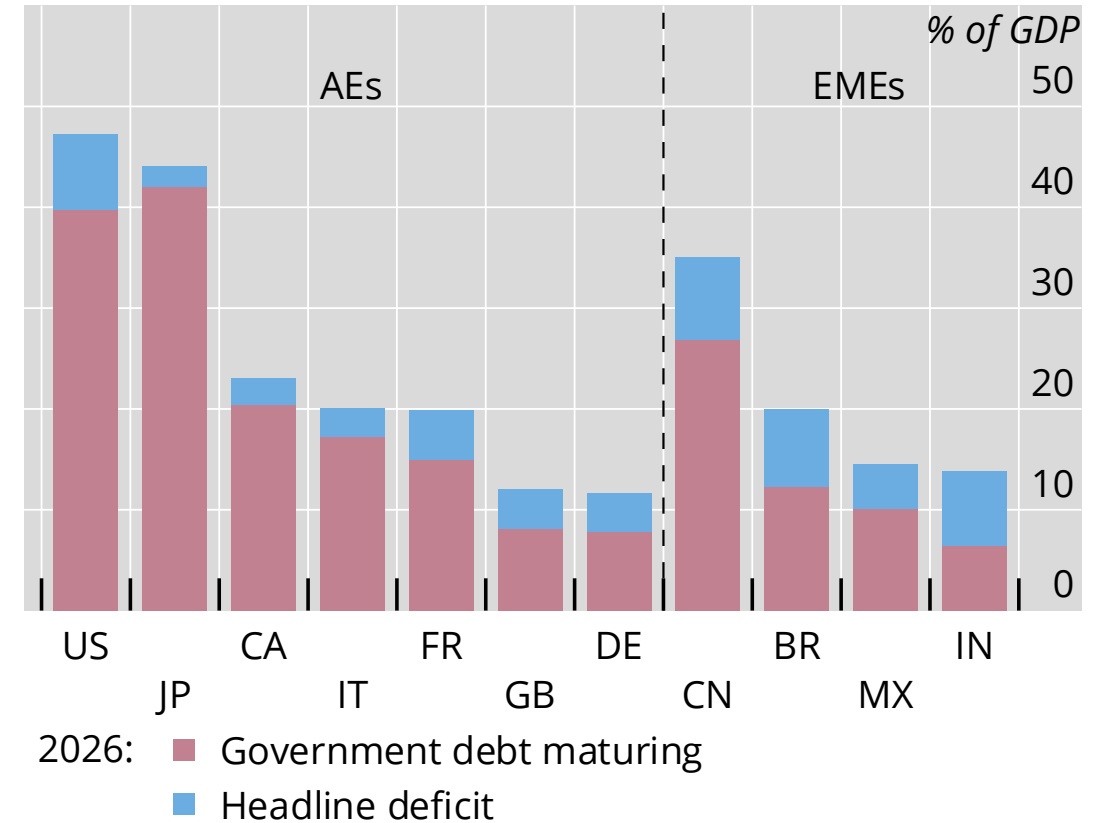


The dotted lines and lighter shaded areas indicate forecasts.

## Interest payments are constraining fiscal space...



## ...as governments face large financing needs

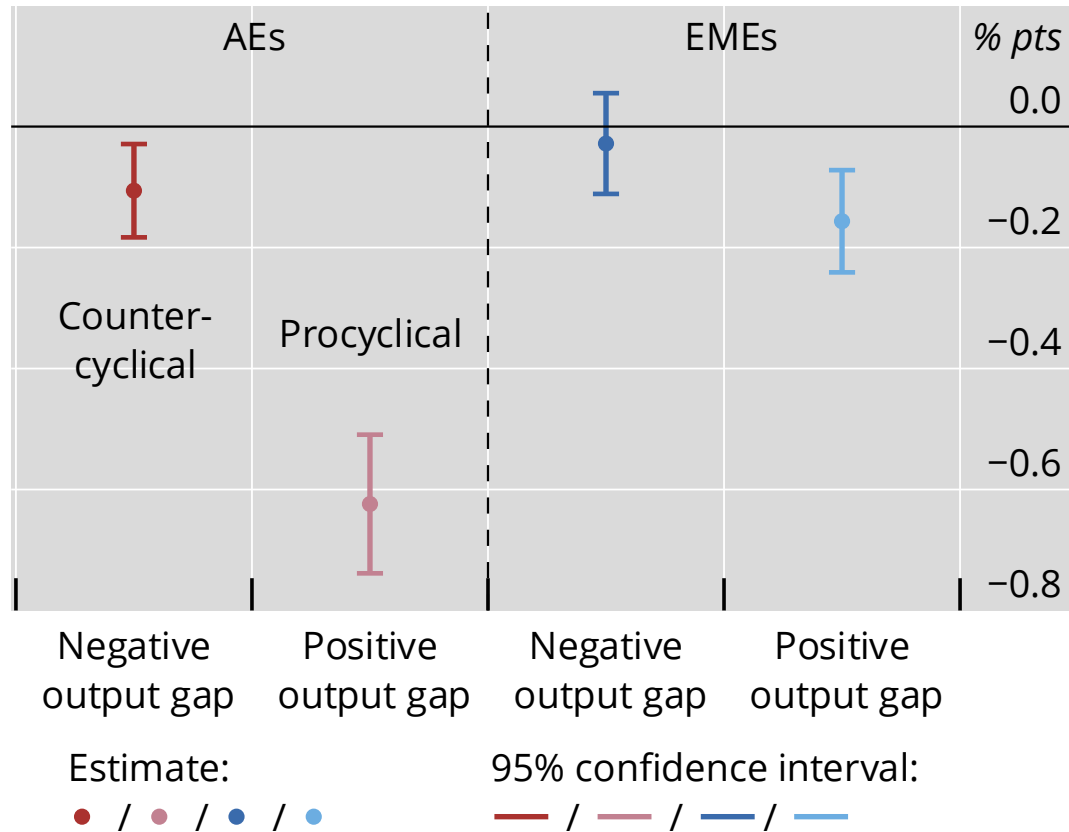


## Chapter II

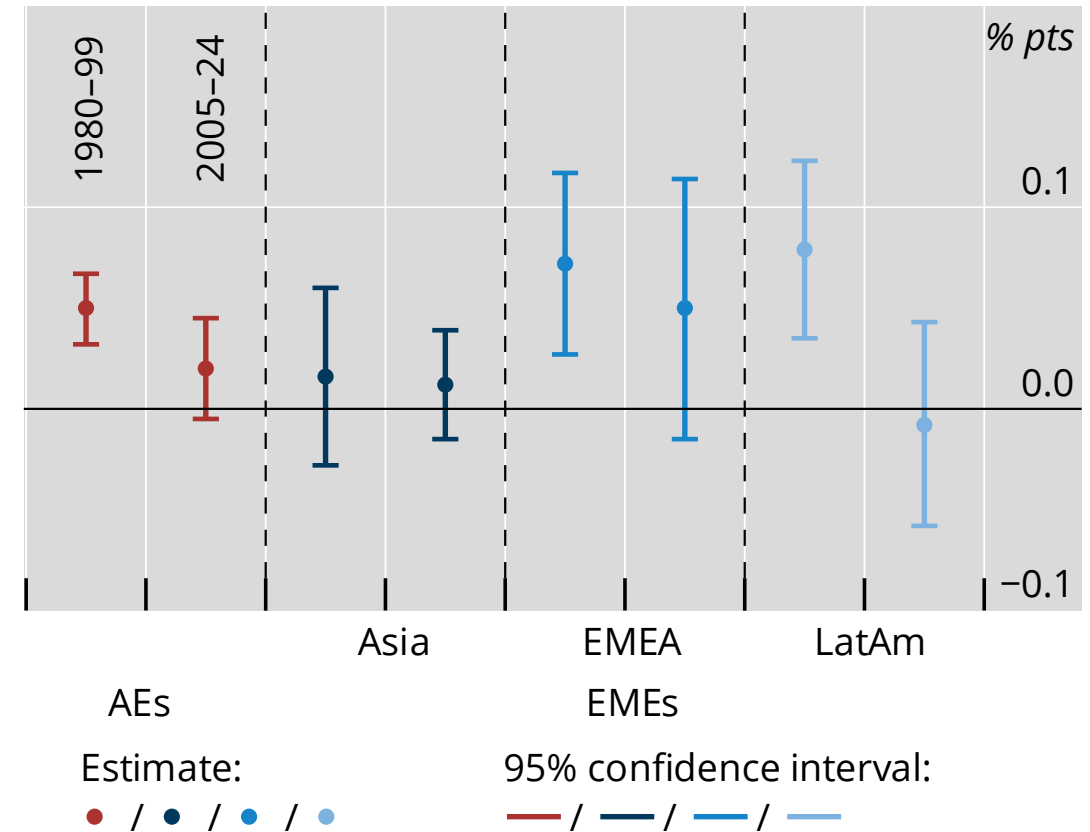
# High public debt and shifting financial markets



## Discretionary fiscal policy is asymmetric over the business cycle<sup>1</sup>

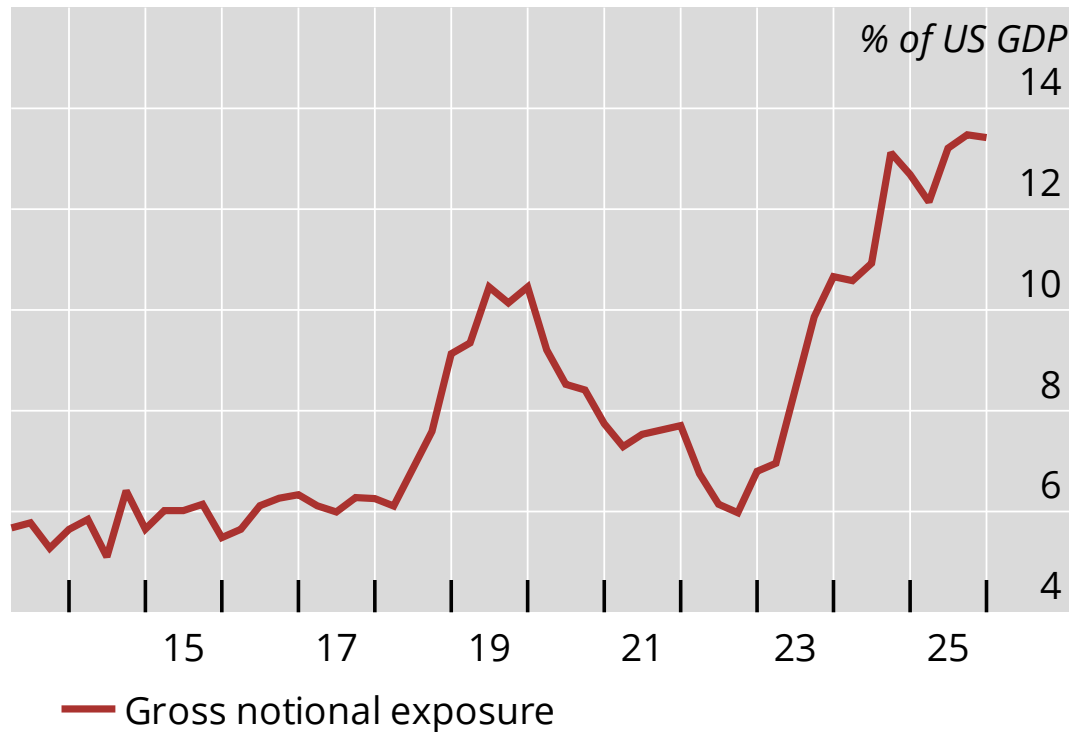


## Primary balance responds less to rising public debt

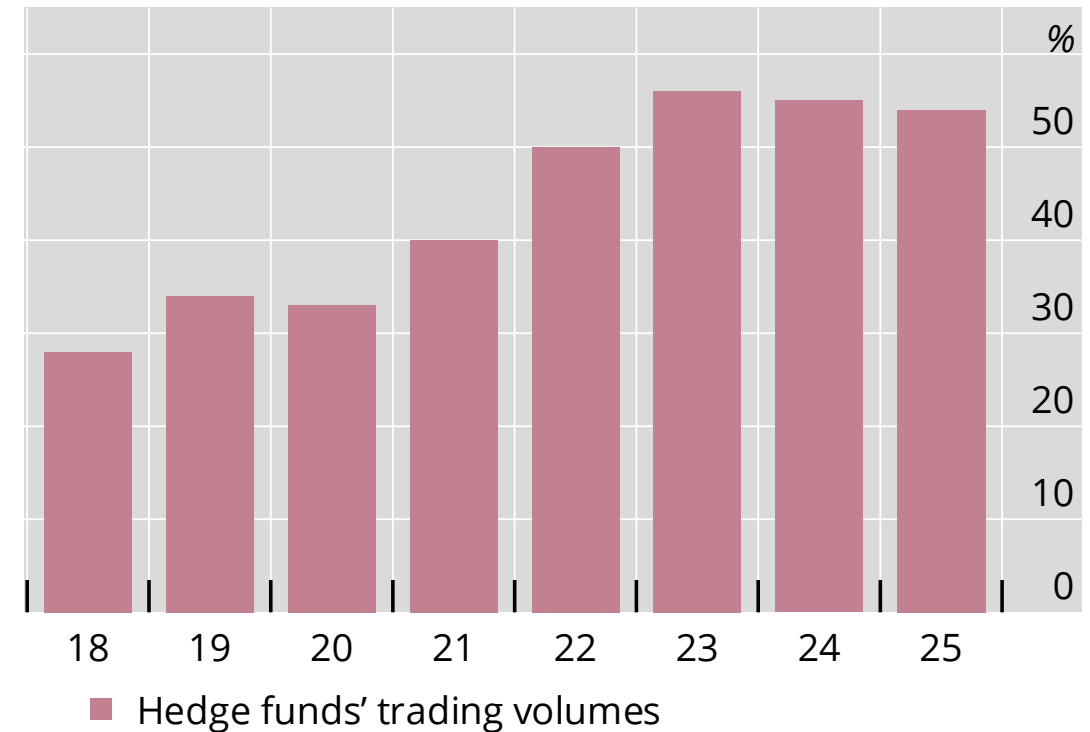


<sup>1</sup> Sample period: 1980–2024, subject to data availability.

## Hedge funds' US sovereign debt exposure has grown...

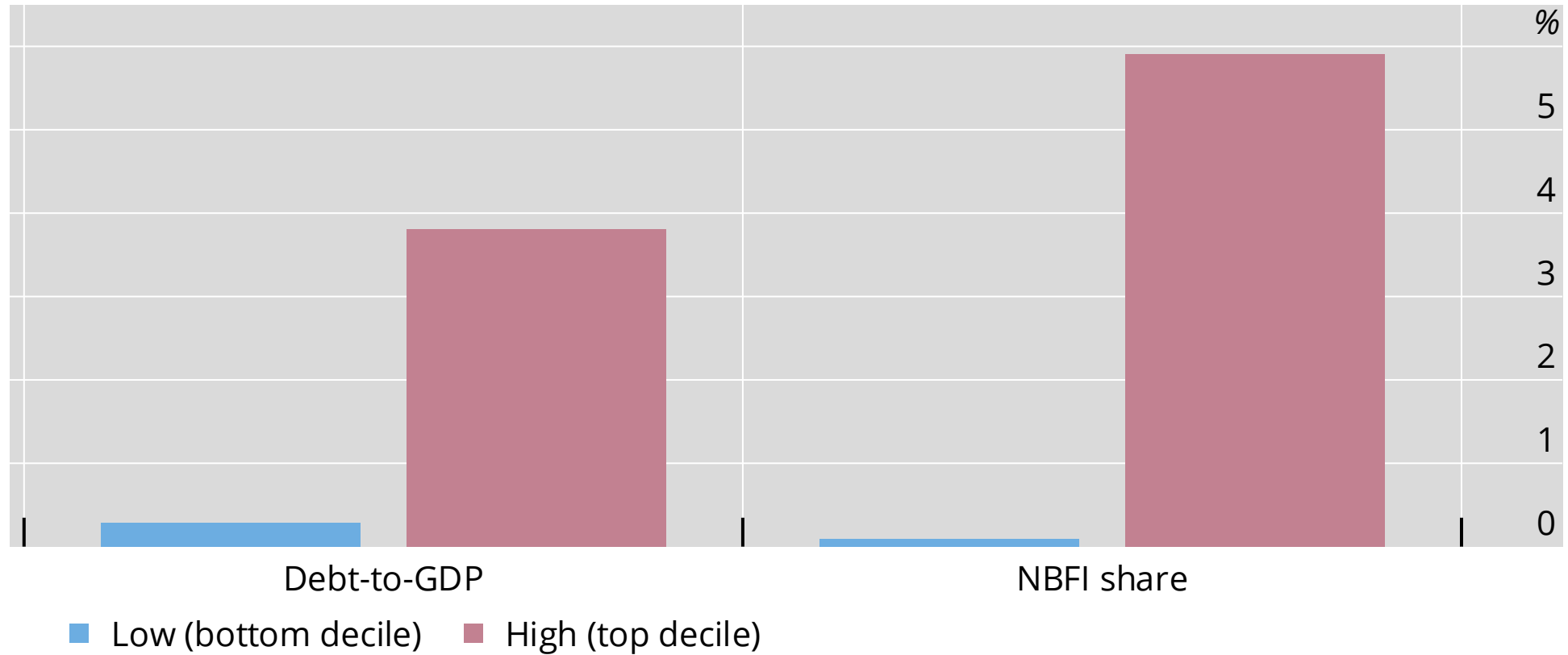


## ...and their footprint in European markets has also expanded<sup>1</sup>



<sup>1</sup> Share of electronic market trading volumes in euro area government bonds.

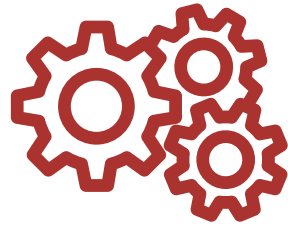
## High public debt and a large NBFIs footprint raise the probability of experiencing severe market dysfunction



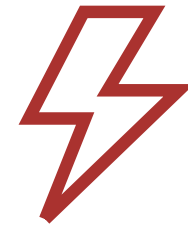
## Three challenges for central banks



Fiscal risk  
repricing

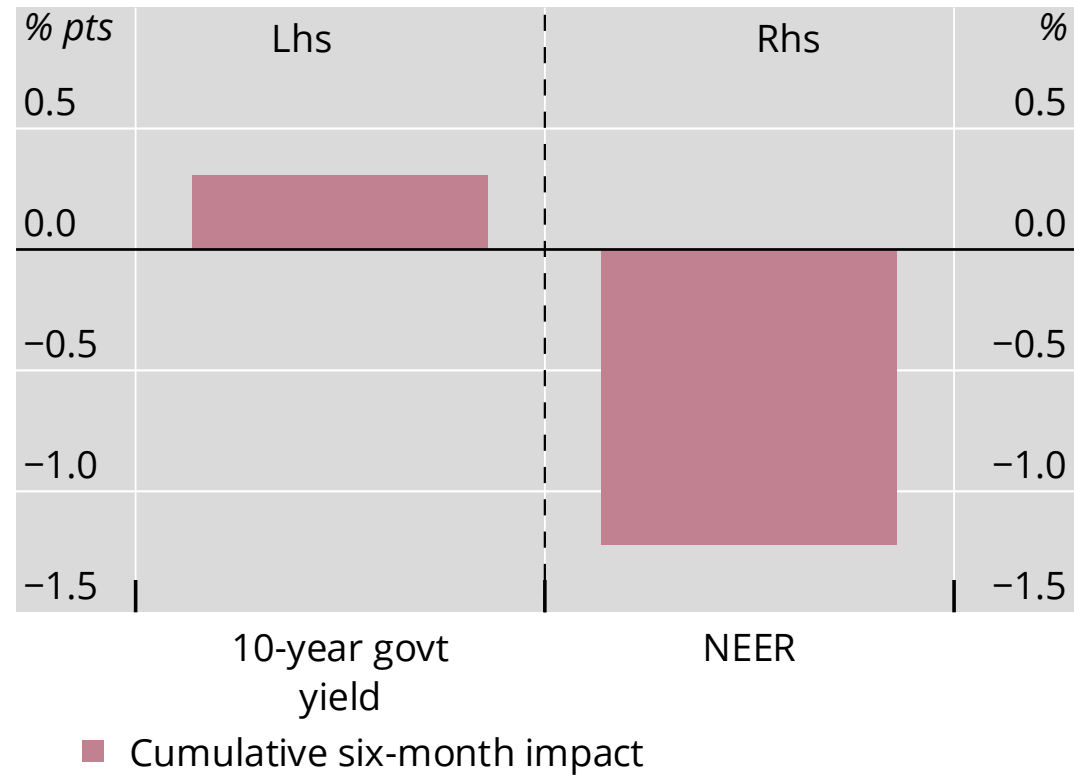


Monetary policy  
transmission

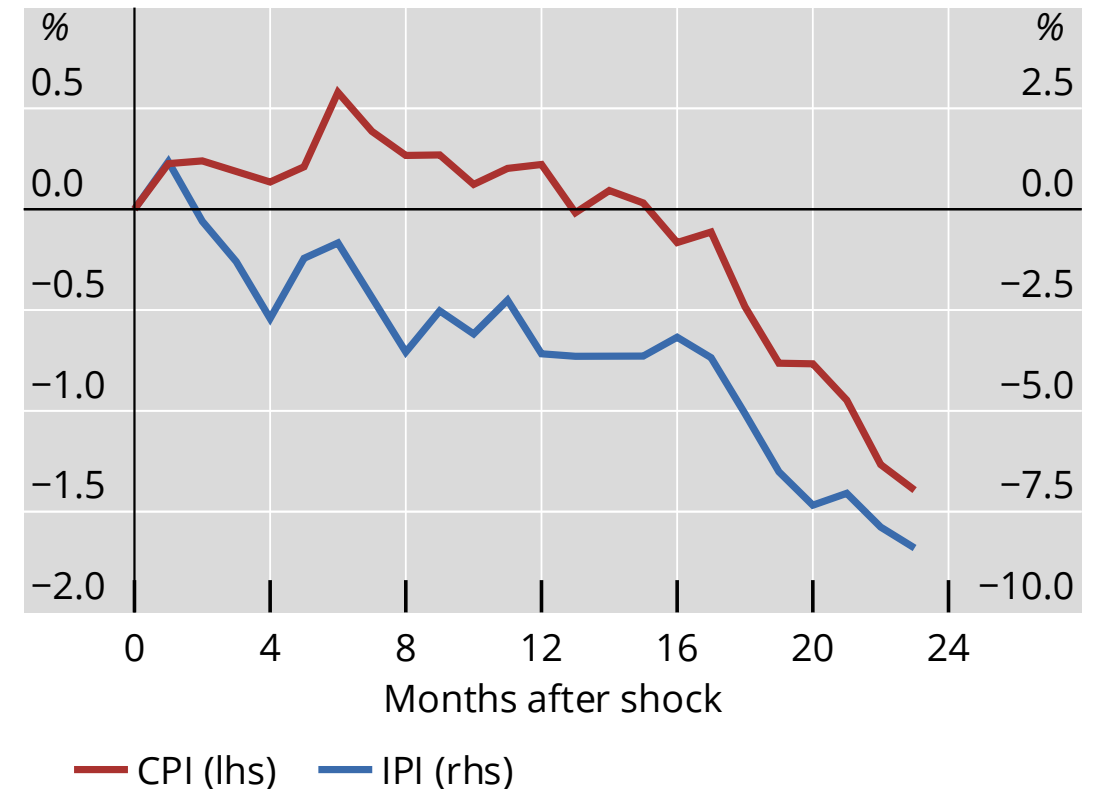


Market  
dysfunction

## Fiscal risk repricing tightens financial conditions...



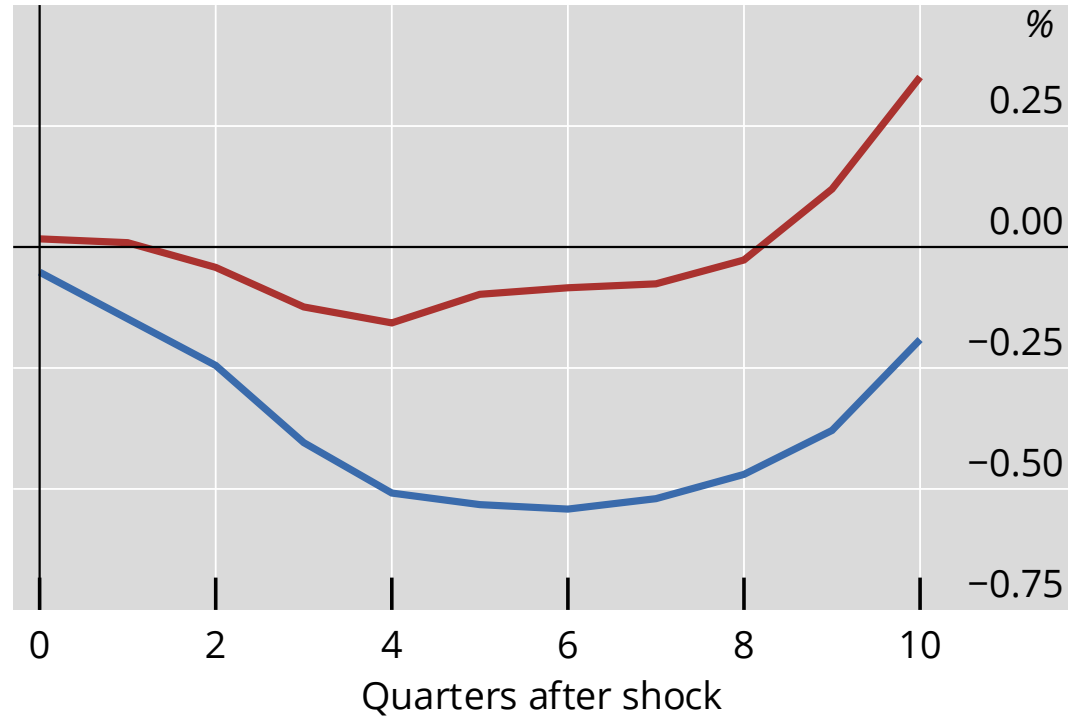
## ...weighing on activity and pushing up prices initially



Impact of a 1 percentage point increase in five-year government bond yields due to a fiscal risk shock.

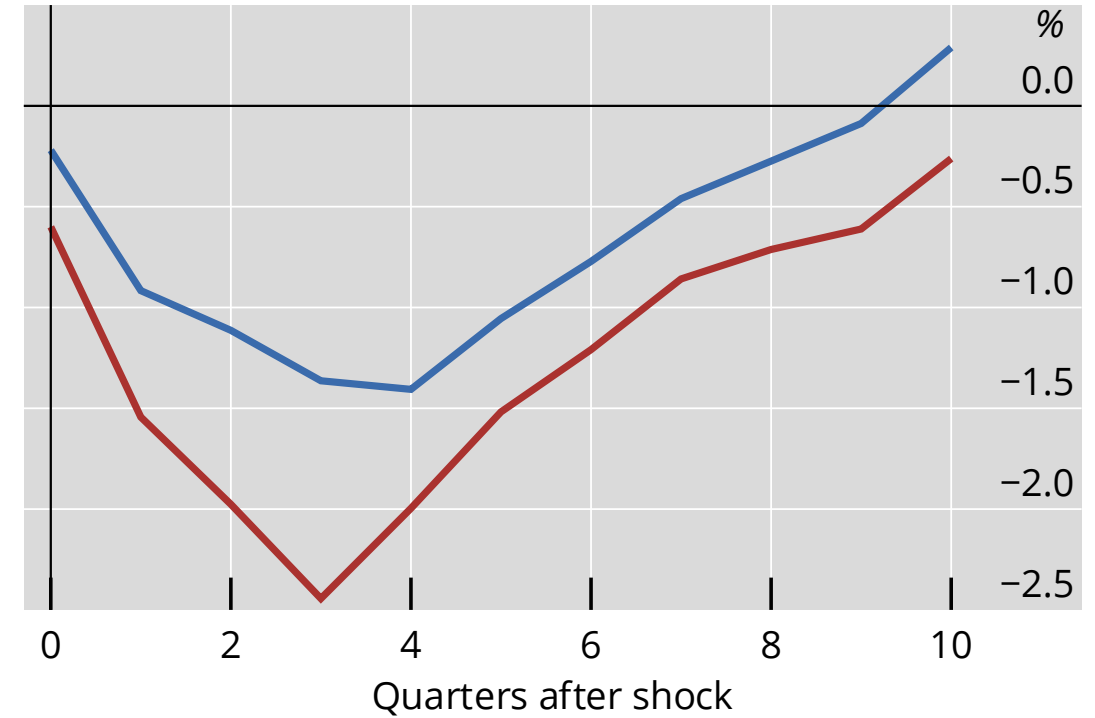
# High public debt may dampen disinflation from monetary tightening

Prices: smaller declines at high debt



Debt-to-GDP ratio: — 120% — 60%

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



Impact of monetary policy shocks (one standard deviation in size), based on local projection regressions for 11 euro area economies.

# Policy implications



Monetary  
policy



Fiscal policy



Regulation



Liquidity  
backstops

# Conclusion

